Is Diversification Oversold?

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In our view, taking money out of your best ideas where you have the most confidence in future returns and ability to withstand risks to put it in companies you know less about and have less confidence in makes little sense.

Phillip Fisher who has one of the best long- term track records said it this way many years ago:
"Investors have been so oversold on diversification that only a small percentage of their holdings are in attractive stocks that they know much about. It never seems to occur to them that buying a company without having sufficient knowledge may be even more dangerous than having inadequate diversification."

We have found that for the equity portion of portfolios 15-25 well selected companies provides adequate diversification and that our knowledge level of companies in the portfolio is greatly diminished with more than 25 holdings. That knowledge deficit along with allocating money away from our best ideas makes it more difficult for us to produce attractive long term returns in a risk averse way

Further, we believe investors underestimate the differentiation in returns and valuations in the companies comprising the market. To us, this variation means there is an opportunity for concentrated portfolios to avoid the more overvalued and or overleveraged sectors of the market but only if rigorous hurdles are met and you are disciplined about implementing your investment process.

Phillip Fisher who we mentioned earlier did a five study many years which is outlined below of 140 companies in the various Dow Index's at the time that started with an A or T. He found a wide variation in returns over the period among the 140 companies. *(Common Stocks and Uncommon Profits first* *published in 1958)*

Opportunity Cost of Diversification

Percentage Capital Gain or Loss	Number of Stocks in Group	Percentage of Total Group
200% to 1,020% gain	15 stocks	11%
100% to 199% gain	18 stocks	13%
50% to 99% gain	14 stocks	10%
25% to 49% gain	21 stocks	15%
19% to 24% gain	31 stocks	22%
unchanged	3 stocks	2%
1% to 49% loss	32 stocks	23%
50% to 74% loss	6 stocks	4%
	140 stocks	100%

Warren Buffett has described this blind faith in diversification as “protection against ignorance”, David Swenson who manages Yale’s endowment calls it “failing conventionally,” and Peter Lynch referred to it as “deworsification.” We think of excess diversification as a high opportunity cost which we believe is illustrated in the table above as well as by looking at the wide spread of returns among S & P 500 companies currently.

For example, in 2017, a great year for the S&P 500 with a 21.83% total return Bespoke Investment Group found that the average return for the top 40 performers was 71.83% while the average return for the bottom 30 was a loss of 23.59%, obviously a wide spread. In no way will we ever match the performance numbers of the top 40 stocks or ever invest in the top performers and avoid the bottom performers. We’re simply pointing out the spread in returns and potential for a concentrated portfolio to outperform the index.

In our view, excess diversification can also dilute the knowledge and conviction in your investments making you more prone to emotional mistakes in volatile periods. Please feel free to contact us if you would like more information on our investment philosophy and performance. info@southatlanticcap.com

Mr. Nowell has over thirty years of experience in the finance business. Prior to founding South Atlantic Capital he worked in the leveraged lending department of Bankers Trust Company, New York as an Assistant Vice President. His primary responsibility was arranging bank financing for leveraged buyouts led by Kohlberg, Kravis, Roberts & Company. During graduate school he interned with Merrill Lynch's Capital Markets Group in New York. Later he served as an institutional fixed income salesman for Carolina Securities/Prudential Bache Securities and worked with Fox, Graham, and Mintz Securities. Mr. Nowell graduated from the University of North Carolina with a B. S. in Economics and received his MBA from the University of Virginia.