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Conglomerates in Portfolio Management

by Bennett S. Kopp

FROM THE POINT OF VIEW of the portfolio manager, the most important thing about conglomerate companies is their utilization as vehicles for the achievement of various investment objectives, and the degree to which basic portfolio decisions might be modified by their use. Although tentative in nature, there is evidence to suggest that the unique nature of conglomerates makes it possible for a portfolio manager to select those which combine (to a degree) performance characteristics of both defensive and growth stocks. They therefore appear to be ideal vehicles for a "hedge" or "straddle" approach to portfolio management. If this is so, such structural determinations as portfolio balance, diversification, size of invested unit and type of stock may be modified.

One acceptable definition of portfolio management is the blending of the various available investment forms in such a way as to maximize the achievement of the investment objectives of the individual or institutional investor, and minimize the susceptibility of the investor to the various investment risks. A concomitant, of course, is the selection of the most appropriate issues within the available instruments.

Although it may be obvious to most, it is nonetheless important to emphasize the point that the several investment instruments offer varying characteristics and potentials for the achievement of different investment objectives. Therefore, it is a matter of no small significance to the portfolio manager if a new investment vehicle or, as in the case of conglomerates, a substantially modified form of an existing one, with new characteristics and potentials, becomes available to him.

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A Modified Type of Equity

Whether called multi-industry companies, multi-management companies or conglomerates (the latter term will be used throughout), it does appear that a modified type of equity is becoming more prominent in the investment spectrum. An increasing number of security analysts have drawn innumerable distinctions between different types of conglomerates and have attempted, as is the rightful function of the security analyst, to select the more promising ones. Drawing upon the information they have uncovered and conclusions they have drawn, and utilizing those that appear most valid, as is the rightful function of the portfolio manager, and drawing upon the results of a series of comparative tabulations, a tentative conclusion can be arrived at. Conclusions must of necessity be tentative because most conglomerates are too new and because there are still only a relatively few of them.

Notwithstanding those limitations, however, it does appear that the flexibility and "synergism" inherent in the conglomerate concept offers the *potential to achieve more of a combination of stability and growth in a portfolio than has heretofore been possible.* This combination of terms of course refers to an "upward stability," such as the United States economy has experienced in recent decades, rather than stability in the sense of being flat. It cannot be emphasized too strongly that no panacea has been discovered; merely, it is *possible* through utilization of conglomerates alone to realize more desirable results than through traditionally defensive stocks alone or growth stocks alone, where multiple investment objectives prevail.

Statistical Evidence

At this point it seems appropriate to describe the method of drawing up the aforementioned tabular comparisons, from which much of the evidence for the tentative conclusions of this paper comes. The objective was to determine whether in fact conglomerates provide a combination of stability and growth. Inasmuch as the portfolio manager is constantly faced with alternatives for the employment of funds, several alternative types of equity portfolios were set up.

Comparisons were made over a period of approximately 2½ years from June, 1964 to November, 1967. The relatively short time span was used because conglomerates, as a phenomenon of any significance, are recent and because no fewer than six distinctive moves of 10% or more in the Dow-Jones Industrial Averages took place during the period. Specific cyclical high and low closes used as benchmark dates were June 8, 1964 when the Dow dropped to 800.31; May 14, 1965 when it rose to 939.62; June 28, 1965 when it was down to 840.59; February 9, 1966 — up to 995.15; October 9, 1966 — down to 744.32; September 25, 1967 — up to 943.08; November 8, 1967 — down to 849.57.

Following are brief descriptions of the composition of the several portfolios and the results observed:

I. *Conglomerates:* These consisted of six of the largest, each with 1966 sales or revenues in excess of $1 billion. Included in approximately equal amounts were FMC Corporation, General Tire & Rubber, International Telephone & Telegraph, Litton Industries, Tenneco and Textron. The initial portfolio value was $170,000.

The portfolio performance during the aforementioned cyclical high and low periods was: +27.6%; −13.2%; +41.1%; −11.2%; +69.3%; −6.7%. The initial $170,000 portfolio value increased to $372,300 over the 2½ year period, a gain of 119%.

II. *Cross Section:* This so-called cross-section of American industry portfolio included six of the largest and highest quality corporate names in six different industries, each basic to our economy. Included were American Telephone & Telegraph, General Electric, General Motors, International Business Machines, Standard Oil of New Jersey and United States Steel.

Performance during highs and lows was: +9.4%; −9.6%; +11.9%; −23.3%; +33.8%; −5.0%. An initial portfolio total of $167,900 had increased modestly to $181,200, or a gain of about 8%.

III. *Defensive:* Six stocks, each of the type traditionally thought of as defensive were chosen for this portfolio. Included were Chase Manhattan Bank, General Foods, Reynolds Tobacco, American Electric Power. Consolidated Edison and Pacific Gas & Electric.

Performance during high and low points was as follows: +5%; −6.6%; +1.1%; −19.1%; +16.9%; −7%. The total portfolio value declined from $169,300 to $147,500, a drop of 12.2% during the 2½ years under study.

IV. *Growth:* This portfolio, with the benefit of hindsight, consisted of some of the outstanding performers of the past few years so as to measure the growth and stability of some of the outstanding "winners." Names included Burroughs, Victor Comptometer, Collins Radio and General Instrument. As would be characteristic of a growth portfolio, fewer names were included.

The performance during the cyclical high and low points on the Dow was: +64.4%; −17.1%; +117.5%; −2.2%; +136.8%; −9.8%. The initial portfolio value of $162,400 appreciated to $1,005,600 for a gain of 519%.

Satisfaction of Growth Objective

Inasmuch as the growth portfolio was the only one of the four deliberately selected on the basis of known past performance, it is not surprising that its appreciation during the 2½-year period under study, and during each of the three upward moves in the averages, was the best in comparison. This method, of course, ignores the strong possibility of being wrong when foresight rather than hindsight is used, with the resultant substantial capital loss that might be incurred. As suggested previously, it was resorted to in order to subject the conglomerates to a stringent comparison with respect to the stability factor. Indeed, if the same method had been used with respect to conglomerate growth stocks, one could have picked a portfolio consisting of Teledyne, Ling-Temco-Vought and White Consolidated Industries. The appreciation during the period under study would have been close to 700%.

The study of comparative portfolios indicates that a representative sample of the largest conglomerate stocks would have provided a very satisfactory degree of growth over the past 2½ years. Indeed, an appreciation of more than 100% in that period should satisfy anyone. This performance is particularly favorable in light of the fact that during that time the DJI rose about 6%, the cross-section portfolio was up about 8%, and the defensive portfolio actually declined by 12%.

Figures previously noted in the discussion of the various portfolios reveal that in each of the three cyclical upswings the appreciation in the conglomerate portfolio was substantially greater than in either the cross-section or the defensive portfolios.

The evidence drawn upon here, therefore, suggests that if one is skilled (or lucky) enough to select growth stocks that prove to be outstanding performers, the resultant appreciation will outstrip all but the most rapidly growing conglomerates. Barring that, however, a portfolio of the largest conglomerates is likely to outperform the most commonly used alternative types of portfolios. The selection process for individual issues obviously must take place with care. What is most important here, however, is that there appears to be inherent in the conglomerate type of equity a substantial appreciation potential.

Satisfaction of Stability Objective

When referring to stability, the term must be related to the experience normally associated with the type and class of security. Inasmuch as stability is not a predominant characteristic of the equity form, if it can be found in a higher degree in conglomerates than in most equities, the objective can be considered to be met. Failing that, if a degree of stability equal to most alternative equities, accompanied by growth superior to most alternatives can be realized, a desirable combination of conditions may indeed be present.

Reference here is to relative stability of principal, a characteristic which should, in the equity form, be accompanied by stability of income. It is important to re-emphasize the point that the concept is one of upward stability or degree of deviation from a rising trend line rather than the flat stability associated with fixed income securities.

In measuring the growth rates of the comparative portfolios their values at the beginning and end of the 2½-year period and the respective increases during periods of marked advances were compared. This is not to dispute the fact that every security has its own distinctive trend line. Since we are measuring portfolios of securities, however, the high and low market points made, as indicated earlier, are convenient benchmarks.

Some have claimed conglomerates as a class to be quite volatile. This has been determined by comparing the beginning and ending price of a rising trend line for a period of time, noting the difference, and assigning a volatility factor. If the conglomerate portfolio used in this paper were treated in that statistical fashion it would indeed appear volatile (i.e., not stable). From the point of view of portfolio management with respect to equities, however, the only meaningful measure of volatility/stability is the downside deviation from a trend line.

Thus, in this study comparisons have been made of the relative behavior of the conglomerate, cross-section, defensive and growth portfolios during three downward movements in the DJI of 10% or more. Reference to the previous figures disclose the following:

1. In two of the downturns the percentage decline in the conglomerate portfolio was substantially less than in the growth portfolio.

2. With respect to the so-called defensive portfolio, the conglomerates decline substantially more in one downturn, substantially less in another, and about the same in the third.

3. A similar relationship was evidenced between the conglomerate and cross-section portfolios. The conglomerates were off more in one downturn, less in another, and about the same in the third.

4. When portfolio declines are measured as percentages of the preceding appreciation, the performance of the conglomerates in each case is far superior to either the cross-section or the defensive portfolios but inferior to the growth portfolio. In addition, the total percentage decline, both in absolute terms and relative to the total appreciation (or depreciation) was less than the cross-section and the defensive portfolios.

The evidence seems to suggest that conglomerate companies are ideal vehicles for a "hedge" or "straddle" approach to portfolio management. Their utilization provides in most cases a potential for a degree of price stability greater than found in growth stocks and at least equal to that found in more stagnant equities. At the same time substantially greater price appreciation is likely to be realized by comparison with a defensive or a cross-section portfolio.

Problem of the Small Portfolio

The small portfolio ($50,000 or less) has always been a particularly vexing problem. It is impossible to fully employ the principles of portfolio management so that the usual checks and balances are lacking. Growth is usually desired, but the investor frequently cannot tolerate the lack of principal stability which accompanies the consolidated aggressive portfolio normally best for the attainment of growth.

Mutual funds have been and continue to be one of the vehicles for the solution of the problem of the small portfolio. The twin protections of expertise and diversification have maximum application.

An alternative approach to the problem is hedging by the utilization of a portfolio of conglomerate companies.

A conglomerate is in many ways similar to a compact mutual fund. One could select Textron and International Telephone and Telegraph in a portfolio and very likely enjoy superior growth as well as the protection inherent in the diversification into at least seven industry areas. Virtually any four or five conglomerates could be selected which would provide representation in 20-25 industries with the propensity towards stability thereby added.

It appears, therefore, that a portfolio of conglomerates would provide a reasonable vehicle for the satisfaction of the investment objectives of many small portfolios. Growth superior to most equity combinations and stability at least equal to most should be readily attainable.

Portfolio Balance

The balance of the portfolio between fixed income and equity type securities is ordinarily the most important structural decision to be made. Where stability is an important consideration, fixed income securities are ordinarily employed to a significant extent. At the same time, of course, much of the growth which is always desired, and which is most readily achieved through common stocks, must be sacrificed.

A workable compromise seems to be the addition of conglomerates to the portfolio. The combination of better than average growth and average or less volatility may permit the fixed income sector to be reduced. It is, therefore, possible to add substantially to the growth potential of the portfolio without significant sacrifice of stability.

Diversification

Portfolio diversification is usually framed in terms of number of securities and number of industries. It rests on the concept of the "law of averages." The broader the number of securities and/or industries, the more fully that law is brought to bear, the more likely it becomes that average results will be experienced. It, therefore, follows that where stability or preservation of principal is desired, a portfolio is widely diversified. Where enhancement of principal is desired a portfolio is consolidated.

A conglomerate in effect provides built-in diversification of both "companies" and industries. A portfolio with substantial representation in conglomerates can be more consolidated in terms of names and, at the same time, be more diversified in terms of industries represented.

In most cases the opposite side of the diversification coin is the invested unit concept. This, in part, rests on the premise that too large a commitment in one issue exposes a portfolio to unnecessary risk. Investor revaluation of earnings, a decline in earnings, or both could result in a sharp price decline.

Elementary arithmetic suggests that the diversification inherent in conglomerates lessens the risks. Earnings in all segments of a conglomerate are not likely to drop at once. There is protection in the averaging of results from the various segments. It, therefore, seems logical that higher maximum invested units could be tolerated without added risk exposure.

It is possible through use of conglomerates to reduce exposure to other factors, such as the business cycle. The cyclical machinery business of FMC Corporation, for instance, is offset by its defense activities and its film and fiber activities. Over-all results are thereby smoothed out.

On the basis of this appraisal of the characteristics and potentials of various industry areas, the portfolio manager usually will have made a judgment as to the representations he desires in these areas. Purchase of a conglomerate company may increase the industry exposure in a given area to a desired—or to an excessive amount. For instance, the approximately 60% of White Consolidated Industries in machinery could increase the portfolio exposure to that area beyond the desired percentage.

Type of Stock

The function of the common stock sector may be primarily defensive in that it is intended only to provide sufficient appreciation to offset the effects of inflation, while maintaining a high degree of stability or producing a high current income. More often its function is aggressive, where maximum capital appreciation is sought by virtue of structure and composition.

One would expect the defensive stock portfolio to emphasize defensive stocks and the aggressive stock portfolio to emphasize growth stocks. If conglomerates are to be included it is necessary to examine the mix of industries represented to see whether the result is a defensive or aggressive amalgam.

Most conglomerates, of course, are in aggressive areas. One could select Teledyne for instance, which with its representation in such dynamic areas as electronics, oceanography and metals, has a highly aggressive mix. On the other hand, Genesco, with its representation in such aseas as footwear, clothing and retailing has a defensive amalgam and would fulfill most of the requisites for a defensive portfolio.

Problem of Classification

It can be argued that the art of portfolio management rests in large part upon an effective system of classification of major portfolio sectors and sub-categories of those sectors. With respect to the common stock sector, classification is usually made on the basis of industries. The underlying premise that varying characteristics and potentials are inherent in different industries has much to commend it.

Some have questioned the validity of industry classification. Some of the most commonly used alternatives are classifying stocks as either growth, cyclical or income; or as consumer and service, heavy capital goods or technological products.

The proliferation of conglomerates seems to lessen the effectiveness of the industry classification. On the other hand, none of the alternatives seem to be satisfactory.

It would appear that a separate conglomerate category within whatever system of equity classification is used would be best. This would, to some extent, recognize the vogue factor which affects most types of stocks at one time or another and the "synergism" unique to conglomerates. ♦