Insights, Tacit Thought | Weekly Investment Insights

Diversification is good and bad for long term returns

Published on: 10 December, 2021 **|** Author: Investment Team

Imagine you are a schoolteacher. You are looking for a new job and there are two alternatives. The first involves a small school – there are 20 pupils, admitted for their ability.

It isn't an easy job. You will be responsible for keeping a very close eye on the children, analysing their every move, every day and hoping they reach their potential. You also have endlessly to liaise with the school governors and with parents about each child. To add to your trying admin burden, you must also keep a long waiting list of the children whom you will admit when the ones you have move on.

The second job comes with the same responsibilities, boring admin tasks and reporting duties. The difference is that the school has 60 children of more mixed ability – you have triple the number of needy kids to keep an eye on at any time and triple the number on your waiting (or watch) list. The pay is the same for both, and both offer the same level of general social and professional status, as well as the same opportunities for advancement.

Which would you choose – the one which makes you responsible for a small number of carefully chosen clever children, or the one where you take charge of a larger group of children with mixed abilities?

At Tacit, we wouldn't need to think about this for long. We would choose the first – fewer children would allow us more time to get to know each child better.

At this stage you are probably wondering where this is going?

Well, in the investment industry there is a great deal of academic and practical research available into the optimum number of stocks that should be held in a portfolio (from Harry Markowitz's Modern Portfolio Theory to date). The results are consistent. They tell us that you must diversify a portfolio. If you hold only a couple of stocks, you run the risk of losing a large percentage of your money if one goes horribly wrong. However, they also tell us that there is no point in diversifying too much: all the benefits of diversification in terms of cutting your risks can be gained by holding 15-20 stocks, and there is almost no more benefit to be had from holding more than 25.

Yet, despite this volume of research and the fact that (unusually) almost everyone agrees with its premise, the average fund manager holds more like 40-50 stocks in his portfolio and some hold 100 plus. That means higher trading expenses (the average fund manager turns over about 80 per cent of his portfolio every year, and the more stocks he has the more he is likely to trade) and higher research expense (all those company visits for starters).

So why does our industry do it?

A mixture of reasons, really. Some are technical. Managers worry about liquidity. If they have large positions in a few stocks, will they be able to sell should investors redeem in volume? And funds are subject to rules about how much of the portfolio may be held in anyone. These can be valid reasons for having more holdings – particularly at the small-cap end of the market. We suspect the true reason why many managers hold more than the necessary or optimum number of stocks is psychological rather than technical.

There's the fact that everyone hates to sell stocks that have gone up and replace them with new ones (looks good on a valuation if nothing else). There is the novelty factor of investing new money coming into a fund into a new company, rather than adding to existing ones. There is the herding instinct (whereby managers are more comfortable owning the stocks other managers own), and there is, of course, career risk. It is much safer for a manager to hug their performance index (almost inevitable if you hold 100 stocks) than to risk underperforming it, even in the short term. Finally, there is the fact that holding a smaller number of stocks with conviction requires a degree of mental stamina that not every professional manager possesses. Performance does not arrive in a straight line unfortunately (as our clients are only too aware) and it is important to take a view at times, even if that makes investing less comfortable.

At Tacit, we prefer to focus on what we own for clients and to ensure that these holdings are positioned for the economic environment ahead. Change for change's sake will only detract from our conviction-based approach and it is why our strategies have half the number of holdings of most of our peers.