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For the Intelligent Investor
Answers to questions you may not even know you have.

Diversification—Too Much of a Good Thing

This essay was originally published in Muhlenkamp Memorandum *Issue 32, October 1994. At that time, there was an emerging trend in the investment advisory business to have a stockbroker or financial planner pick a broad array of investment managers in order to diversify your portfolio. Perhaps the planner would choose a dozen mutual funds for you to invest in. Those dozen funds might include growth funds, value funds, small funds, and large funds. That's what they meant by diversity— covering all the bases. Ron offers another perspective on diversity—an informed diversity where you diversify, but only among good investments.*

We often hear the phrase "Don't put all your eggs in one basket." We think that's good advice. We always use at least 20 baskets, never putting more than 5% of our assets into any one of them.
But it's still important to check the quality of the baskets. Not all baskets are well constructed. Easter baskets are designed to be pretty. They are okay for carrying a few eggs which are already hard-boiled, but they are not suited to carrying a full load of fresh eggs on a daily basis.

Not all baskets are appropriate in all climates or for all purposes. A fiber basket that is ideal in a dry climate will disintegrate in a wet one. A plastic basket that cushions the eggs in a warm climate will turn brittle and crack in a cold one. A plastic-coated wire basket that is ideal for gathering eggs and transporting them a few yards is unsuited to transporting eggs long distances, where a cardboard box is much better.

In the investment business, a CD basket differs from a bond basket, which differs from a stock basket, which differs from a commodity basket, and so on. And the General Electric basket differs from the Ford basket, which differs from the Exxon basket. . . . Some people selling investment advice maintain that you should use all of these baskets *for diversity*. They speak or write of diversity as if it were the goal of investing. It's not! The goal of investing is to increase the purchasing power of your assets—to make you money. Any potential investment should be measured by the likelihood of making you money. Any potential investment that is unlikely to make you money should be discarded.

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Diversification as a "Safety Factor"

The people who say you should own some of each investment *for diversity* are really telling you that they don't know how to judge a good investment from a bad one, or that they don't know what kind of investment climate we're living in. In one respect they are right. The less you know, the more you should diversify. If you don't know anything, you might as well own some of everything. But why should you pay a fee to people who don't know any more than you do?

Again, the goal of investing is to make you money. To do this, you can either take the time and make the effort to learn how to do it yourself, or hire someone to do it for you. If you had a perfect crystal ball, you would select the one best investment and put all your money into it. Nearly all great fortunes are the result of concentration, usually one person founding a company and focusing on one idea. But this is an all-or-nothing strategy, and no one has a perfect crystal ball. If you pick the wrong person or the wrong idea, you can lose your investment.

Warren Buffett (the most successful investor of our generation) operates one step removed from this. He has suggested that people would do better if they limited themselves to 20 investment selections in their lifetime. But he has also said that he wouldn't care if they closed the stock exchange for two years, and that he's willing to hold through price declines of 30%. Most investors are unwilling to take that 30% risk or to ignore the prices of their investments for two years. They lack the confidence to choose the one right idea or the one right stock or the one right time. So, for our clients, we diversify into 20 or more securities. We spend a lot of time and mental effort working to understand the securities available and the climate in which we live. We put what we learn on paper because, frankly, the better you understand what we are doing, the easier it is for us to make money for you.

When I was studying engineering, we were taught to include a "safety factor" in all of our designs. In many cases, the safety factor was 100%. One day, when discussing safety factors, our professor commented that a safety factor is really an ignorance factor. We used the safety factor to compensate for our ignorance of the material, the construction, the maintenance, and (of course) our design. Similarly, in investing, we diversify to compensate for our ignorance.

No matter how much work we do in getting to know a company, an industry, or an economy, we will still have a 20%–30% chance of being wrong. No matter how well we get to know the people involved, there are some things they won't tell us. Often this is because they don't (or can't) know, but sometimes it is because they won't admit it. A certain small percentage will lie to us. So we check the statistic books and find that most of this risk can be neutralized (diversified away) by owning 15–20 securities. As a result, we plan to own 20 or more securities.

Based on some knowledge of basket/security construction:

- We avoid commodities and futures because they are a zero-sum game, and both the users and producers work to drive prices down.
- We are very skeptical of buying options and other derivatives because they are also a zero-sum game, and time works against you. [1]
- We avoid limited partnerships because the fees are too high.
- We know that CDs are guaranteed to lose you money after taxes and inflation (except for a brief period of time in the early 1980s).
- We are skeptical of debt instruments—bonds, mortgages, fixed annuities—because we know they are managed for the benefit of the issuers and against the interests of the investor.

Based on some knowledge of the current (1994) investment climate:

- We are avoiding real estate.
- We are very skeptical of foreign investing because the dollar is undervalued.[2]
- We are willing to own bonds at a price.
- We are not willing to confine ourselves to narrow categories of investments.

Generalists vs. Specialists

When you check the history of the people who have good long-term records in investing, you will find that they are generalists. Warren Buffett concentrates his assets, but he chooses from a broad list of possibilities. So does (did) John Templeton, Peter Lynch, John Neff, and so on. If you read what they've said or written, each has strong convictions about how to choose investments and/or egg baskets. Each one has a consistent philosophy of investing and a documented track record of results. We would be comfortable having any one of these people managing all of our money.

[1] We do, on occasion, sell options, allowing time to work for us.

[2.] In 2007, this is no longer true.

But the recent, self-promoted fad in the investment advisory business is to have a journalist, a stockbroker, or a financial planner pick a broad array of investment specialists *for diversity*. They will tell you to own or hire a specialist in paper baskets, a specialist in cloth baskets, a specialist in metal baskets, a specialist in plastic baskets, and so on, in order to have diversity, as if that were your goal. They even document the success of each specialist in his or her field, but they don't show you their own past record at picking the specialists. Their selections are all hindsight. They imply that perfect hindsight equates to perfect foresight, but that's not often the case.

The Importance of Being Informed

So what should you do? Keep a diary of your thoughts on investing and the articles that make sense to you. Over time, you will learn what works and what doesn't.

You can shorten the learning curve by using your local library. The next time you are in the library, get the January 31, 1994, issue of *Forbes* magazine. On pages 132–33, Mark Hulbert lists the performance since 1983 of a number of investment letter writers.[3] Make a copy of the article and take it home. When you get a solicitation in the mail from a letter writer, check their track record.

In addition, when you read an article in a current magazine that seems to make a lot of sense, go to the library and see what the author or the magazine recommended three to five years ago. Use the same method for checking Morningstar's reviews of mutual funds.

Checking the record of your stockbroker or financial planner is likely to be more difficult. Most don't keep or publish a record of their recommendations or their results. Talking to a number of satisfied clients may be the best that you can do.

Finally, try to get differing opinions and question them all. This will broaden your perspective and help you make informed decisions.

3. This list was updated in a January issue each year from 1995 to 2001.

Editor's Note

This trend to diversify among many investment managers specializing in different kinds of investments continues today. It allows the investor to feel secure (they have covered all the bases) without knowing anything about investing. The drawback is that you are likely to get as many poor managers as good ones, and even the best managers will be constrained by the limitations imposed upon them by categorization of their investment fund. (See our essay, "How Much Money Are You Willing to Lose for a Theory?") By trying to blindly eliminate risk, you've increased your probability of poor returns. You will do better to take the time to find a good manager whose investment philosophy makes sense to you and let that individual manage your money. (See our essay, "How to Choose a Money Manager.")