Kayne Anderson Rudnick

A VIRTUS INVESTMENT PARTNER

The Case for a Concentrated Portfolio

A CONCENTRATED PORTFOLIO IS A HIGH-CONVICTION STRATEGY that can serve as an effective component of a well-executed asset allocation strategy. We have found that a focused group of well-researched companies, each with a sustainable long-term competitive advantage, can provide superior protection against a permanent loss of capital when compared to portfolios with a higher number of holdings, each with a lower degree of conviction. Further, with fewer companies to oversee, concentrated portfolios allow portfolio managers to more intimately understand their companies, and own their best ideas, thereby potentially decreasing the risk of underperformance.

Know Your Companies

A concentrated portfolio focuses on fewer companies, which allows a portfolio manager to devote more time and resources toward obtaining a more complete picture of the companies' long-term competitive advantages. If a manager has fewer stocks to look after, he or she can develop a deep understanding of the business and how appropriate its current valuation is. This depth of knowledge facilitates making educated decisions on whether to hold, increase, or sell a position, which may improve both downside protection and upside potential.

Conversely, having too many different positions prohibits managers from understanding the businesses as intimately as needed. This is problematic because the risk involved in buying a security is chiefly determined by how well one understands it. For example, it is clearly less risky to own 35 stocks that you know extremely well (and have purchased at an attractive valuation) than it is to own 50 or more stocks that you have spent little time investigating.

John Maynard Keynes was one of the earliest economists to express this idea.

> *I get more and more convinced that the right method of investment is to put fairly large sums into enterprises which one thinks one knows something about and in the management of which one thoroughly believes. It is a mistake to think one limits one's risk by spreading too much between enterprises about which one knows little and has no reason for special confidence.*[1]

Other notable investors have echoed this sentiment in recent years, including Warren Buffett, who has frequently extolled the benefits of picking fewer sensibly-priced companies with long-term competitive advantages instead of pursuing conventional diversification.

> *[If] you are a know-something investor, able to understand business economics and to find five to ten sensibly-priced companies that possess important long-term competitive advantages, conventional diversification makes no sense for you. It is apt simply to hurt your results and increase your risk.*[2]

In lieu of a portfolio manager putting money into a business that is his 51st favorite idea, it makes more sense—as Mr. Buffet explained—to simply increase his investment in "his top choices—the businesses he understands best and that present the least risk, along with the greatest profit potential." Adding new securities should be justified based on the manager's conviction and not merely by the need to diversify.

1. Keynes, John Maynard. Letter to business associate, F. C. Scott, on August 15, 1934. www.maynardkeynes.org, 2015
2. Buffet, Warren. Chairman's Letter – 1993. Berkshire Hathaway Inc., 1994

Enhance Returns

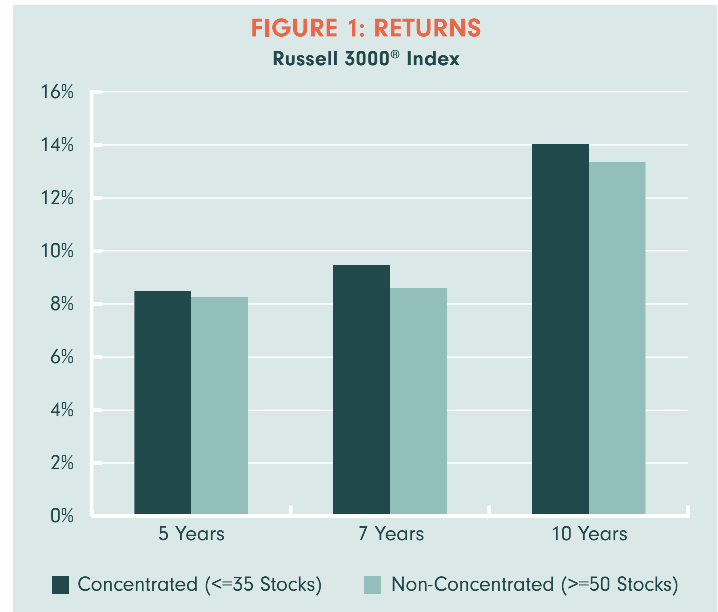
Adding more stocks to a portfolio solely for the sake of diversification tends to water down returns. As the portfolio looks more and more like the benchmark, the likelihood of outperformance decreases. Further, a large number of different securities in a portfolio typically means the equity positions are so small (sometimes only 0.2% to 1%) that no individual stock can affect portfolio returns—negatively or positively—with any real degree of significance. The result is often just a high number of average companies generating only an average return on capital. Accordingly, this process is sometimes referred to as "over-diversification" or "closeted indexing," because these "active" portfolios begin to look more and more like their benchmarks.

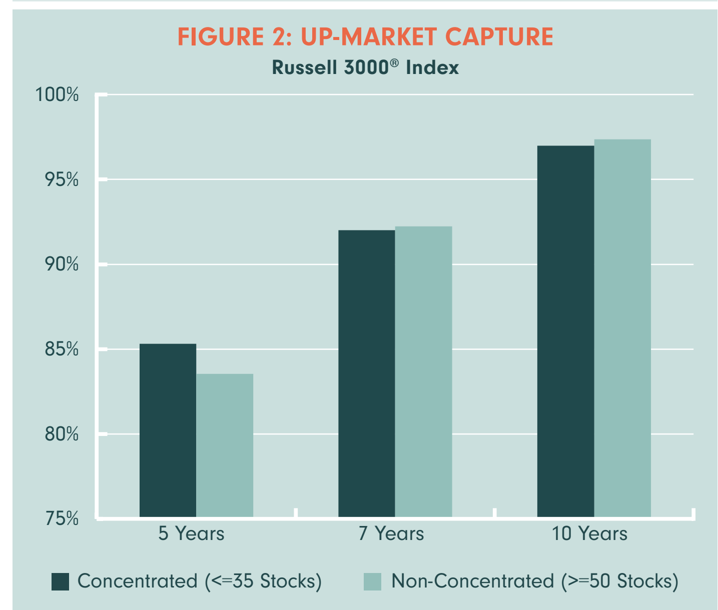
This behavior is counter-productive because managers' best ideas have a stronger likelihood of outperforming over time. Researchers from MIT and the London School of Economics analyzed monthly stock returns and quarterly fund holdings data of U.S. equity funds over the period 1984 to 2007, and found in their aptly titled paper *Best Ideas*, that equity managers' highest conviction ideas outperformed the market as well as the other stocks held in the managers' portfolios, by 1.0% to 2.5% per quarter.[3]

The focus on fewer and higher-conviction investments increases the chance that a strong performer will have an outsized positive impact on the account. This is a finding reinforced by professors Baks, Busse, and Green from Emory University's Goizueta School of Business. In their paper entitled *Fund Managers Who Take Big Bets: Skilled or Overconfident*, the authors recognized the value of portfolio concentration.

> *Our evidence indicates a positive relation between fund performance and managers' willingness to take big bets in a relatively small number of stocks. Concentrated managers outperform their more broadly diversified counterparts by approximately 30 basis points each month, or roughly 4% annualized.*[4]

In comparing concentrated portfolios to non-concentrated portfolios, we looked at data through June 2016 from the following eVestment universes: Non-U.S. Diversified Equity, U.S. Large Cap, U.S. Mid Cap, U.S. Small-Mid Cap, U.S. Small Cap, U.S. All Cap, and U.S. Micro Cap. Our findings are illustrated in Figure 1: concentrated portfolios (here with 35 or fewer holdings) outperformed larger, non-concentrated portfolios (50 or more holdings) in the prior 5, 7, and 10-year windows.





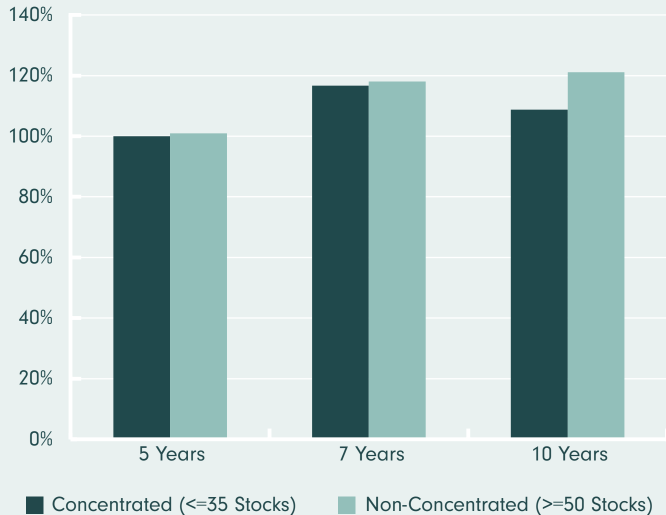
Data presented is for the period ending June 30, 2016.
Figure 1: Universe average annualized returns. Figure 2: Universe average up-capture for annualized periods. Data is obtained from FactSet Research Systems and is assumed to be reliable. ***Past performance is no guarantee of future results.***

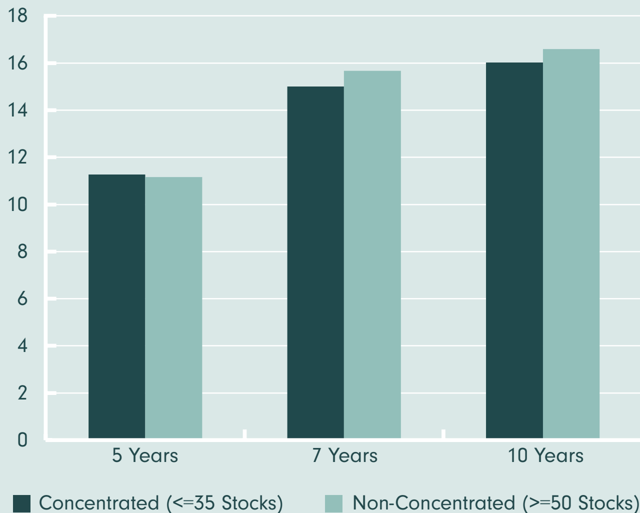
Of particular interest is that during these time periods, these concentrated portfolios captured almost as much, if not more, of the up-market returns as the non-concentrated portfolios did, as shown in Figure 2.

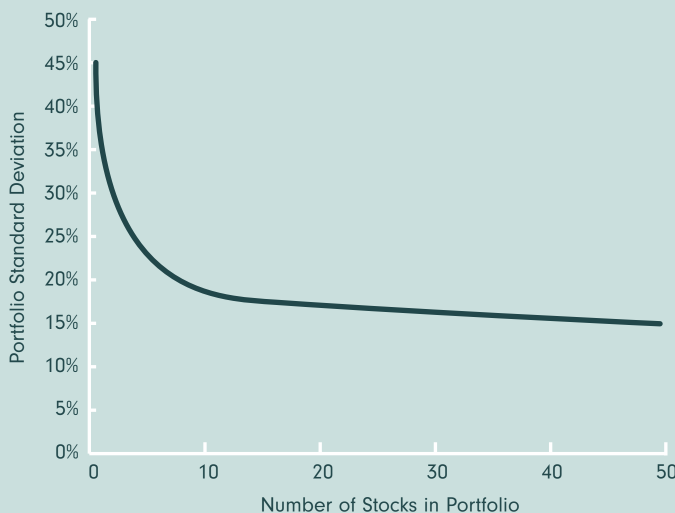
However, they captured less of the down market performance, as shown in Figure 3.

In other words, concentrated portfolios can do as well as larger, non-concentrated portfolios when the market is healthy, and they have historically tended to hold up better during difficult market environments.

3. *"High Conviction Equity: Why Fewer Names May Be Better," GE Asset Management, October 2012*
4. *Baks, Klaas P., Busse, Jeffrey A. and Green, T. Clifton. "Fund Managers Who Take Big Bets; Skilled or Overconfident," Emory University Goizueta Business School, March 2006*







Decrease Risk

A common fallacy about concentrated portfolios is that they are inherently more risky. This misconception exists because the relationship between diversification and volatility has been over-stated for years, leading many investors to believe they can only properly diversify away risk by including a large number of stocks. Yet, as Warren Buffet once said, "wide diversification is only required when investors do not know what they are doing."[5]

In fact, Figure 4 uses the same set of data to demonstrate how concentrated portfolios actually experienced lower levels of standard deviation (risk) than non-concentrated portfolios did in the prior 5, 7, and 10-year windows.

A minimum level of diversification is needed to reduce portfolio risk, but after a point, adding more stocks to the portfolio does not significantly reduce risk, and may in fact diminish returns. Numerous studies have shown that a relatively small number of stocks can provide most of the diversification that an investor actually needs. In fact, the diversification benefit of adding additional stocks to a one stock portfolio is largely captured within the first few additions, as illustrated in Figure 5.

Furthermore, even a portfolio of well-diversified assets cannot escape all risk. It will still be exposed to systematic risk, which is the uncertainty that faces the market as a whole. Also known as "undiversifiable risk," "volatility," or "market risk," systematic risk cannot be diversified away. However, it can be mitigated by diversifying beyond equities into asset classes such as cash, fixed income, and alternative investments. For this reason, a partial allocation to a concentrated equity strategy can also make sense as part of an overall asset allocation plan. This approach is preferable to investing in "closet indexers" or fund managers whose mandate prohibits them from investing heavily in their best ideas because research has shown that the extra attention these fewer holdings demand may deliver strong, even superior, returns in the long run.

Data presented is for the period ending June 30, 2016.
Figure 3: Universe average down-capture for annualized periods. Figure 4: Universe average annualized standard deviation. Figure 5: Assumes inter-stock correlation of 0.1 and average stock standard deviation of 45%. For illustrative purposes only. Data is obtained from FactSet Research Systems and GEAM (based on Modern Portfolio Theory) and is assumed to be reliable. ***Past performance is no guarantee of future results.***

The ***Russell 3000® Index*** *is a market capitalization-weighted index of the Russell Universe, which comprises the 3,000 largest U.S. companies.*

Up/Down Capture Ratio: *a measure of how well a manager was able to replicate or improve on phases of positive benchmark returns and how badly the manager was affected by phases of negative benchmark returns.*

Standard Deviation: *Measures variability of returns around the average return for an investment portfolio. Higher standard deviation suggests greater risk.*

5. *Orfalea et al. "Buffet Teaches Us to Concentrate," Exclusive outlook, West Coast Asset Management, The Entrepreneurial Investor, July 2007*

Reduce Correlation

Concentrating an equity portfolio in fewer stocks can also help reduce a portfolio's correlation to overall market returns. High-conviction ideas, those without a "top-down" bias (or predisposition to thematic or macro-economic drivers), tend to have a low correlation to each other, and therefore help mitigate non-systematic risk within a portfolio. As demonstrated in Figure 6, concentrated portfolios are characterized by a lower stock-market correlation than non-concentrated portfolios.

Further, over the same timeframes, concentrated portfolios have demonstrated lower correlation than non-concentrated portfolios when compared to other major asset classes including international developed equities, emerging markets equities, and U.S. corporate debt, as shown in Figure 7.

FIGURE 6: CORRELATION TO RUSSELL 3000® INDEX

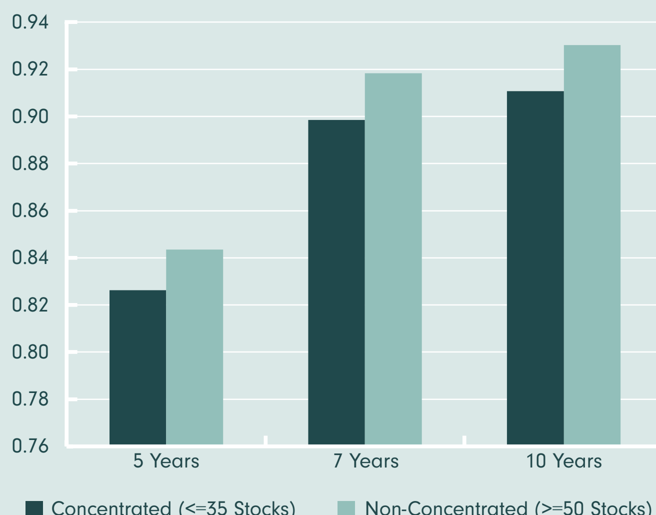


FIGURE 7: CORRELATION TO INTERNATIONAL DEVELOPED EQUITIES, EMERGING MARKETS EQUITIES, AND U.S. CORPORATE DEBT

Data presented is for the period ending June 30, 2016. Universe average correlation. Data is obtained from FactSet Research Systems and is assumed to be reliable. ***Past performance is no guarantee of future results.***

Correlation Coefficient: *a measure that determines the degree to which two variables' movements are associated. The correlation coefficient will vary from -1 to +1. A -1 indicates perfect negative correlation and +1 indicates perfect positive correlation.*

Conclusion

A concentrated portfolio in and of itself is not necessarily a wise investment strategy. Such an approach can only generate alpha (risk-adjusted excess returns) if it is accompanied by a strong research process capable of uncovering quality companies at attractive valuations. However, limiting a portfolio to a smaller pool of businesses does improve a manager's depth of knowledge of each company and focuses his or her clients' capital in the manager's very best ideas. By focusing on those companies in which a manager has the highest conviction, one has the potential to capture strong returns, and often with less risk. A concentrated portfolio can thereby serve as an effective component of a well-executed asset allocation strategy.

To learn more about how strategies managed by Kayne Anderson Rudnick can help you pursue your goals, visit virtus.com or call 1-800-243-4361.

This report is based on the assumptions and analysis made and believed to be reasonable by Advisor. However, no assurance can be given that Advisor's opinions or expectations will be correct. This report is intended for informational purposes only and should not be considered a recommendation or solicitation to purchase securities. Past performance is no guarantee of future results.

The ***MSCI EAFE® Index*** *is a free float-adjusted market capitalization-weighted index that measures developed foreign market equity performance, excluding the U.S. and Canada. The index is calculated on a total return basis with gross dividends reinvested. The* ***MSCI Emerging Markets Index*** *is a free float-adjusted market capitalization-weighted index designed to measure equity market performance in the global emerging markets. The index is calculated on a total return basis with gross dividends reinvested. The* ***Bloomberg Barclays U.S. Credit Index*** *measures the investment grade, U.S. dollar-denominated, fixed-rate, taxable corporate, and government-related bond markets. It is composed of the U.S. Corporate Index and a non-corporate component that includes non-U.S. agencies, sovereigns, supranationals, and local authorities. The indexes are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and they are not available for direct investment.*

5133 11-16 © 2016 Virtus Investment Partners, Inc.