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# FINANCIAL EXECUTIVE

For Today's Strategic Business Leader



## Shepherding Your Employees' Investments

- ◆ The dangers
- ◆ The rewards

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## 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.”

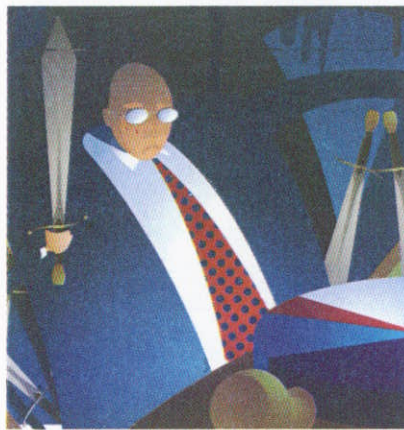
Obviously, Mr. Buffet believes diversification increases risk.

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



a broadly diversified portfolio.

The reason we have embraced the oil service industry is simple. World demand for oil is as high as it's ever been, at 3 percent per annum; in India and China, it's around 9 percent. The surplus of oil and gas we enjoyed in the 1980s and much of the 1990s is over. With the exception of Saudi Arabia, Kuwait and Iraq, the world is pumping at full capacity.

Interestingly, oil service companies are under-owned by the investing community. Now you know why we have pursued this theme with such gusto.

Is this type of focus on "one big idea" riskier than a portfolio diluted for the sake of diversification? I think not. Does this concentration create greater volatility? Certainly, but on the upside, based on my experience.

A recent study of concentrated funds by Morningstar indicates that, in general, fund returns do not improve as the number of stock holdings decrease. But the study concedes that the performance of a few consistently strong concentrated funds is largely due to good stock selection by their managers. These findings reinforce the concept that quality, not quantity, is critical in reducing risk, and that quality can be more readily achieved and maintained in a portfolio containing fewer stocks. Naturally, the competence of the fund manager is just as important. This leads to the prevailing question: What elements are always present in good stock selection?

### A Four-Part Test

Containing risk and achieving superior performance involves the presence of four elements in an investment idea. Three of the four are germane to the company as opposed to the underlying equity. The fourth has to do with the stock.

Not necessarily in any order of importance, the first element is growth, meaning growth in the top line (revenues) and in the bottom line (earnings). I refer here not to what is commonly conceived as a traditional growth stock (Intel, Merck, Coke, et al). A cyclical stock can be a growth stock for a period of time in its cycle. For instance, businesses in the oil service industry (the drillers, the equipment companies) are not considered growth stocks as conventionally defined; they're highly cyclical. But if they're caught early in their cycles, you can achieve outstanding returns.

The second element has to do with the stock. Corporate investors should be wary of what they pay for a company's growth rate. For instance, no one doubts that Coca Cola is a great company, but with a real growth rate of 12 percent, you could quarrel with its stock being awarded such a premium to the market's forward multiple of 18 times. After all, the growth rate of the S&P 500 is around 7 percent. Investors should take issue with the firm's price/earnings multiple of 45 times, about 26 times the year 2000's expected earnings. This relationship between Coke's growth rate and its multiple is out of whack and lacks equilibrium.

The third factor is management, whose importance is impossible to overestimate. Isn't it fascinating how certain individuals can be dropped into a humdrum industry and are able to transform a given company into a growth stock, resisting all the natural tugs of the industry's cycle? An example is the airline industry, which is notoriously cyclical and cut-throat. It's hard to imagine a more treacherous climate in which to operate, yet Herb Kelleher, who runs Southwest Airlines, has managed to compound investors' money at an average rate of growth around 24 percent. The overall industry's growth has been about 10 percent. Parenthetically, the general public loves that airline as measured by satisfaction polls, constantly rating it number one.

Finally, great companies tend to dominate their industry. The fourth element is superiority over competitors. Such companies are the alpha apes of their group; with their size, they get greater access to capital and lower borrowing rates, have greater R&D budgets and can thwart competition through pricing since they're typically the low cost producer.

I believe this strategy of concentration using the four dynamics of growth, equilibrium, management and superiority-(I call it "GEMS"), acting in confluence, can simultaneously limit risk and open up the potential for superior results within a concentrated portfolio. ♦

**Mr. Cashman** is founding partner of Cashman and Associates, an asset management firm located in Valley Forge, Pa. You can reach him at (610) 725-8200.

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