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## Too many diversifiers hugging the index

By Mike Scott

It is widely held that it is important for investors to be diversified in order to reduce risks. But the financial crisis revealed that many stock portfolios, even those that held hundreds of shares, were not as well diversified as thought.

Diversification is one of the most powerful concepts in portfolio management but it also has the potential to make investors lazy, according to Patrick Armstrong, managing partner of Distinction Asset Management.

“[Active managed funds](#) can benefit from diversification, but often fall into the trap of becoming closet benchmark trackers,” he says.

Terry Smith, founder of Fundsmith and a prominent critic of the way the asset management industry operates, says the average equity fund manager owns far too many stocks and in effect tracks the index. “So what you are buying is in fact an index fund less the manager’s fees and costs of dealing, which is also expensive.

“Why do fund managers do this?” he asks in Fundsmith’s ownership manual. “Because for them the greatest risk is not underperforming the index with your money, it is stepping out of line with their peers.”

Most asset managers care about the wrong risks, agrees Mr Armstrong. “The vast majority of asset managers view risk as doing something different to their peers, or to their benchmark. Managers diversify to lower tracking error, when end clients want diversification to lower the volatility of the value of their wealth.”

Tracking error [the measure of how closely a portfolio tracks the index against which it is benchmarked] is in fact something that should be embraced, says Mr Smith. “We want to diverge from the benchmarks. In a positive way, of course.”

Simon Wong, a partner at Governance for Owners, claims the optimal benefits from diversification, provided the stocks are uncorrelated, come from owning between 30 and 50 stocks. “So why do you see funds that are nominally active holding hundreds of shares and ‘hugging the index’?”

The answer, according to Andrew Sykes, a fund manager at Senhouse Capital, is that fee structures are typically based on assets under management rather than

performance, which creates a strong incentive to run diversified vehicles capable of absorbing more capital. Senhouse limits portfolios to a maximum of 25 stocks.

Gervais Williams, managing director at [MAM Funds](#), maintains portfolios expanded because the credit boom that persisted for 25 years allowed those with good access to debt and international growth markets to produce returns with minimum effort. “But the credit boom was an abnormal period and you can no longer continue to add value in a rising market. We’re all going to have to work harder to deliver value for our clients.”

The more diversified you are, the closer you come to creating a tracker fund, says Tom Winnifrith, a senior fund manager for t1ps Investment Management. “Moreover, the more shares you own the less time you can devote to ongoing analysis of what you own.

“Those who are ‘looking after’ far more stocks are not doing what they say and are really running trackers. They should be paid less for doing so,” Mr Winnifrith asserts.

An active manager should be seeking alpha – or stock specific return – and this must be diluted the more holdings are held, points out Mike Jennings, chief investment officer at Premier Asset Management.

The benefits of portfolio diversification diminish rapidly once a portfolio gets above 25-30 holdings, says Robert Churchlow, head of active equities at Legal & General Investment.

“Limiting the number of stocks in a portfolio forces the fund manager to make tough decisions – without a limit there is a strong temptation not to address underperforming positions. Having a concentrated portfolio gives them more time to hunt out new ideas rather than be focused on maintenance of existing positions.”

This approach is borne out in other parts of the financial world. A [report](#) by the Edhec-Risk Institute released earlier this year suggests that the more holdings a private equity fund holds, the worse these investments perform.

“Scale is a robust and consistent driver of the cross-section of returns of private equity investments,” the report says.

Holding a large number of stocks can suggest a lack of conviction in the portfolio’s holdings, says Matthew Leeman, managing director of the European equity team at Morgan Stanley Investment Management. “Most fund managers tend to be good at buying stocks but less good at selling. When you see a portfolio with a long list of stocks, it’s an indicator of investments that have not performed as expected,” he says.

Another problem, says Mr Wong, is that holding a large number of stocks prevents investors from properly engaging with the companies involved. “If you want to apply the Stewardship Code properly, you have to ask yourself if you have the bandwidth to monitor all the companies you are invested in.”

Richard Urwin, head of investments at [BlackRock](#)'s fiduciary mandate team, says there is nothing wrong with a fund holding a large number of stocks, providing you have the resources and scale to manage them.

Ultimately the basic rules of investment never change, says Mr Winnifrith.

“Long term buy-and-hold is the only way to make money. A diversified portfolio is manageable and has interests in 25-40 different stocks. If your bottom-up analysis is correct, you are okay, and all talk of sectoral allocation or market diversification is an excuse by thick, greedy and lazy fund managers who cannot be bothered to do rigorous bottom-up analysis,” he argues.