

CONGLOMERATES

The "conglomerate" category is reserved for those companies which participate significantly in so many different and unrelated industries that they defy any single industry categorization.

Admittedly, each conglomerate must be looked at on a case-by-case basis, but some general observations can be made about the role of conglomerates as a group in an efficiently-managed portfolio.

The corporation's traditional purpose in "conglomerating" has been to smooth out the hills and valleys in its earnings. By involving itself in several unrelated industries, it should be possible to add stability to the company's earnings. When some industries do poorly, others may do well, and vice-versa.

From the point of view of the self-interest of a company's management, conglomerating may be a constructive strategy. From the point of view of portfolio management, however, it is self-defeating. If one believes that the outlook for one of a conglomerate's industries is particularly promising, he does not want to be saddled with some others that are not. Furthermore, it is unlikely that all of the industries in which a conglomerate participates will look favorable at the same time, because management has selected its industries purposely with the intention of having them out of phase.

As a rule of thumb, then, conglomerates do not make efficient investment vehicles in the constructive management of a common stock portfolio.

Irrespective of their suitability in investment portfolios, conglomerates, as operating companies, historically, also have left much to be desired. Conglomerates seem to provide good examples of totals being worth less than the sums of their parts.

The belief has been long held that top corporate management is not likely to exhibit sufficient expertise in several diverse industries to enable it to excel in all, or even in many. In fact, one study has documented and quantified the shortfall of conglomerate managements by demonstrating how conglomerate subsidiaries underperform their peer companies in their respective industries, on average, by about 15% per year.

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