FINANCIAL POST

Why portfolio diversification is overrated or 'protection against ignorance'

December 30, 2015 — By Jonathan Ratner

'Diversification is protection against ignorance. It makes little sense if you know what you're doing,' says investing guru Warren Buffett. Besides...

You don't have to be Warren Buffett to build a concentrated portfolio of stocks that outperforms the market, but you do need to adopt some of his investing strategies.

The world's most famous investor has many notable quotes that both retail investors and some of the biggest money managers around rely on to guide their decisions. One of them focuses on narrowing your investment choices: "Diversification is protection against ignorance. It makes little sense if you know what you're doing."

The case for a concentrated portfolio – whether that's just 10 stocks or closer to 30 – can be summed up rather easily. When a portfolio manager or individual investor holds say 40-plus stocks, probably no more than a dozen are their best ideas. The remainder are filler, perhaps intended to protect the portfolio through diversification, but instead serving to water down its returns.

Charles Ellis, a prominent consultant and professor, put it best when he said, "increasing the number of holdings dilutes our knowledge, disperses our research efforts, distracts our attention, and diminishes our determination to act – when really called for – decisively and with dispatch. If you work hard enough and think deeply enough to know all about a very few investments, that knowledge can enable you to make and sustain each of your major investments with confidence."

Studies dating back as early as 1968 are frequently cited by investors making the case for concentrated portfolios. Way back then, Evans & Archer found that stock-specific risk can largely be eliminated by holding approximately 15 stocks.

In 1970, Fisher & Lorie found that 80 per cent of risk can be eliminated by holding eight stocks, and 90 per cent by holding sixteen stocks.

This stands in stark contrast to modern portfolio theory, which states that a more diversified portfolio leads to less risk from each of its components.

More recently in 2014, CIBC World Markets published a report that looked at historical returns for 1,000 randomly selected portfolios between August 2003 and October 2013. The results lined up with previous research, showing that average volatility declines steadily until portfolios hold approximately 15 stocks. Adding more names to the portfolio after this point, produced virtually no further risk reduction.

Increasing the number of holdings dilutes our knowledge, disperses our research efforts, distracts our attention, and diminishes our determination to act

However, quantitative analyst Jeff Evans noted the flaw in most diversification studies. That is, they assume portfolios are selected entirely at random.

That's why having the right strategy - such as those utilized by the likes of Buffett, George Soros and Martin Whitman – comes in.

"A concentrated portfolio goes hand in hand with your investment approach," said Effie Wolle, chief investment officer at Toronto-based GFI Investment Counsel. "If you're investing in the tech sector where things change month-to-month and year-to-year, a concentrated portfolio probably doesn't make sense. On the other hand, if you're investing in carefully selected businesses with modest leverage, and you can see them being around for 20 or 30 years, then a concentrated portfolio makes a lot of sense."

The notion of being a business owner when you buy a stock is something common to those, like Buffett, who use the concentrated approach.

Wolle, who typically owns 15 to 20 names for his clients, stressed the importance of taking your time and getting to know a business before putting money into it. After all, it's hard for anyone, even with a army of analysts, to keep track of 50 or 100 companies and know them intimately.

David Barr, chief investment officer at Vancouver-based PenderFund Capital Management, usually owns 20 to 40 stocks in his portfolios.

He also has a longer-term approach to his investments, and looks at a stock as if he's buying the entire business.

Our 100th best idea isn't all that good. We'd much rather continue allocating capital to our best ideas

"For some people, a stock is just three letters on a screen. It's like being an ETF, which doesn't care what the business risk is," Barr said. "Our 100th best idea isn't all that good. We'd much rather continue allocating capital to our best ideas, where we have a much higher level of conviction and understanding."

He focuses on companies with a sustainable competitive advantage. These high-conviction names get a higher grade because they are poised to dominate their respective markets five to ten years out.

Of course, investors must track what these companies are doing to deepen that competitive advantage and what the external threats are that may knock them back.

Barr also looks for businesses in large and growing markets, so they have a long runway of healthy returns ahead. "Businesses that meet this criteria are more predictable and have a lower chance of something sideswiping them, which might mean you lose half your money overnight," he said.

Investors need to remember that diversification isn't only sourced through from buying more stocks in a wider variety of sectors. It also comes from a better understanding of a business.

For example, an information technology company may get half of its revenue from the oil and gas sector. So while it's categorized as a tech stock, what really matters to its business is the end customer. That's where the real risk lies.