DIVERSIFIED OR WATERED DOWN?

HOW DO INVESTORS GET THE DIVERSIFICATION THEY WANT WITHOUT SACRIFICING OPPORTUNITY?

by Isaac Braley, President and Co-Portfolio Manager, BTS Asset Management, Inc.

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"Diversification is a protection against ignorance. It makes little sense for those who know what they are doing." - Warren Buffet.

Allowing conviction in an investment strategy is crucial for long-term success. Diversification does not mean introducing hundreds of securities into a portfolio only to have the portfolio track the market. Advisors and Investors should look to diversify between multiple investment managers with high-conviction portfolios.

Historically, we look to diversify our assets by purchasing investments that hold hundreds of securities each. We do this believing that we can lower our portfolio's risk/return profile. After we add up our mutual funds and ETFs, we often find that we have a thousand or more securities in our portfolio, with little rhyme or reason to the actual diversification we may have been looking for. A crucial issue in today's portfolio is the problem of layered diversification, when not only have the money managers over-diversified their portfolio, but also advisors and investors add additional layers of diversification.

Many investors today look to invest in indexes to create better diversification, only to discover that just a few names are leading market cap-weighted indices. As of December 31, 2023, even though there are eleven industries in the S&P 500, just one of them (Info Tech) holds a 29.81% weighting. Just three of the eleven sectors make up 55% of the Index. As you can see in the table below, it would be hard to argue that you have gotten much diversification from the top 10 holdings of the Index. Sadly, these ten securities make up more than 30.86% of the S&P, and two are just different share classes of the same company.

Top 10 S&P 500 Constituents by Index Weight

Constituent	Symbol	Weight*	Sector*
Apple Inc.	AAPL	7.03%	Information Technology
Microsoft Corp	MSFT	6.98%	Information Technology
Amazon.com Inc	AMZN	3.45%	Consumer Discretionary
Nividia Corp	NVDA	3.06%	Information Technology
Alphabet Inc A	GOOGL	2.06%	Communication Services
Meta Platforms, Inc.	META	1.96%	Communication Services
Alphabet Inc C	GOOG	1.75%	Communication Services
Tesla, Inc	TSLA	1.72%	Consumer Discretionary
Berkshire Hathaway B	BRK.B	1.62%	Financials
JP Morgan Chase & Co.	JPM	1.23%	Financials

*Weight: Source Morningstar 12/31/2023, Sector: Based On GICS Sector Weighting

We must find ways to lower risk in our portfolios, but understanding how we create this long-term risk-adjusted value must be further explored. Too often, great investment ideas are ruined by the watering-down effect of the diversification myth. Diversification is crucial, but understanding how to build diversification is the challenge plaguing the industry today. Harry Markowitz, The Father of Modern Portfolio Theory, who sadly died in 2023, began pioneering diversification work in the 1950s. Although the principle was and still is sound, for the past 70 years, many in the industry have completely ruined the process. Markowitz's approach was to create a risk management strategy that would introduce a mix of distinct asset types and investment vehicles to lower the risk of any one security negatively impacting the whole portfolio while also maximizing returns.

Markowitz believed in utilizing statistical analysis to find an optimized level of portfolio return for a given risk tolerance. Today, investment managers start with an outstanding investment thesis but introduce too many securities to the investment process. This waters down the investment return and creates unneeded complexity. It is paramount that each investment manager understands that they are just one of many investments inside an investor's portfolio. When advisors and investors build their end portfolio, they want to ensure they create the final aspect of diversification. Managers should stick to providing diversification of risk management within their own narrow investment approach and not try to look like the market.

So, How Many Investments are Needed to Create Diversification for an Investment Thesis?

A quick internet search will show you numerous pundits, from journalists to investment shops to academics, telling you the number is nowhere near the hundreds we see in most indexed type investments today. All agree that there is a diminishing benefit of too much diversification.

In a study published in the Journal of Business, "Risk Reduction and Portfolio Size An Analytical Solution", Edwin Elton and Martin Grubers looked at a population of 3,290 securities and all of the possible randomly chosen portfolio combinations of equally weighted holdings. They found that risk was little changed after reaching a portfolio of 20 securities.

# of Stocks in Portfolio	Average Standard Deviation of Annual Portfolio Returns	Ratio of Portfolio Standard Deviation to Standard Deviation of a Single Stock
1	49.24%	1.00
2	37.36%	0.76
4	29.69%	0.60
6	26.64%	0.54
8	24.98%	0.51
10	23.93%	0.49
20	21.68%	0.44
30	20.87%	0.42
40	20.46%	0.42
50	20.20%	0.41
400	19.29%	0.39
500	19.27%	0.39
1,000	19.21%	0.39

Source: Journal of Business, Risk Reduction and Portfolio Size an Analytical Solution

In the 1949 book The Intelligent Investor, Benjamin Graham believed a portfolio of 10 to 30 securities could provide adequate diversification. Of course, he did not believe these investments should be randomly chosen, nor do we. Much of the academic research on diversification has been through the necessary number of securities in randomly selected portfolios, and the results are not that much different. With randomly selected portfolios, academic studies have suggested that no less than 30 securities can provide market diversification. We believe that creating a diversified portfolio of 20 to 40 securities can allow an investment strategy to provide adequate diversification while still allowing for high conviction. This approach, coupled with the addition of other investments that an investor will bring in for a total portfolio, will further the diversification.

So, what should a manager do to seek better risk management in their own smaller group of securities?

1) Focus on a base investment thesis that seeks lower risk than the base index.
2) Bring securities in from multiple industries. Diversifying amongst sectors can help lower correlation more than adding numerous securities from the same sector.
3) Heavily deploy security analysis to study the underlying fundamentals of an organization and purchase those that show better health than their peers in a given sector.
4) Have conviction to remove or overweight securities in sectors based on their current fundamentals compared to their recent history.
5) Unlike today's most popular indexes, do not invest based on market cap weighting.
6) Reconstitute the portfolio frequently based on new financial data available from each organization.
7) Let the end investor and advisor diversify your conviction-based portfolio with other investment products. Managers need to realize they won't or shouldn't be the only investment in an investor's portfolio.

DEFINITIONS:

S&P 500 is an index that includes 500 leading companies in leading industries of the U.S. economy and is a proxy for the total stock market. This is the primary index used for comparison to the portfolio as we believe this portfolio should be used in the equity portion of a client's account.

The Global Industry Classification Standard (GICS) is an industry taxonomy developed in 1999 by MSCI and Standard & Poor's (S&P) for use by the global financial community. The GICS structure consists of 11 sectors, 25 industry groups, 74 industries and 163 sub-industries into which S&P has categorized all major public companies.

Information Technology Sector The Information Technology Sector comprises companies that offer software and information technology services, manufacturers and distributors of technology hardware & equipment such as communications equipment, cellular phones, computers & peripherals, electronic equipment and related instruments, and semiconductors and related equipment & materials.

Communication Services Sector The Communication Services Sector includes companies that facilitate communication and offer related content and information through various mediums. It includes telecom and media & entertainment companies including producers of interactive gaming products and companies engaged in content and information creation or distribution through proprietary platforms.

Consumer Discretionary Sector The Consumer Discretionary Sector encompasses those businesses that tend to be the most sensitive to economic cycles. Its manufacturing segment includes automobiles & components, household durable goods, leisure products and textiles & apparel. The services segment includes hotels, restaurants, and other leisure facilities. It also includes distributors and retailers of consumer discretionary products.

Financials Sector The Financials Sector contains companies engaged in banking, financial services, consumer finance, capital markets and insurance activities. It also includes Financial Exchanges & Data and Mortgage REITs.

Market Capitalization refers to the total dollar market value of a company's outstanding shares of stock.

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SOURCES:

E.J. Elton and M.J. Gruber, Risk Reduction and Portfolio Size: An Analytic Solution, "Journal of Business 50 (October 1977), pp. 415-437 http://en.wikipidea.org/wiki/Diversification_(finance)#cite_note-14.

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