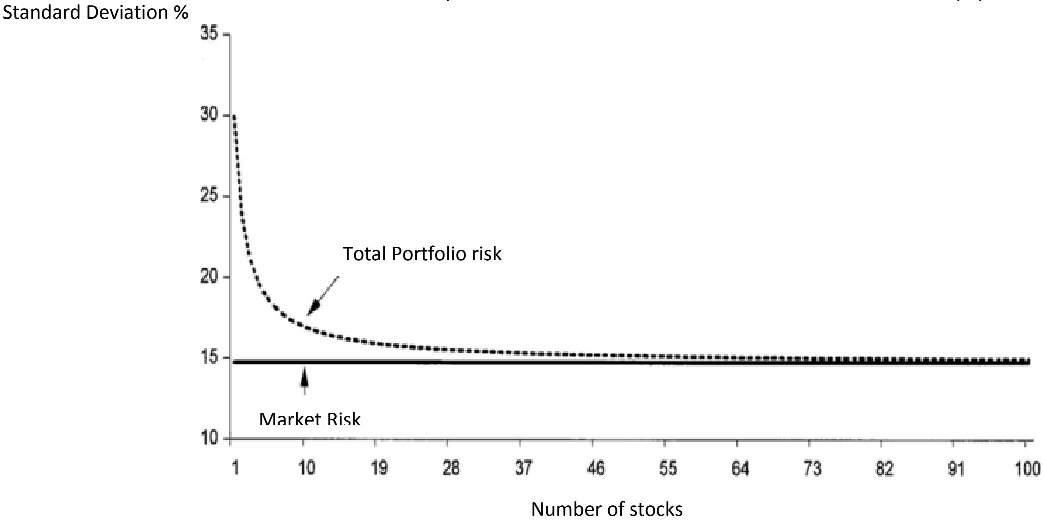
Diversification? More like diworsification!

By Chris Andrews

We are regularly asked to explain the benefits of investing in a concentrated portfolio of 25-35 holdings versus a more diversified portfolio. Many people believe that further diversification lowers risk. We believe this is flawed thinking. Many equity managers that invest in a limited number of stocks based on high-conviction have a very strong track record. In this article, we share our thoughts on diversification and the reality behind statistics claiming the underperformance of active managers.

The goal behind diversification is to reduce stock specific risk in a portfolio leaving only market risk. Near optimal diversification is achieved with a stock portfolio of only 20 holdings. Contrary to popular belief, increasing a portfolio to as many as 1000 holdings only marginally further reduces the stock specific risk. The chart below shows how 93% of stock specific risk is eliminated with a 20 stock portfolio:

Diversification: total portfolio risk as a function of number of stocks held (%)[1]



Modern Portfolio Theory has led investors to increasingly diversify with the opinion that this will reduce risk. Modern Portfolio Theory is based on the false assumption that risk is defined by volatility and that one would only be willing to accept high risk in exchange for a high potential return. Research has shown that a more volatile stock is not necessarily more likely to generate a higher return than a less volatile one. A stock that falls by 50% would be deemed extremely risky based on its volatility. This investment may at that point, however, present a low risk opportunity to make a large return. Without carrying out in depth fundamental analysis on the specific company, we would argue that it is impossible to determine the riskiness of a stock investment by its stock price volatility alone.

Numerous statistics over the years show that, on average, active managers underperform after fees. Broad statistics such as these are misleading. One of the problems with these statistics is a large proportion of the so called active managers are not really active managers at all. Studies in the past such as that by WM Company, a subsidiary of State Street, showed over a 20 year period that almost 75% of so called active funds only deviate from their benchmark by 0-6%[2]. Despite charging active fees, these fund managers diversify away any added value from stock picking. If we look at true "stock pickers" rather than all active managers as explained by Petajisto in his study on Active Share and Mutual Fund Performance, they outperformed their benchmark by 1.3% per year after all fees and expenses despite "closet indexers" underperforming by 0.9% per year (Jan 1990 to Dec 2009)[3]. This analysis resonates well with the famous words of Charlie Munger, Berkshire Hathaway's billionaire money manager who stated that:

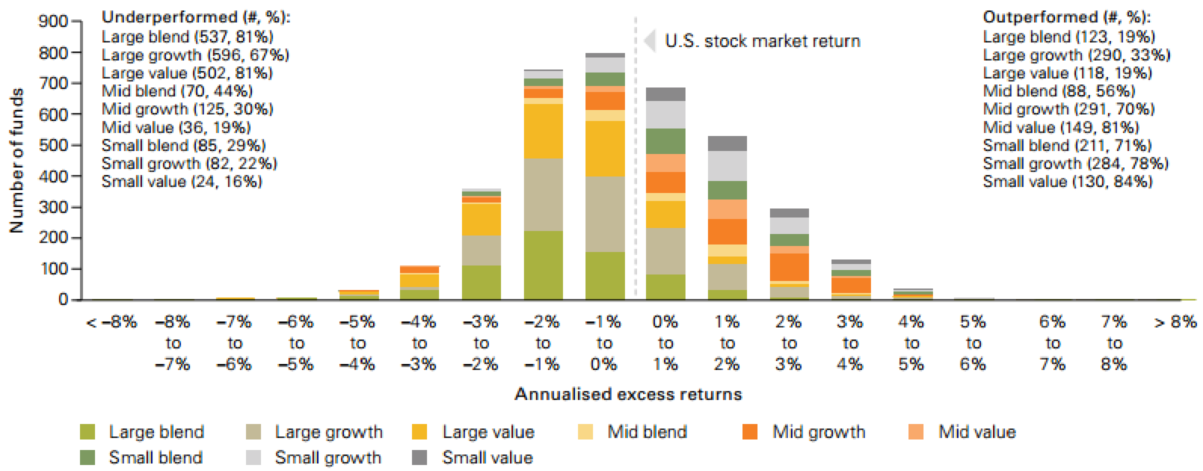
> "*Wide diversification, which necessarily includes investment in mediocre businesses, only guarantees ordinary results*"[4].

Academics Cohen, Polk and Silli from Harvard Business School and the London School of Economics have highlighted similar findings in their 2009 paper titled "*Best Ideas*". They showed that "*the best ideas of active managers generate up to an order of magnitude more alpha than their portfolio as a whole*" concluding that:

"*investors would benefit if managers held more concentrated portfolios*"[5].

A further problem with statistics that show the underperformance of active managers after fees is that they bucket all managers together. An active small-cap manager has more opportunity to add value versus an active large-cap manager. Small-caps are under-researched and provide many more opportunities for those that have time to trawl the large universe and discover mispricing through fundamental analysis. By breaking down the universe of active managers into subsets, the picture changes significantly. For example, between 2000 and 2012 the median small-cap value manager outperformed the relevant universe, returning 10.4% after fees versus just 6.2% for the US small-cap index (Russell 2000) whereas the median large-cap growth manager underperformed returning only 2.5% versus 2.9% for the large-cap index (Russell 1000)[6]. The chart below shows a similar analysis by Vanguard highlighting the significant difference in performance for active managers when broken down by subsets with significant outperformance coming from small-cap managers and significant underperformance from large-cap managers.

Active manager net excess returns versus market benchmark: Ten years ended December 31, 2013.[7]



Despite the evidence of value added by active management, the allocation to passive managers continues to increase. We see this as a great development for active managers like us. Passive investment leads to more money being invested without any regard for the fundamentals of a company leading to an increased incidence of stock mispricing. This creates a growing opportunity for investors to outperform the market by backing truly active managers that invest in equities with conviction after carrying out fundamental bottom-up analysis. Active managers are able to build a more accurate picture of risk and reward rather than relying on a flawed analogy that volatility is equal to risk. Stuffing a portfolio with mediocre businesses with the sole purpose of "reducing risk" leaves no other conclusion than diversification really is diworsification.

Sources

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4. SPANO, K. (2011) *The Great Retrenching*. Bluemound Asset Management.
5. COHEN, R. POLK, C, SILLI, B. *Best Ideas.* Harvard Business School and London School of Economics.
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7. Vanguard and Morningstar