Concentrate **dammit!**

How many stocks are required to achieve sensible diversification in a portfolio? The average mutual fund holds over 100. The average fund also underperforms the index, trades its portfolio a lot and charges a high fee. To be certain, *average* never gets you far.

"**Market-beating managers express their insights in concentrated portfolios that differ dramatically from the character of the broad market**"

- **David Swensen (Chief Investment Officer, Yale University)**

In our view, you can achieve a well-diversified portfolio by owning 20-25 companies that operate in 7-8 different industries. By focusing on a limited number of stocks, portfolio managers have a much greater understanding of the businesses in which they invest and a higher level of conviction in their best ideas. Charles Ellis (a prominent consultant, author and professor) said it best:

> *"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. The more you "diversify" by increasing the number of different investments you must understand, the more you risk increasing your* not *knowing as much about each investment as do your best competitor investors..."*[1]

Many academic studies and investment textbooks on the topic of diversification come to a similar conclusion. In fact, some studies suggest that substantial diversification benefits can be achieved by owning as few as 8-10 stocks.[2]

These types of reports look at how much risk can be reduced by increasing the number of stocks in a portfolio. Risk in this context refers to non market-related risk (the risk that is unique to a specific company), as opposed to economic-related risk (e.g., interest rates and inflation), which affects the overall market and cannot be diversified away. The classic Fisher and Lorie study, for example, concluded that risk can be reduced by 80% by holding 8 stocks; 90% by holding 16 stocks; and 99% by holding 128 stocks.[3] There are, of course, reports that argue the opposite. One such study (Shawky and Smith) suggests that the optimal number of stocks to hold in order to maximize a fund's risk-adjusted returns (Sharpe Ratio) is well over 400.[4] Yet, this particular study also acknowledges the costs of overdiversification – the practice of owning too many stocks – and suggests that holding an extremely low or high number of stocks is suboptimal.

"Wide diversification is only required when investors do not understand what they are doing"

- **Warren Buffett**

It's worth noting that all of these studies focus on reducing risk in relation to the market. Yet, while this is certainly important, it should not necessarily be the main goal of every investor. If you want to beat the market, you have to take on risk and be willing to accept some volatility of returns along the way. So while adding a fiftieth or sixtieth stock to a fund may slightly reduce its risk, it may also dilute its best ideas and bring it closer in line with the market.

Statistics and studies aside, there are a number of common sense reasons why building a concentrated portfolio makes sense, besides those previously identified. First, great stock mispricings are a rarity. Managers who are skilled at identifying these opportunities must act on them with conviction. A position of 1% or less will do little for a fund's performance even if the stock soars. Second, along with opportunity costs there are hard costs to owning and monitoring a large number of stocks, such as transaction and research expenses. And finally, in order to beat the index, you have to look different from it. This means owning fewer stocks, and in different weightings, than those that comprise the index. Beyond a certain point, the more stocks added to a fund, the greater the likelihood that it will replicate the index. Indeed, the dangers of overdiversification are well documented.

"When you own too many companies, it becomes nearly impossible to know your companies well. Instead of having a competitive insight, you run the risk of missing things"

- **Morningstar (USA)**

Given the merits of a concentrated approach to investing, why do so many fund managers own 100+ stocks? There are a few explanations:

1. There are many different ways to 'skin a cat'. Some managers follow a top-down strategy and load up on stocks in a specific sector or two, hoping that their call on a particular industry will pay off.
2. Managers are increasingly being judged on short-term performance in relation to the index, and are therefore reluctant to stray too far from the benchmark. Whereas a generation ago fund managers paid little heed to the index, the industry today has become obsessed with it. A short stretch of underperformance can lead to a pink slip. The solution? Look more like the index by owning more stocks. The term 'closet indexing' has emerged in recent years to describe this practice.
3. As funds grow in size, an easy way to accommodate inflows is to own more securities, particularly if the fund's mandate is to invest in stocks with limited liquidity where it can be more difficult to add to existing positions (e.g., small-cap equities).

Concentration is a key tenet of Steadyhand's investment philosophy. We hire managers who invest with conviction in their best ideas. Our equity funds typically hold 15-35 stocks and are well-diversified across different sectors and geographic regions. Our approach will produce significant dispersion of returns from the index and our funds may move in cycles of their own. These are attributes that would cause some managers much grief. We believe they should be embraced. After all, you're not going to beat the market by looking like it. So concentrate, dammit!

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[1] Ellis, Charles D., "Small Slam!", Financial Analysts Journal, January/February 1997.
[2] Evans, J. and Archer, S. "Diversification and the Reduction of Dispersion: An Empirical Analysis", Journal of Finance, Vol. 23 (Dec 1968); Fisher, L. and Lorie, J. "Some Studies of Variability of Returns on Investments in Common Stocks", The Journal of Business, Vol. 43 (Apr 1970); Cleary, S, and Copp, D. "Diversification with Canadian Stocks: How Much is Enough?", Canadian Investment Review (Fall 1999).
[3] Fisher and Lorie.
[4] Smith, D. and Shawky, H. "Optimal Number of Stock Holdings in Mutual Fund Portfolios Based on Market Performance", Financial Review, Vol. 40 (Nov 2005).

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