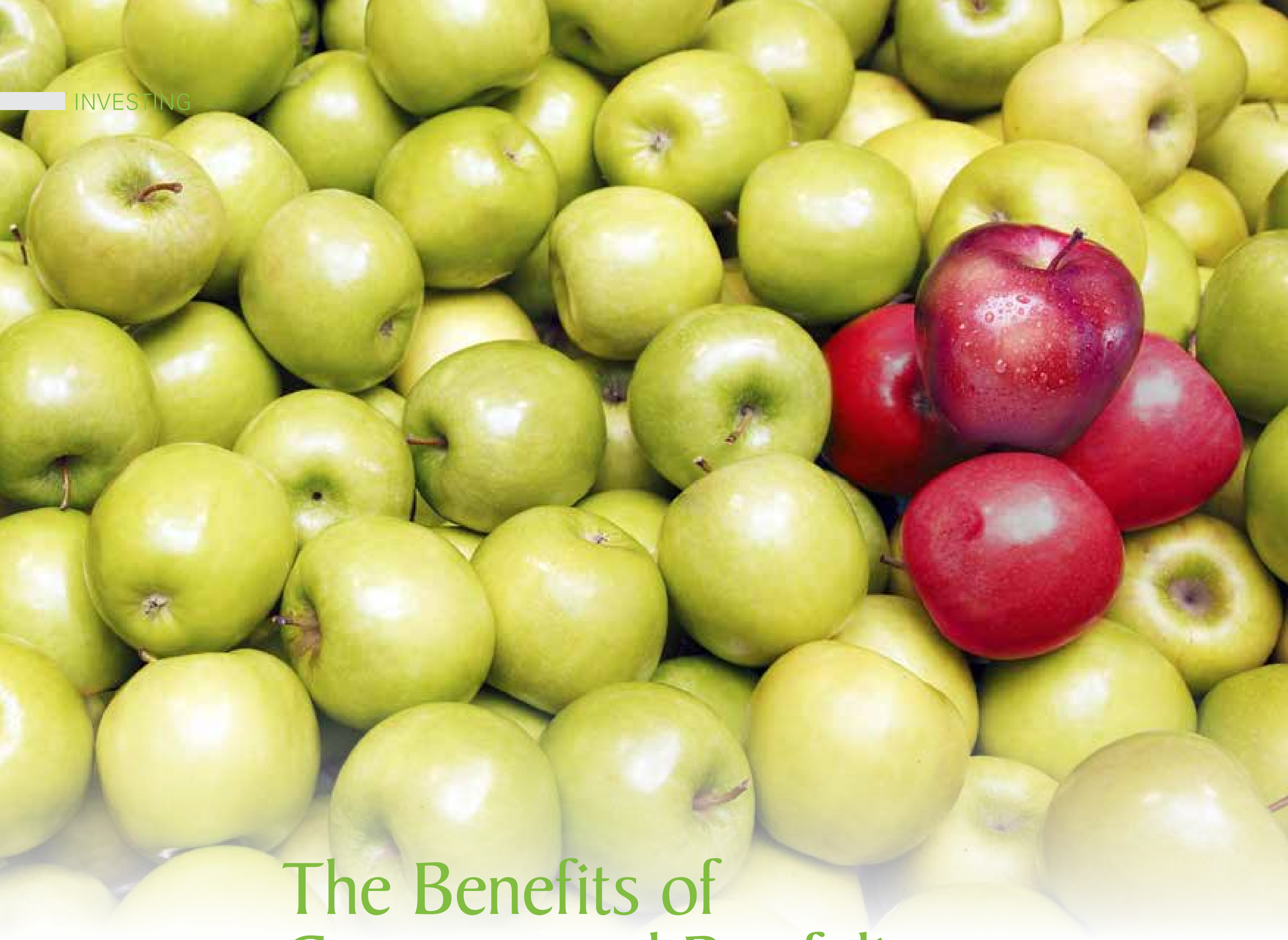

The Benefits of Concentrated Portfolios

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Since the beginning of index investing over 40 years ago, the debate on active and passive equity management has raged with no end in sight. As the institutional money management industry has grown and come to represent a majority of assets, the average money manager has, unsurprisingly, been unable to beat the market, leading some investors to index their equity exposure. At the same time, there are many investors who seem to defy the odds and consistently land in the top performance deciles amongst their peers. While simple math tells us that it is impossible for the average active manager to outperform a market in which they represent a majority of the assets, we also believe most active investors make several systematic errors that doom them to mediocre long-term investment results. One of these errors is the overdiversification of their portfolios. At BBH, we believe in the value that carefully chosen active investors can add to our clients' portfolios. As such, active share, a holdings-based metric that can be interpreted as the portion of a portfolio that differs from its index,[1] is one figure we focus on to help guide us in our decision making.

The Concept of Active Share

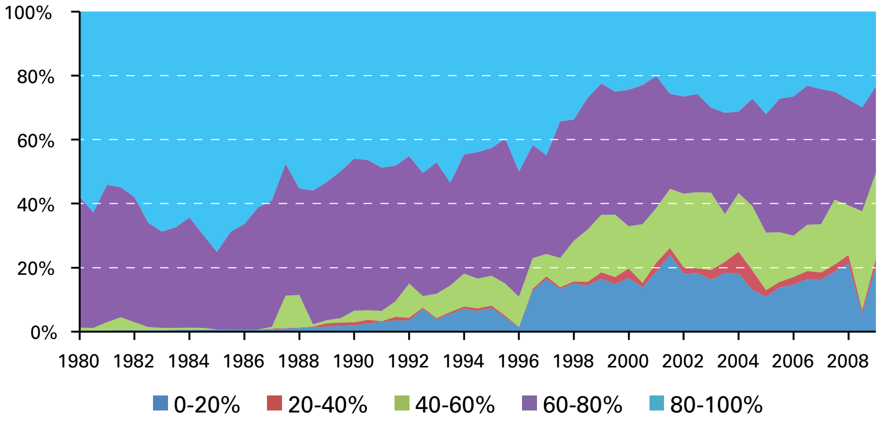
For years researchers have strived to identify inefficiencies that can be exploited to generate superior investment performance in what, most of the time, are relatively efficient financial markets. While the majority of studies fall short of offering any useful information that will stand the test of time, more recently researchers have shifted gears and attempted to explain why the minority of funds that do outperform are successful. Among these studies, a landmark 2006 paper from the Yale International Center for Finance that coined the term "Active Share" convincingly demonstrated a glaring weakness in the U.S. mutual fund industry: overdiversified funds, or more specifically, funds with a low active share, significantly underperform their high active share counterparts.[2] These overly diversified "closet index funds," as the authors of the study call them, which are managed more for the benefit of their parent firm than the underlying investors, are one of the more notable black eyes on the fund management industry.

Research on Concentration

In the early 1980s, over 60% of mutual funds fell into the highest quintile of active share. In the five years ending in 2009, that number was closer to 25%. Why does this matter? In the most up-to-date version of the study, Petajisto (2013) finds that as a group the most active stock pickers beat their benchmarks by 1.26% per year after fees and expenses.[3] The finding is strongest amongst small-cap managers but is also significant for large-cap funds. While anyone can simply purchase a small number of stocks, we believe this study shows that the decision by a mutual fund manager to concentrate purchases is often a signal of manager skill.

The biggest problem with low active share funds is that they charge fees comparable to other active managers but, because of their over-diversification, it is improbable that their performance will ever differ materially from their respective index. After calculating the active share metric across the universe of registered mutual funds, it is clear that a large portion of U.S. equity mutual funds charge active management fees for undifferentiated portfolios, and as expected, the study finds that these closet indexers as a group largely match the performance of their benchmark indices before fees and expenses. These managers' clients are thus doomed from the start: after fees and expenses, which is what matters for clients, these funds are almost certain to underperform their benchmark indices.

Evolution of Active Share (1980-2009)



Source: Antti Petajisto, www.petajisto.net/data

Other research supports the notion that concentrated stock portfolios comprised of a manager's highest conviction positions are more likely to outperform. In a 2005 paper entitled "Best Ideas," the authors identify, ex ante, which positions in fund managers' portfolios are their "best ideas," by looking at position weights relative to their benchmark. They find that "best ideas not only generate statistically and economically significant risk-adjusted returns over time but they also systematically outperform the rest of the positions in managers' portfolios.[4]" The level of outperformance varies between 1.6% and 2.6% per quarter depending on what factors are used to risk-adjust the returns. The authors postulate that the remaining positions that a fund owns are low conviction ideas that serve mainly to reduce tracking error versus the fund manager's index.

Another study on fund managers who have concentrated stock positions finds that, on average, these managers outperform their more broadly diversified peers by roughly 4% per year.[5] Drilling further into this study, the authors find that these managers' outperformance can be traced specifically to their biggest bets, and their results suggest that a portfolio comprised of several concentrated managers would outperform a highly diversified portfolio from a single manager.

Overall, the body of research on concentration supports the notion that active stock pickers as a group possess real skill; however this skill is diluted by the holding of low conviction positions that result in needless diversification. As to why so many managers choose to engage in a game where the odds are stacked against them, in many cases their actions may simply reflect their intent to maximize fee revenue as opposed to performance. As Charles Ellis points out, most large managers, because of their size, are unable to run concentrated portfolios and are forced to "invest primarily in the 300 stocks most widely owned and closely covered by experienced portfolio managers and expert analysts.[6]" In other words, much of this over-diversification is simply the result of institutional constraints that are imposed on the portfolio management process by fund management companies. While concentrated portfolios tend to outperform over time, they also lead to tighter capacity constraints on fund size, which limit the manager's ability to grow their fee revenue. Concentrated funds are also subject to more volatility and since many funds are judged, in our view inappropriately, on metrics such as Sharpe ratio,[7] reducing volatility versus a benchmark can make the fund look more attractive to certain audiences. Lastly, fund managers are more likely to get fired when they drastically underperform

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their benchmarks, so “rounding out” their portfolios with low conviction positions helps reduce this risk.

Other Benefits of Concentration

Leaving aside for a moment the empirical evidence on active share, there are other logical reasons for owning concentrated portfolios. While behavioral finance theory may seem to suggest that concentration could be a sign of overconfidence, in reality the literature on this topic suggests that high levels of trading activity, something we actively avoid, are more closely associated with overconfidence. Concentration, in our view, is many times a sign of humility, a trait that we value greatly in managers. As Warren Buffett said perfectly in his 1996 letter, “What an investor needs is the ability to correctly evaluate selected businesses. Note that word ‘selected’: You don’t have to be an expert on every company, or even many. You only have to be able to evaluate companies within your circle of competence. The size of that circle is not very important; knowing its boundaries, however, is vital.[8]” The concentrated managers that we believe are differentiated have a keen understanding of their circle of competence and have the discipline to stay inside their circle, which is what gives them the conviction to hold large positions. The level of rigor in fundamental research required to have this conviction provides a steep hurdle to managing a concentrated portfolio, which we like.

Another rationale for holding concentrated portfolios is simply that good investments are hard to find. A manager diligently looking for opportunities within their circle of competence in markets that are efficient much of the time may only find a few opportunities to invest each year. When a manager does find an opportunity that meets their criteria, we prefer that they hold a substantial position in that investment.

As our clients know, one of our primary risk management techniques is insisting on knowing what we own and why we own it, and this is well aligned with how most concentrated portfolios are managed. In our view, a portfolio should contain only as many ideas as can be thoroughly researched. The ability to focus on a smaller number of companies is a competitive advantage for concentrated managers versus other more diversified funds, and is also one of the more effective ways of managing risk. As a manager we respect once said, “Our strategy is to concentrate in our best investment ideas – the ones we believe are the safest, highest return places for our capital. Investment safety is a function of solid research, rational thinking, financial strength, durable competitive position and valuation. While a widely diversified portfolio may feel safer as it closely tracks the market, it will not necessarily protect your principal or grow your wealth. As the fund’s largest investors, we greatly prefer a bumpy ride to paradise over a smooth ride to nowheresville.” We would rather build a portfolio by allocating capital to several concentrated managers who invest only in their best ideas than by investing with managers who dilute their best thinking in order to manage volatility relative to a benchmark.

Conclusion

We believe investing with managers who hold concentrated positions in their highest conviction ideas increases our chances of earning attractive long-term returns for our clients, while the manager’s deep knowledge of each position also serves to reduce the risk of permanently impairing capital. Not only is this way of investing highly logical, but also supported by empirical evidence. While active share is only one metric we look at in our manager selection process, failure to realize its importance can doom a portfolio to mediocre results. ■

Past performance is no guarantee of future returns.

[1] *Mathematically, active share =* $\frac{1}{2}\sum_{i=1}^{N}(w_{fund,i} - w_{index,i})$ *Long-only equity funds will always have an active share between 0 and 100%.*

[2] *Cremers, Martijn, and Petajisto, Antti. “How Active is Your Fund Manager? A New Measure That Predicts Performance.” Yale International Center for Finance. August 2006.*

[3] *Petajisto, Antti. “Active Share and Mutual Fund Performance.”* Financial Analysts Journal. *Volume 69, No. 4. July/August 2013. www.cfapubs.org/doi/pdf/10.2469/faj.v69.n4.7.*

[4] *Cohen, Randolph B., Polk, Christopher, and Silli, Bernhard. “Best Ideas.” http://ssrn.com/abstract=1364827. May 2010.*

[5] *Baks, Klaas P., Busse, Jeffrey A., and Green, T. Clifton. “Fund Managers Who Take Big Bets: Skilled or Overconfident.” AFA 2007 Chicago Meetings Paper. http://ssrn.com/abstract=891727. March 2006.*

[6] *Ellis, Charles D. “The Rise and Fall of Performance Investing.”* Financial Analysts Journal. *Volume 70, No. 4. July/August 2014.*

[7] *A metric used to risk-adjust performance. The Sharpe ratio is equivalent to the incremental return a portfolio achieves above the risk free rate divided by the portfolio’s standard deviation (a measure of variation from an average).*

[8] *Berkshire Hathaway shareholder letter, 1996.*

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