

**When Less Is Blessed**

**By Simon Hoyle**

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Why pay a fund manager to pick a portfolio so diversified it gives index-like returns? Simon Hoyle examines those who back only the stocks they reckon are winners.

Mum always said that to do well in school, you should concentrate (it would have been good advice to heed). The same may be true for making money in the share market.

When you hire an "active" fund manager, you want that manager to pick good stocks and deliver investment performance that's better than a given market benchmark (which is usually a price index).

Trouble is, most of them then go and buy so many stocks that their portfolios end up looking, and behaving, pretty much like the index anyway. If they do outperform, it's marginal.

Investors frustrated with paying fund managers a hefty fee only to see them go and deliver index-like returns are turning in greater number to managers who concentrate their portfolios in far fewer stocks.

These managers are carrying out research on companies listed on the Australian Stock Exchange. But then, instead of committing only a small percentage of their total portfolio to each of the stocks they like, they place a significant amount in each.

They typically hold about 35 stocks, about half the number of many of their peers, and in some cases only a third the number other managers hold.

In extreme cases, concentrated or focused managers might hold fewer than 10 stocks. But whatever the number, these are managers who make a call and back their judgement.

As an investor familiar with the conventional wisdom of diversification and risk control, your first reaction might be that concentrated portfolios are inherently more risky than widely diversified portfolios.

That's not necessarily the case.

Published analysis of the diversification benefits of investing in shares, including *An Introduction To Risk And Return From Common Stocks* by US author Richard Brealey, suggests that the additional benefit you get from holding 100 stocks is not significantly greater than the benefit you get from holding a dozen.

You don't get twice the benefit from holding 20 stocks that you do from holding 10, and you certainly don't get 10 times the benefit from holding 100 that you do from holding 10.

In that context, it's difficult to see why a manager would put in all the research, analysis and effort to find another 60-odd stocks when the diversification benefit per stock is so small for each stock they add.

Warren Buffet once memorably described diversification as "a hedge against stupidity". However, some diversification is desirable; that much does not seem to be in dispute. But once you get past a certain point, you enter a world where arguments rage over whether the additional risk reduction benefits are justified by the performance dilution of adding more and more stocks to a portfolio.

The argument does not go so far as to dismiss out of hand the ultimate diversified investment: index fund management. There's a place in many investors' portfolios for index funds. The point is that if you're going to receive index performance, you shouldn't have to pay active fees to get it .

Concentrated or focused managers take the view that some diversification is necessary but not too much.

"What we're trying to do is outperform the market by 5 per cent a year over a three-year period," says Peter Hall, executive chairman of Hunter Hall Investment Management.

Hunter Hall's flagship fund, the \$515 million Global Ethical Trust, holds just 32 stocks, with 10 holdings accounting for 46 per cent of its money.

"So you can see that a few big bets are very important to our performance," Hall says.

"The distribution of investment opportunities in the share market follows a normal distribution curve. If your target is to add 5 per cent to the average annual return, it means the opportunities in the market are a much smaller subset of the overall market.

"About 5 per cent of the market has the risk and return attributes that we are looking for. Five per cent, we think, offer higher returns and lower risk. Obviously, the number of opportunities fluctuates as the market moves up and down. As the market moves higher, the number gets even smaller."

Hall says that, theoretically, a smaller number of stocks should make a portfolio more volatile than the market index.

"I am not sure what the academic research says on it," he says. "But if you look at our portfolio, we have had lower-than-average volatility, and we have a very concentrated portfolio.

"We've tended to have stocks that edge up over time."

Hall says performance capital growth and dividends accounts for about \$200 million of the firm's \$720 million total funds under management. Nevertheless, consultants and research firms generally still prefer to stick with managers that have far more diversified portfolios and more mediocre performance.

"People are totally impervious to our arguments," Hall says. "We don't get a look in. We've been going for 10 years and van Eyk haven't even bothered to rate us."

Mediocrity continues to be rewarded, Hall says, "because everyone is covering their bums".

"People who are really focused on performance are the boutiques; people who are not employees of a fund management company but who are actually the owners of the fund management business people who are far more focused on performance and much less focused on presentations and placating the researchers.

"I think it's a huge disservice [to investors]. But, essentially, as long as the ultimate consumers are willing to put up with it, it's going to continue."

The kind of investors attracted to Hunter Hall, and to others with concentrated portfolios, are "people who are really interested in performance", Hall says. "It's all about presentation versus substance."

Part of the "presentation" aspect of funds management is not standing out too far from your peers, says Wayne Peters, chief investment officer of Peters MacGregor Capital Management. Big fund managers cannot tolerate underperformance, and the loss of funds under management that would be the result, so they can't take a chance on outperforming, he says.

He runs highly concentrated portfolios through an individually managed account structure for high net worth individuals. The minimum investment in a PMCM account is \$2 million, and clients now are invested in no more than seven stocks.

Paul Moore, chairman and chief investment officer of PM Capital, says a concentrated portfolio is a result of the way he prefers to manage money, rather than a deliberate strategy on the firm's part.

"It's not that we've set out to be more focused than anyone else, it's just the way we have done it," Moore says. "We've always run our portfolios around a certain number of stocks. We've always just been traditional investors. We go out and try to find stocks that we like and that we want to put our own capital into.

"Once you get to 30 or 35 stocks, it's a bit of a struggle to keep on top of them. I can't work on 100 stocks at once I don't imagine most people can."

Moore says there's been a space opened up for managers with concentrated portfolios because, over the past decade or longer, the focus of institutional fund managers has drifted from investment risk to what's known as "tracking error" that is, the variation of a portfolio's return from the benchmark against which it's measured.

"Tracking error is more a judgement of what is the likelihood that you are going to perform differently from the market index and that has got nothing to do with investment risk," Moore says.

Moore says investors sometimes confuse "institutional risk" and "investment risk".

"The reality is that the bigger you are, the higher the risk from an investment point of view," he says.

"But most people look at a big name, they look at an institution and they think they are safe. But they don't recognise a difference between the risk that the institution will be around, and investment risk.

"If you've got 10 times the amount of money to invest, it's got to be harder."

Challenger Financial Services Australian equities portfolio manager Pano Raftopoulos says a more refined appreciation of what risk really is means managers with concentrated portfolios are slowly gaining a wider audience.

"As an active manager, we are paid to deviate from the benchmark," he says. "That does not mean that we take more risk. If you don't have a tracking error then you are basically a passive or 'enhanced passive' manager."

"What we've done is operate between 25 and 45 stocks, with an average around, say, 35. That's mainly because of the belief that you need a portfolio that is diversified across market sectors and industries, but to add value as an active manager you really need a portfolio that's backing your judgement, or backing your analysts' judgement."

Raftopoulos says there will be a continued drift to concentrated portfolios as investors, advisers and asset consultants realise that it's difficult to get really strong returns if you simply mirror a market index.

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