

Power Law

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Over 300 years of Romanov rule ended in 10 days during the Russian revolution. Very few cars are majority contributors to overall air pollution. A few words in the English language like “the” and “is” occur with disproportionate frequency compared to every other word. A minority of the population owns the majority of the wealth. A minority of all pieces of art ever created generate a majority of the attention.

The examples above show that domains as different as history, environmental science, linguistics, economics and art all show a power law distribution where the frequency of different outcomes is very uneven.

It should come as no surprise that this also applies to finance and the stock market. In a [recent study](#), only about 1% of stocks (out of a basket of 62,000 in 40 different countries) were responsible for almost all of the wealth creation during the 28 year period from 1990 – 2018.

This almost natural power law distribution observed in so many domains of human enquiry goes against modern portfolio theory which states that broad diversification reduces risk. If 99% of stocks do not create wealth in the long term as the data shows, over diversification will *increase* risk.

If you look at the fund level, most active managers underperform the general market. Again the power law distribution is observed. Some active managers are bad at picking the 1% of stocks that do generate wealth. Others are closet index trackers i.e. they are overdiversified to the point that you might as well buy an index fund and spare yourself the extra management fees.

Since most active managers underperform the market, the only reason to invest with an active manager is if they have shown evidence of superior judgement. This is difficult to quantify but in the long term should show itself through superior returns and a consistent investment style.

Applying the power law distribution to how we make investment decisions at Tacit is quite simple. We focus 99% of our time on the 1% of active managers who have shown evidence of a good and consistent investment approach.

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