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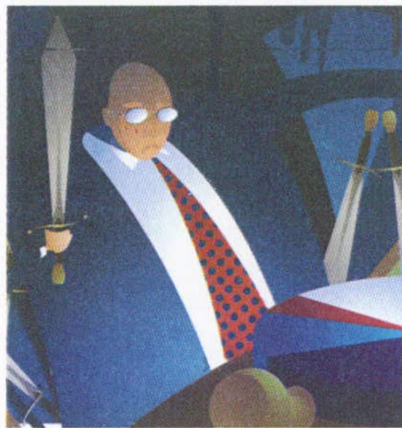
Viewpoint

by Dan Cashman

The Myth of Portfolio Diversification

Concentrating a portfolio in one or two "big-idea" industries scares many corporate investors. Is it volatile? Yes. Risky? Not necessarily.

Conventional wisdom — espoused by the majority of market analysts — theorizes that a diversified portfolio is less risky. But analysts, entrenched in a system that equates productivity with volume, are compelled to present dozens of ideas each year. Doubtless, the ones they are truly passionate about tend to be the best money makers, but what about their inferior notions? Should corporate investors embrace their lesser lights simply to help achieve "diversification" in their employee investor portfolios?



The answer is no, because while this diversification may not necessarily be a risk to employee investor capital, it most definitely creates a risk to investment opportunity. And that should concern corporate plan sponsors, who should never, ever confuse volatility with risk.

Obviously, a concentrated portfolio will be a more volatile entity than a fully diversified one, but there is nothing wrong with upside volatility. Have you ever heard an employee complain because a stock in your 401(k) portfolio went from $20 to $70 per share in a given year? Of course not. Is such a move volatile? Yes. But is it risky? Not necessarily.

In his 1993 Berkshire Hathaway annual report, Warren Buffett wrote, "We believe that if you are a know-something investor, able to find five to ten sensibly priced firms that possess important long-term competitive advantages, then conventional diversification makes no sense for you. It is apt simply to hurt your results and increase your risk. I cannot understand why an investor of that sort elects to put money into a business that is his twentieth favorite rather than simply adding money to his top choices — the businesses he understands the best, and that present the least risk, along with the greatest profit potential."

Obviously, Mr. Buffet believes diversification increases risk.

Of course, there's risk in a concentrated portfolio. Risk is inescapable, whether it be risk to invested capital or risk of opportunity. The best way to make money is not to lose it, or, as Cus D'Amato, the late prize fight trainer, quipped, "The object is not to get hit." But since rewards are spawned from risk, a productive portfolio must contain a sufficiently high level of risk.

In a presentation made several years back to the Endowment Institute, the President of TIFF Investment Program, David Salem, noted that money managers and plan sponsors alike must be willing to take career risks to achieve something worthwhile. What his advice implies is that you must commit to a profession where you're likely to be uncomfortable most of the time. Not many people have the fortitude for this and that's why most money managers do what's currently fashionable or comfortable. An example is paying close to 50 times earnings for Coca Cola, a company that's really growing only around 12 percent. This strikes me as lunacy, yet it's one of the most popular and most overowned stocks in money management circles.

On the other hand, our firm currently has 42 percent of our investors' money concentrated in one small subsector of the S&P 500 — the oil service industry. Our commitment would put most investors on the edge of their seats, and frankly, it even makes my partners and me somewhat uncomfortable. We understand the risk we are taking if we are wrong, but we reason that when crafted intelligently and in measured fashion, such concentration is actually less risky than