

When you should diversify (and when you shouldn't)

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Diversification is vital when aiming to manage investment risk. Diversifying asset classes reduces volatility of returns (and returns themselves) whilst diversifying holdings reduces the chances of loss (and gain!).

We have been questioned many times regarding the relatively concentrated nature of our strategies (for those who don't know, we limit the numbers of holdings in each strategy to force clients' capital to be allocated to our best ideas). It is a valid question to most as direct equity investors must consider stock specific risk. But is it still valid for portfolios made up of funds?

We would argue not.

Long standing analysis conducted by Franklin, Fant and O'Neal looked at the variability of returns for two styles of US equity funds, namely growth and value, to assess whether investors actually benefitted by diversifying across funds with the same objectives. The aim was to understand if investors should diversify to increase their chances of success.

The findings were quite stark. The analysis concluded that the variability of value funds was small and therefore holding one or five funds for value exposure did not affect performance sufficiently to warrant diversification across many funds.

This was not the case for growth funds, however. The variability for this investment style was very high and the performance of a portfolio of five growth funds performed better over the longer term than many of the individual funds, it was therefore concluded that when considering exposure to growth funds, the performance over the longer term is much more varied and a selection of funds is more suitable than any individual fund.

Why is there such a differential? Well, there is one fundamental reason why returns from growth funds vary considerably. This is that growth investing relies heavily on the judgement of key individuals to forecast the future.

Investing for growth relies on forecasting returns into the future that have not necessarily existed in the past. Growth companies are, by definition, businesses that are expected to either take market share from other competitors or have the ability to increase the size of the market in which they operate through innovative technologies or processes. The failure of growth companies to meet expectations is high and so the scope for disappointment and significant investment disasters is also high. Conversely, getting just one call very right can deliver an enormous boost to performance. The stakes in either case are high.

Value investing however looks at the underlying worth of a company's assets and generally extrapolates historic returns on investment and cash flow into the future. This is more predictable and therefore, as long as the industry dynamics are not changing dramatically, the probability of understanding the longer-term value of a business in this way is higher than that which applies to a growth company. Returns are likely to be lower, but the variability of returns will also be lower than for growth investing.

Investing is about stacking the odds in one's favour and remembering that the above analysis is just one of the pillars of our investment process which has helped us deliver strong returns whilst managing losses when markets are more volatile.

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