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Wealth

Concentrate that portfolio

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As in most subjects relating to money management, there's a wide diversity of opinion on portfolio concentration versus diversification. Few, of course, would argue for the extremes: owning only one or two stocks invites potential disaster (ask those whose entire retirement portfolio consisted of Lucent or Enron stock), while owning hundreds makes it very difficult to outperform the market.

Between the extremes, however, those advocating both more or less portfolio concentration have defensible arguments.

Warren Buffett, who often held fewer than 10 stocks in his partnership before he took over Berkshire Hathaway, has always been an articulate proponent of concentration, arguing that because truly superior ideas are few and far between, the impact of owning them should not be diluted by ideas that are anything less than superior.

David Einhorn of Greenlight Capital puts it well: "We believe in constructing the portfolio so that we put our biggest amount of money in our highest-conviction idea, and then we view the other ideas relative to that. We find things that we think are exceptional only occasionally, so if we find something we think is mispriced, where we have a good understanding of why it's mispriced, where we think the mispricing is very large and the overall risk is very small, we take an outsized position to make sure we give ourselves the chance to be well compensated for getting it right."

Managers in favour of somewhat greater diversification - owning, say, 30-50 stocks at a time - often point to the probabilistic nature of investing as justification for not putting too many eggs in one basket.

Zeke Ashton of Centaur Capital describes this position: "It's not unusual for us to make a good decision that has a bad outcome. If you're really concentrated and have two bad outcomes out of 10 perfectly good decisions, 10 per cent of your portfolio can blow up.

"People say 'why would you want to dilute your 10 best investments with the one that's 11th-best?' The problem is that while I can order my top 10 ideas by how much I think they'll go up, I guarantee you they won't end up being the top 10 in actual performance.

"We're just more comfortable being somewhat more diversified."

Our long portfolio currently consists of 24 positions, but nearly half is in our top two positions and the next four positions are all in the 8-12 per cent range. This extremely high level of concentration results in quite a bit of short-term volatility, but my partner and I are comfortable with this and believe it's the best route to superior long-term returns.

This isn't for everyone, however: unless you have a strong stomach, a great deal of experience and make your living as an investor, I highly recommend much greater diversification.

Two of our current holdings illustrate how we think about the sizing of positions.

Our largest holding, approximately a 25 per cent position, is Berkshire Hathaway. We're comfortable making this such a large position because of its safety: it has one of the few AAA credit ratings in the world, has more than $50bn in cash and is managed by Buffett, one of the most successful and experienced capital allocators of all time. It is also one of the fastest-growing large companies in America (earnings of Berkshire's operating businesses grew at a 31.7 per cent compounded rate from 1995-2006) and we estimate that the stock trades at approximately a 20 per cent discount to intrinsic value. These are the ingredients of a 25 per cent position.

One of our smaller holdings is bookseller Borders Group. The stock has dropped dramatically because of management mistakes and weakening consumer spending, but we've been adding to our position as it's fallen - though it's a small position due to both operational and financial risk (Borders has more than $500m in debt, roughly equal to its market capitalisation).

Successful activist investors Pershing Square and Spencer Capital own approximately 30 per cent of the stock and are pushing the company to finish selling its unprofitable international and mall-based stores and cut working capital. We think Borders can pay off all of its debt over the next few years and that the stock is a good bet to double - and possibly quadruple - over this time period.

While the concentration level of any portfolio will clearly reflect its manager's tolerance for risk and volatility, I'd argue that the level of diversification exhibited by many mutual funds - holding 200 to 300 stocks - is a form of closet indexation that invites mediocrity. This typically amounts to managing with the goal of never doing much worse than a market index. At the same time, it almost ensures that the manager will over time never do well enough relative to the index to justify his or her fees. If that's all you can expect, why bother?

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