

The sweet spot of concentration

Academic theory¹ suggests between 25-30 holdings provide optimal diversity in a single-market portfolio, but for Newton's Raj Shant finding the perfect balance can be as much an art as a science.

For most investors the question of how much diversification is too much is a crucial one. Too few holdings and you run the risk of your portfolio becoming overbalanced in favour of just a handful of favourites; too many and the portfolio loses focus.

On this point, the economist John Maynard Keynes put it best. "To carry one's eggs in a great number of baskets," he wrote, "without having time or opportunity to discover how many have holes in the bottom, is the surest way of increasing risk and loss."²

For Newton global equities manager Raj Shant the question of when and by how much to concentrate portfolio holdings goes right to the heart of successful active investment management. It's a decision, he says, that can make or break returns over the long term. "Up to a point, increased diversification offers better risk adjusted returns," he argues. "But if you go too far and have too many stocks you begin to look more and more like the market, the benefits of diversification diminish and at that point you shouldn't be charging active fees. It's a balancing act that requires constant attention."

Academic theory offers differing views on the question of portfolio concentration. In 1952 in *Modern Portfolio Theory* Harry Markowitz's outlined the concept of an "efficient frontier" – an optimal portfolio that achieves the perfect balance between risk and return. Since then, economists and investors have been split between the concentrators and diversifiers. For some, such as investment guru William J. Bernstein, an investor with even 100 stocks will not be able to eliminate unsystematic risk. Likewise, in *Modern Portfolio Theory And Investment Analysis* (1981), Edwin J. Elton and Martin J. Gruber argue a portfolio with 20 stocks should offer the best balance of risk and reward. For Warren Buffet: "Wide diversification is only required when investors do not understand what they are doing."³

Nonetheless – and putting academic theory to one side – diversification remains the dominant orthodoxy of current markets: a 2008 US study showed the average mutual fund had 90 stocks in its portfolio, while the 20% of fund managers with the most diversified portfolios owned an average of 228 stocks.⁴

Regulators have also taken the diversification mantra to heart. The US Employee Retirement Income Security Act ("ERISA"), for example, which was signed into law in 1974 and which regulates the administration of retirement and benefit plans, has a 'diversification rule'. This rule requires fiduciaries to diversify investments to minimise any risk of loss unless it would be considered prudent not to do so. In Europe, likewise, UCITs' so-called 5/10/40 rule says a

¹ UTS: 'Diversification versus Concentration... And the Winner is?', 2012.

² The 'Uncertain' Foundations of Post Keynesian Economics: *Essays in Exploration*, Stephen Dunn

³ *Financial Times*: 'Concentration: the case for putting all your eggs in one basket', 29 September 2013.

⁴ *Financial Times*: 'Too many stocks spoil the portfolio', 12 April 2013; *Eastern Finance Association*: 'Do Focused Funds Offer Superior Performance?', 2008.



maximum of 10% of a fund's net assets may be invested in securities from a single issuer and that investments of more than 5% with a single issuer may not make up more than 40% of the whole portfolio. In effect, this means funds must have a minimum of 16 holdings. In reality, though, according to the Chartered Insurance Institute (CII), most unit trusts have a pool of between 50 and 100 shareholdings.

The theory behind this clear: since different types of assets change in value in opposite or different ways it can make sense to spread your investments over a broad range of asset classes and holdings. It's an approach summed up by the old adage of not putting all your eggs in one basket.

Diversification: a double-edged sword

But for Shant, this ignores a key truth: beyond a certain point, diversification will begin to work against you. "A popular view is that increasing diversification reduces risk but, in fact, the exact opposite is true. The larger the number of holdings you have, the harder it is to know all the risks associated with every single one of those holdings with absolute certainty all of the time – and that's the case even in a relatively concentrated portfolio. If you hold, say, 100 stocks, the chances are you'll know that 100th stock far less well than you do the first stock in the portfolio. The more diversified the portfolio, the more those unknown and unknowable risks increase.

"As you extend the tail of stocks you know less well, the greater the risk that one of these less known holdings will perform badly and act as a drag on your performance. In this sense, diversification can lead you into unknown and unintentional areas of risk. It's a double-edged sword."

In addition, a thinly spread portfolio also means a lower level of conviction in any individual holding. Says Shant: "With a highly diversified portfolio, the average size of your position in each holding will decline so that even your best ideas get diluted. Even if a single holding performs extremely well, the benefit of that for your portfolio and your clients is diminished."

When concentration hurts

But what of the risks of an overly concentrated portfolio? Here too Shant highlights the danger of going too far towards the opposite end of the spectrum. One problem, he says, is liquidity. In a highly concentrated portfolio, the ownership stake in each firm will be larger and the harder it will be to move in or out of that stock without impacting pricing and affecting the overall performance of the fund.

Another issue is elevated risk. The higher your ownership of any one company, the greater the risk associated with that holding. Says Shant: "Even with the best will in the world you cannot identify every single risk associated with every single company. The history of investing is littered with the carcasses of formerly well respected blue chip companies – the likes of Enron, or Volkswagen, for example – where hidden and unexpected risks turned round to bite investors.

"As you concentrate your portfolio down to fewer and fewer holdings, everything ends up riding on how just that handful of stocks is performing. If things go well, great; but if they go wrong they could go very wrong and your performance will suffer as a result."

For Shant, while theories of optimal portfolio construction are important, in the real world they can be difficult to pin down. For now, while he believes a portfolio of between 30 to 50

stocks in a globally invested portfolio can provide the optimal balance between concentration and diversification, the basics of fund management are equally important.

“Ultimately, regardless of whether you have a highly concentrated portfolio or a highly diversified one, nothing can replace the fundamental importance of thorough research, really understanding a company and really believing in a company’s management team.”

Here, Shant’s view aligns with Keynes. In a letter to Francis Scott, Chairman of the Provincial Insurance Company, the English economist wrote: “As time goes on I get more and more convinced that the right method in investment is to put fairly large sums into enterprise which one thinks one knows something about and in the management of which one thoroughly believes.”⁵

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⁵ Letter to Francis Scott Chairman Provincial Insurance (1934).