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Study debunks diversity dogma PORTFOLIO CONCENTRATION

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Is diversification really necessary?

The idea that a person's portfolio should be dispersed among as many different asset classes and stocks as possible in order to reduce risks has long been conventional wisdom in the fund management industry.

However, many, if not most, fund managers with stellar track records put paid to that idea. Top performers tend to own just a handful of stocks and hold very large positions in each.

The billionaire investor Warren Buffett is possibly the best-known advocate of a concentrated portfolio, once suggesting that investors make no more than 20 decisions in their lifetime about what to buy or sell. Longleaf, Oarkmark and Tweedy Browne are among highly regarded boutique fund firms whose stock portfolios also tend to be highly concentrated.

Nels Wangenstein, who with Dan McCarthy manages Dollars 280m in separate accounts at Neuberger Berman, consistently beating most of their peers, is one who has a contrarian view on diversification. Their pool of money has only 18 stocks - 14, if you count a basket of four education stocks as one - and extremely low turnover, proving

that a buy-and-hold approach with a concentrated number of stocks can work very well.

Mr Wangenstein says: "Diversification does provide a hedge, but it is also an opportunity cost. If you own a large number of stocks, it's very difficult to get performance that is better than the market. If you're buying lots of stocks, you're really making bets about the market rather than judgments about individual companies. We develop an expertise in a small number of companies and use that. I couldn't be an expert in hundreds of stocks."

Few quantitative studies have been done on the success of diversification versus concentration, but one study by two **University of Michigan** academics appears to come down on the side of concentration. The study surveyed actively managed funds from 1984 to 1999, and gave each one a divergence rating, based on how different the fund was from the overall index. Those given the highest rating were the least diversified, and it was these least diversified funds that showed the highest returns. The most diversified funds actually underperformed the market.

Among actively managed funds, the range in the number of stocks held is huge, according to data from Lipper. There are several large-cap funds with more than

600 stocks. Among small-cap funds, there are more than a dozen holding over 1,000 stocks. And the size of a fund is seldom related to the number of stocks it holds.

The Dollars 1.8bn Frank Russell Diversified equity fund has 621 stocks, with a turnover of more than 100 per cent. The fund has returned less than 1 per cent annualised over the past three years.

At the other end of the scale, the Dollars 4bn Sequoia fund has just 15 stocks, and has produced a return of more than 12 per cent a year over the same time period, according to Lipper.

The fewer stocks held, the more the performance of the fund will diverge from the index. However, the divergence could also mean significant underperformance if the wrong stocks are chosen, so for investors, there is still a trick in picking the right stocks, or the right funds. The Janus Twenty fund, for example, has underperformed over the past three years, showing an annualised loss of 3 per cent.

If an investor is seeking a market return, a low-priced index fund appears the best bet. If they want an active manager to give them active value, it is worth looking at the number of stocks the manager holds, and the turnover, as well as performance.