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Think small, but research thoroughly when investing

By Paul Orfalea and Lance Helfert
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The most critical — and controversial — attribute of our entrepreneurial investing style is our commitment to a concentrated portfolio. At any given time, we hold as few as 10 stocks, and rarely more than 15. The very thought of this causes novice investors to swoon.

We're in good company with our preference for concentrated portfolios: master investor Warren Buffett (Berkshire Hathaway) also believes in holding a small number of excellent companies, procured at discount prices. Buffett provides an excellent summary of the case for concentration:

"I cannot understand why an investor elects to put money into a business that is his 20th favorite rather than simply adding that money to his top choices — the businesses he understands best and present the least risk, along with the greatest profit potential."

Nevertheless, many investors insist on overdiversifying their portfolios and sabotaging their own returns. We want people to understand the advantages of a concentrated portfolio, so here are five reasons we consider small portfolios superior to widely diversified portfolios.

Encourages understanding

Investors overdiversify to seek safety in numbers, but entrepreneurial investors seek safety — and superior returns — through knowledge. Deep knowledge of one's companies can improve both downside protection and upside potential.

When focusing on a few companies, one devotes time and resources to seeing beyond the PowerPoint presentations, getting a complete picture of the company's misunderstood or hard-to-see assets. In our view, a handful of companies, each with a strong margin of safety, such as valuable assets available at a discount price, provides superior protection against loss of capital when compared to a large, more diversified portfolio that includes more speculative investments.

Because an entrepreneurial investor gets to know a company's financials in detail, as well as its culture and people, there is also more protection from "scoundrel risk."

We often say that "if you take care of the downside, the upside will take care of itself," because of our obsession with margin of safety. But we should note that deeper understanding of a company also allows an entrepreneurial investor to better grasp the significance of potential catalysts that might boost a stock's price in the future, as well as possible risks.

Our style of investing requires that we think like owners. Owning 30 or 50 or 100 companies would diminish our mastery of the details necessary to put our capital to its best use. A concentrated portfolio allows us to roll up our sleeves, dig into a company and make educated decisions.

Increases rewards

The ultimate goal of thorough research is to understand when the odds of significant capital appreciation are in your favor. Proponents of concentrated portfolios make the most of probabilities by investing big when the odds are in our favor.

Investing meaningful amounts in companies with strong margins of safety and terrific upside potential leads to the situation Mohnish Pabrai often quotes in his value-investing book, "The Dhandho Investor": "Heads I win, tails I don't lose much."

When studying a prospective investment, we look for managers with good capital allocation skills, those who spend money where it will do the most good. A concentrated portfolio allows an investor to likewise practice good capital allocation, putting investment capital where it grows best.

In his seminal book, "Good to Great," Jim Collins describes a best practice of corporate budgeting that evokes our approach to choosing investments: "In a good-to-great transformation, budgeting is a discipline to decide which arenas should be fully funded and which should not be funded at all. In other words, the budget process is not about figuring out how much each activity gets, but about determining which activities best support the Hedgehog Concept and should be fully strengthened and which should be eliminated entirely."

Or, paraphrasing Buffett, why should a manager, of a portfolio or a company, allocate money to his 20th-favorite idea rather than investing more in his best and most productive idea?

Misunderstood concept

Investor revulsion at the idea of concentrated portfolios stems from the assumption that such portfolios are not diversified or underdiversified. As we've written in the past, diversification is the most widely known — and most deeply misunderstood — concept in investing.

At an early age, we all learn the fable whose moral concludes that you should not put all your eggs in one basket. Sage advice, indeed, but the fable leaves the tough decision to the reader: How many baskets should I put my eggs in, and how many eggs should go in each basket?

Ultimately, it depends on how well-engineered your baskets are, how many eggs you can afford to lose, and how many baskets you can competently carry.

Ensuring that every company in your portfolio has a strong margin of safety is like choosing baskets that feature a steel passenger cage, side-impact air bags, anti-lock brakes and integral roll bars. Such companies minimize the loss of eggs, or capital.

Knowing how much money, or eggs, you can afford to lose is very important, because risk cannot be eliminated completely. Proponents of wide diversification may build a portfolio of hundreds of companies, and this indeed reduces the influence of one or two steep declines. However, it also reduces the influence of outstanding performers, reducing returns.

Surely one must not put all the eggs in one basket, as many members of Enron's retirement plan discovered, but neither should one trade effectiveness for excess security.

One needs a portfolio that is just diverse enough to mitigate risk but concentrated enough to magnify returns. We find a portfolio of 10 to 15 judiciously chosen stocks provides adequate diversification without compromising returns. That's about as many baskets as we can prudently carry, considering the time and attention we feel each choice requires.

Easier to manage

Frequent trading diminishes returns, but an entrepreneurial investor must always manage opportunity costs, asking, "Is there a better place for my money right now?"

Without belaboring the point, a smaller portfolio allows one to more easily keep track of each holding's price and value relationship, empowering better decisions on when to sell or when to buy more. Likewise, tax-efficient trading becomes more manageable.

One great joy of concentration is the fact that one does not need to find dozens of great companies; a handful of good performers can make you very rich. Drawing from the entire pool of thousands of available public companies, an investor with 10 to 15 stocks in his or her portfolio and another 30 or so on a watch list enters the realm of meaningful opportunism.

By this we mean that by narrowing the field to a small number of great alternatives, one can act quickly when situations change.

A portfolio for all seasons

Another benefit of portfolio concentration comes from focusing on a handful of companies that are so strong they can prosper in a variety of future scenarios and are less correlated to the general market.

In other words, since we have little control over where interest rates go or who takes control of Congress, we would like to find companies that will do well whether rates rise or fall, or whether Republicans, Democrats or Martians are the majority in Congress.

This is no small task, but thanks to our preference for a concentrated portfolio, we do not need to find very many companies that fit these criteria. Moreover, by creating a portfolio with low correlation to the overall market, one achieves some protection against market risk, which makes the portfolio less susceptible to news-generated volatility.

Berkshire Hathaway, managed by Warren Buffett and Charlie Munger, exemplifies the advantages of a concentrated portfolio. As of June 30, 2006, Berkshire Hathaway reported holding public equities valued at more than $50 billion. Berkshire had 38 holdings, of which the top 10 represented 85 percent of the portfolio's market value. The top five positions represented 67.46 percent of the portfolio's total market value. As Buffett and Munger frequently point out a fortune can be made with very few stock purchases.

There is no doubt that a widely diversified, low-cost index fund can provide a virtually effortless investment for extremely risk-averse investors, and represents the best choice among most mutual funds.

But as our friend Jim Downey used to say, that's like claiming to be the world's tallest munchkin. Index funds may cost less than other mutual funds, but they are still overdiversified and have absolutely no defense against systematic risk.

For these reasons, we believe a concentrated portfolio of carefully researched stocks provides the best balance of asset appreciation and risk mitigation. As Warren Buffett has said, "Wide diversification is only required when investors do not know what they are doing."

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