THE POWER OF CONCENTRATION

> *"Portfolio concentration may well decrease risk if it raises, as it should, both the intensity with which an investor thinks about a business and the comfort level he/she must feel with its economic characteristics."*
>
> *-Warren Buffett*

One of the main tenets of investing is that you should not put all of your eggs in one basket — diversifying asset holdings reduces the overall risk of a portfolio and can help provide better risk-adjusted returns. And when it comes to diversifying, the view has typically been that the more diversification, the better.

Much research has been done, however, that has shown[1] this to only be true up to a point. The benefits of diversification in reducing stock-specific risks to a portfolio are pretty much maximized once a portfolio holds as few as 20 securities — additions above that threshold play only a marginal role in risk reduction (and there is no way to diversify away the market or "systematic" risk).

Furthermore, adding more and more securities to a portfolio has the effect of watering down the overall returns. This is because the benefit from holding winners is muted by their lower weight in the portfolio (more securities in a portfolio typically means lower share of the funds for each stock) as well as the drag provided by the securities that perform at or below the market average.

In other words, as portfolio managers add securities to their core of "high conviction" selections for the sake of (unnecessary) diversification, the portfolio increasingly resembles its benchmark. The more similar a portfolio is to its benchmark (these portfolios can be referred to as "closet indexers"), the lower is the prospect of outperforming that benchmark — a task that is further impeded by the existence of management fees and expenses which further erode net returns and put these funds at a performance disadvantage.

These types of strategies, however, represent a significant proportion of the fund universe — the Investment Company Institute[2] estimates that straight passive index funds account for 9% of equity mutual funds and represent 25% of total net assets while "closet indexers", according to some studies[3], represent another 10% of funds and 20% of assets — and not without reason.

The efficient markets hypothesis posits that financial markets behave rationally and that asset prices fully reflect all available information. As a direct result, the theory implies that it is impossible to beat the market on average since any price movements are strictly based on new information which would be inherently unpredictable.

Accordingly, this theory would suggest that the best strategy for investors with a long-term time horizon would be to simply passively invest in the market index, since active management cannot consistently add value over time. Buying the market index, however, is impractical and/or impossible and so traditionally investors (and institutional investors in particular) have preferred to be involved with funds that track the benchmark as closely as possible (something that can be measured by a fund's "tracking error"). Since these funds have limited deviation from the benchmark, there is limited scope for significant deviation from benchmark returns.

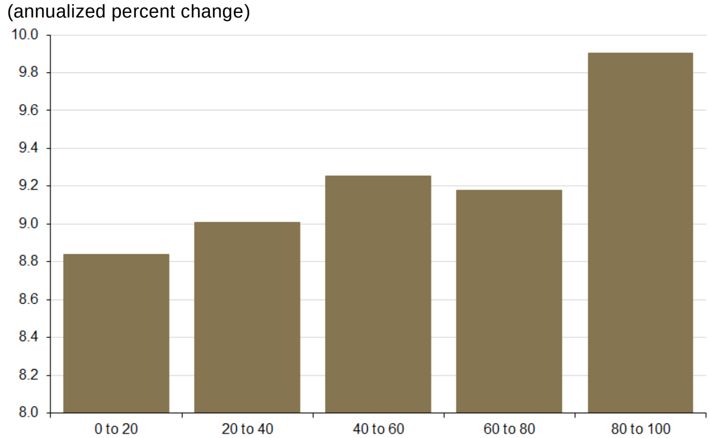
In a market that is saturated by funds tracking the market, there is ample incentive for portfolio managers to use skill to try to differentiate themselves by creating even just a bit of incremental value. This is a big reason why one of the most widely adopted strategies in active management is effectively holding the benchmark index as the portfolio's core and adding allocations to the "best idea" investments (or subtracting the "worst ideas") — this strategy seeks to boost overall performance above that of the benchmark without taking on risk that is materially different to that of the index the fund is tracking.

Increasingly these days, though, investor focus is less on maintaining this consistency of returns with the market index and more on generating returns materially in excess of that benchmark. In this context, it would seem that a skilled manager holding a portfolio of assets that is differentiated from the index provides the best opportunity to achieve above average performance.

This is where the concept of active share — a measure of the degree that a portfolio differs from its benchmark — warrants attention. Initial research[4] shows that funds that have a higher active share tend to outperform both their benchmarks and lower active share peers (such as "closet indexers") over time.

CHART 1: MORE ACTIVE, BETTER PERFORMANCE

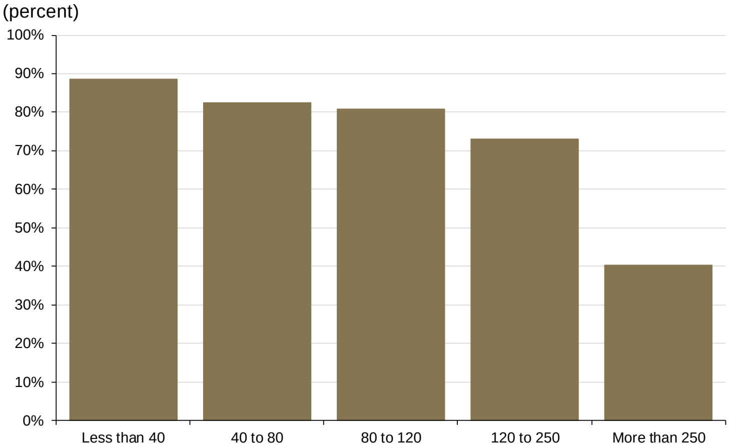
U.S. Equity Fund 10-Year Performance by Active Share
(annualized percent change)



Source: eVestment, Guardian Capital

CHART 2: HIGHER ACTIVE SHARE, MORE CONCENTRATION

U.S. Equity Fund Active Share by Number of Stocks Held
(percent)



Source: eVestment, Guardian Capital

Perhaps unsurprisingly, it is the case that portfolios that typically have higher active share are those with more concentrated holdings since these portfolios hold a smaller portion of the market at relatively higher weights.

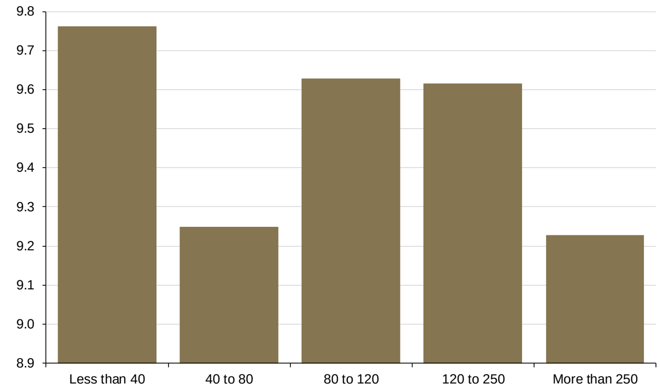
As a corollary to this, the performance records echo those for higher active share funds as well.

What is perhaps most notable, however, is when the most significant outperformance of more concentrated and actively managed portfolios occurs. These portfolios tend to thrive in more volatile market conditions, where rather than having a rising tide lifting all boats, choppier waters can cause some stocks to sink while others are better positioned to successfully navigate the high seas.

It is this type environment in which skill in stock selection matters most — and true active portfolio management is all about focusing on best idea stocks that have the greatest prospects while eschewing those that offer less upside in an effort to generate returns in excess of the broad market[5].

CHART 3: REWARDS FOR CONCENTRATING

U.S. Equity Fund Average 10-Year Performance by Number of Stocks Held
(annualized percent change)



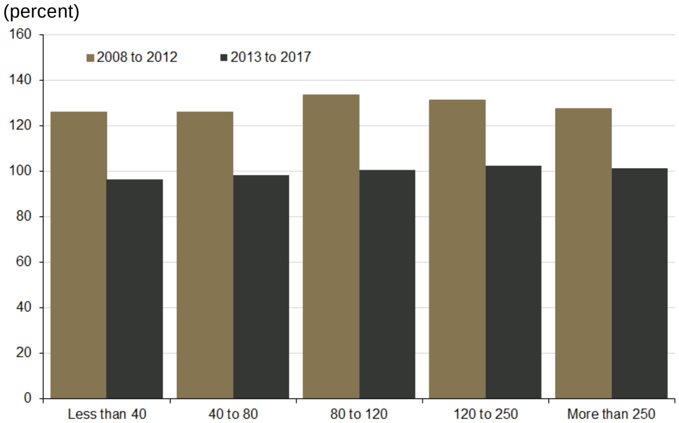
Source: eVestment, Guardian Capital

By focusing on a concentrated number of stocks, skilled portfolio managers are able to have a deeper understanding of each company they own and the underlying drivers of the businesses. These managers approach their holdings not from the perspective of short-term investors, but of long-term business owners and as such they do not panic and sell in times of broad-based market turbulence like a correction or even bear markets. Instead, these periods are viewed as opportunities to build their positions at even better prices, thus setting themselves up well for the time when markets recover.

Further to this point, the data indicate that while concentrated portfolios have been able to largely keep up with their peers in periods of rising markets over the last decade, they actually captured materially less of the downside performance of the market — that was most evident in early stages of this current bull market, with particularly strong relative outperformance in the tough markets in the aftermath of the financial crisis.

CHART 4: KEEPING PACE IN UPMARKETS…

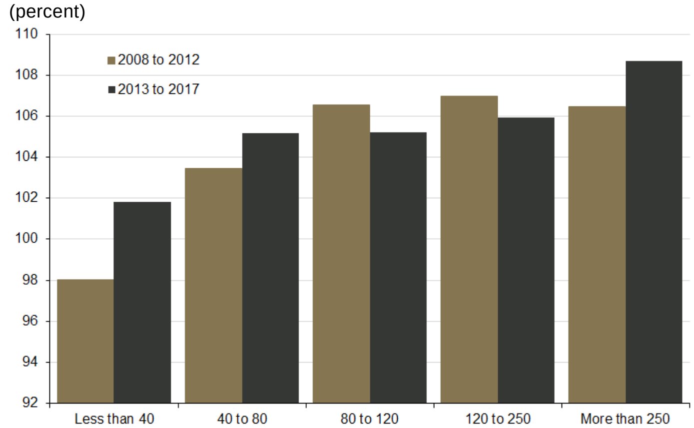
U.S. Equity Fund Average Upmarket Capture by Number of Stocks Held
(percent)



Source: eVestment, Guardian Capital

CHART 5: … BUT WEATHER THE STORM IN DRAWDOWNS

U.S. Equity Fund Average Downmarket Capture by Number of Stocks Held
(percent)



Source: eVestment, Guardian Capital

More succinctly, concentrated and more actively managed portfolios rise with the market when performance has been positive but sink less than when market performance has been negative. This downside protection means that capital deteriorates to a lesser degree in the downswings, and given the compound nature of returns, that in turn means that the impact of subsequent recoveries are amplified within the portfolio (a 10% return on $100 is larger in dollar terms than a 10% return on $95) and leads to a general outperformance over time.

The bottom line is that more is not necessarily better with respect to portfolio holdings; there are clear and attractive benefits to focusing on a small number of "best idea" stocks.

[1] The pioneering analysis on this topic is the 1968 paper by Evans & Archer entitled *Diversification and the Reduction of Dispersion: An Empirical Analysis*, but other seminal research includes Fisher & Lorie's *Some Studies of Variability of Returns on Investments in Common Stocks* from 1970.
[2] ICI *2017 Investment Company Fact Book*
[3] Such as the work by Antti Petajisto; see *Active Share and Mutual Fund Performance* (2013).
[4] See *How Active is Your Fund Manager? A New Measure That Predicts Performance* (2006) by Martijn Cremers and Antti Petajisto
[5] For additional support to this, Randolph Cohen, Christopher Polk and Bernhard SIlli's 2010 paper *Best Ideas* found that "nest 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."