Capstrive Limited – Concentration versus Diversification

Capstrive

For the purposes of this discussion I have, somewhat arbitrarily but not unreasonably, assumed that a concentrated portfolio has fewer than twenty positions. In the spirit of inversion, let's firstly highlight the problems with each approach:

The main problems with concentration:

1. Mistakes are costly; and
2. Bad-luck is costly.

The main problems with diversification:

1. Holdings are not properly understood or monitored carefully enough;
2. Difficult to materially outperform the market over a sustained period; and
3. Almost impossible to deliver exceptional returns over a long period of time.

What then are the factors which should guide one's approach? My sense is that it depends primarily on two things:

1. Who you are; and
2. What you buy (and keep).

Who you are

Investing is a personal/behavioural activity. Whether to concentrate or to diversify should be consistent with one's temperament and confidence levels. Walter Schloss liked to diversify as it helped him sleep more easily. Others diversify as a demonstration of humility and a recognition of fallibility. Charlie Munger prefers to concentrate in those few investments where he has high conviction. He firmly believes that, for knowledgeable investors who know their circle of competence, to do otherwise makes no sense.

Most of the truly great investment records have been built through focus investing. There is arguably some survivorship bias in these records, though I would strongly suggest that there is also a 'brilliance bias'. Concentrated investing is hard and is probably getting harder as the rate of change in business models accelerates.

A concentrated investor has to have a strong stomach to withstand the ulcers of underperformance.

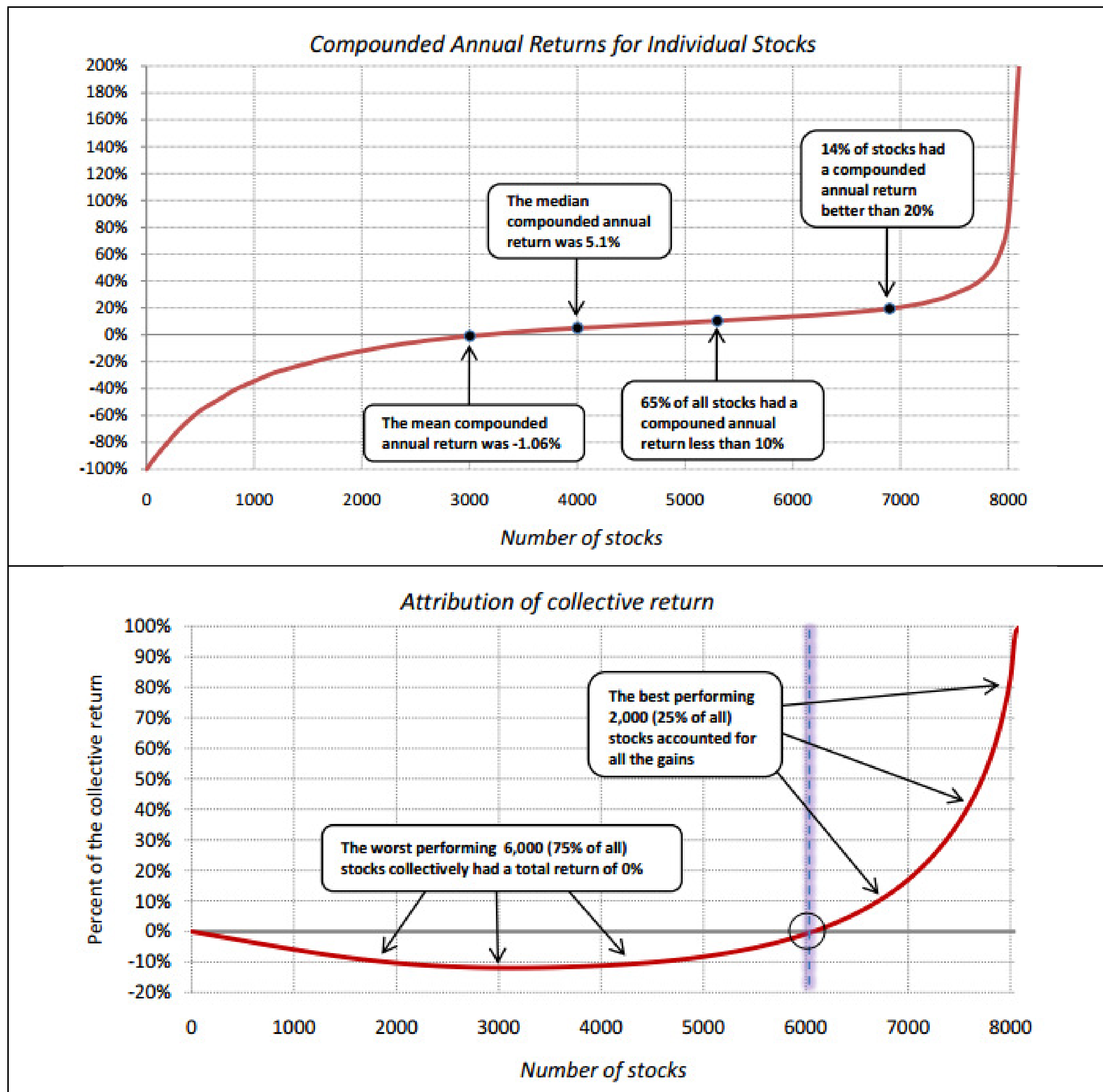
If you are going to concentrate successfully you need to be emotionally strong and exceptionally smart.

What you buy (and keep)

This might sound obvious but certain investments are simply not suitable for concentrated investing. Such investments include small cap stocks, leveraged entities (especially in commodity industries), mezzanine debt, correlated holdings (in the business sense), start-ups, concept stocks, options, and basically anything that has a non-negligible chance of going to zero.

For concentrating investing to work well you need to both avoid losers and own winners. In a diversified portfolio owning winners *might* be enough to do the heavy lifting (if you keep the winners).

A study by Blackstar Funds of returns between 1983 and 2007 covering over 8,000 US stocks shows the degree to which returns follow a non-normal distribution.



Perhaps then a better question to consider is which approach is most conducive to <u>both</u> avoiding mistakes and owning winners?

As it pertains to avoiding losers the concentrators should have the upper hand.

On the question of owning winners, I think the result depends on how good an investor you are <u>and</u> how likely you are to let winners run. Assuming average, or arguably even somewhat above average, skill levels, the likelihood of having a winner in the portfolio favours the diversifiers.

On the important proviso of letting winners run, this would intuitively seem to favour the concentrators. Very few people end up with multi-baggers as the temptation to 'lock in' gains after say a double or treble is too strong to resist.

An underappreciated feature of why index investing works is that it automatically 'keeps' the winners which doesn't seem to be shared by the diversifiers and is certainly not shared by individuals generally. In my view the disposition of concentrators is conducive to keeping winners.

To sum up:

Characteristic	Style with the likely edge
Avoiding Losers	Concentrate
Owning Winners	Diversify
Keeping Winners	Concentrate

A personal framework

I am naturally a little paranoid and feel that the conviction bar is high one. Holding a somewhat (though not overly) diversified portfolio feels like a good place to start. However, I am ambitious in the quest to deliver strong returns which brings two guideposts:

Guidepost one: Don't diversify beyond the point that gets one into material return reduction.

Guidepost two: Only concentrate in those instances where an understandable, un-leveraged, quality opportunity can be bought cheaply.

I see this as a flexible approach to capital allocation, consistent with an un-constrained investment mandate. It is an approach where one can tailor personal competence, and thus conviction, to varying investment contexts.

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