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Overdiversification is a Risk

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Imagine you are a school teacher. You are looking for a new job and there are two alternatives. The first involves a small school – there are 20 pupils.

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 to endlessly liaise with the school governors and with parents about each child. To add to your trying admin burden, you also have to keep a long waiting list of the children who you will take on 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 it houses 60 children – 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 huge amount 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 down). The results are pretty consistent.

They tell us that you must diversify a portfolio. If you only hold 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 in research expense (all those company visits for starters).

So why does our industry do it?

A mixture of things, really. Some are technical. Managers worry about liquidity. If they have large positions in a stock will they be able to liquidate it should investors redeem in volume? And funds are subject to rules about how much of the portfolio any one stock makes up. These can be valid problems – particularly at the small-cap end of the market. We suspect the biggest factors in here are actually more 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 holding than top up old. There is the herding (whereby managers are more comfortable owning the stocks other managers own too) and there is, of course, career risk. There is more benefit to a manager in tracking their index (almost inevitable if you hold 100 stocks) than in underperforming it, even in the short term. Finally, there is the fact that holding a smaller number of stocks with conviction requires a certain amount of mental stamina. Performance does not arrive in a straight line unfortunately (as our clients are only too aware of).

At Tacit, we prefer to focus on what we own for clients and ensure that these holdings are positioned for the economic environment ahead. For a new investment position to be taken it must provide a superior risk/reward profile than one of the 12 holdings currently in our strategies.