
RESEARCH PERSPECTIVES

January 2006

Why Diversified Portfolios?



Last year, we mentioned that many of the portfolio managers that we interview often fall back on Warren Buffett quotes to provide some sort of evidence to fortify their stated philosophy or process. We have two small pet peeves about this practice. First, too many people do it, and sometimes in situations that don't make much sense. Second, they often misspell Buffett's name with one "t". If you are going to quote him, often as a key part of the argument, get his name right!

Now, that I said this, I am about to be found guilty for using a bunch of Warren Buffett quotes myself. In this case, however, instead of simply using the thoughts and words of Warren Buffett as a confirmation tool, I will also compare and contrast his comments with our own style of managing investment portfolios.

“Rule No.1: Never lose money. Rule No.2: Never forget rule No.1.”

We can't guarantee that we won't ever lose money. In fact, we guarantee that during some periods of time, we will. These losses though, hopefully will be temporary in nature, driven by short-term market volatility and eventually recouped when the stock market moves higher.

The important point that Warren Buffett is making here, and we fully agree, is that risk considerations should at least take equal importance to total return potential. We need to ask questions like: “What are the worst case scenarios? What are the probabilities of negative outcomes? What can we afford to lose?” The quote above is not about short term market volatility. It's about long-term permanent capital loss. It is not about sticking all of your cash under the mattress. It's about taking reasonable risks and being prepared for negative outcomes.

“Diversification is a protection against ignorance.”

“Ignorance” is defined as lacking education or knowledge (not necessarily lacking intelligence). As a professor of mine once reminded his class: “All that we know is that we don't know.” Uncertainty is risk.

One way of managing risks is to build a diversified portfolio. The idea behind this is that when one market is cold, another may be hot. Given the positive expectation of most markets (i.e., they make money over time), and the cyclical nature of markets, this seems like a prudent approach. So, why would Warren make a comment like he made above?

First, while this comment is widely quoted (always by managers or representatives of concentrated portfolios), in reality, Buffett isn't as negative on diversification as many think him to be. Besides, he

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owns a lot of companies and stocks. He does have a diversified portfolio.

Second, the comment above is basically right. If one doesn't know a particular investment opportunity or market niche in detail, doesn't have a controlling interest in the opportunity, and doesn't have a high degree of conviction, then one should diversify. As I learned years ago: "If in doubt, flatten out." Even if one could identify a high conviction investment idea, they could still be wrong. Permanent capital loss is what we are trying to avoid at Kobren Insight Management.

Third, concentrated portfolios are indeed preferable to diversified portfolios if one wants to maximize wealth. Diversified portfolios, however, are preferable if the goal is to maintain the wealth. If avoiding permanent loss and letting the long-term effects of compounding to work is the goal, diversified portfolios are often better.

Lastly, we really don't know what the future holds.

"There are very few secrets in investing that are known only to the priesthood."

The gift of prophecy is what many people expect in their money managers. It doesn't really work that way. Instead, to be a successful money manager, it takes a disciplined investment process, populated with the right tools and talent to make it work over time. It requires "doing your homework" to uncover new investment ideas and to monitor existing ones. It's about trying to put the probabilities in your favor of higher expected risk-adjusted returns.

"If past history was all there was to the game, the richest people would be librarians."

Often times in the financial press, a market relationship will often be identified to promote an investment or market view. If it was only this easy. Past history is indeed invaluable in beginning to understand market relationships and potential outcomes, but the markets are ultimately more complex than that. Besides, the ability to collect information is one thing. The ability to examine it and act upon it is another.

It often takes a different temperament to succeed in investing. Unlike most other things in life where a winning strategy is to reward success and punish failure, the markets don't necessarily operate in that fashion (except over short periods of time). It's truly a "the first shall be last and the last shall be first" sort of environment. As a result, it's important to stay independent, yet humble, in making investment decisions.

"If you join the crowd, you have a much higher risk of being trampled."

This is why you may often hear us commenting about all the things that aren't necessarily positive when investor sentiment is very bullish, and writing positive commentary when sentiment is bearish. Another old saying I learned years ago was that "the markets often move in

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the direction that cause the most pain.” Data does show the forward returns in the stock market are generally positive when current sentiment is bearish and vice versa.

“We simply attempt to be fearful when others are greedy and to be greedy only when others are fearful.”

There are many ways to get “an edge” on the markets. We like to think that our value orientation and our attention to costs help improve our returns. We also think that taking at least a mildly contrarian stance versus the crowd will also give us a boost.

“Look at market fluctuations as your friend rather than your enemy; profit from folly rather than participate in it.”

Diversified portfolios not only allow us to dampen over-all portfolio volatility, they provide a useful formation to take advantage of market volatility. Volatility is destabilizing, more so to some than others, but it also presents opportunities. With market volatility, we can attempt to take advantage of what we perceive to be fresh attractive relative valuations within the markets.

“We enjoy the process far more than the proceeds.”

This is an important comment, and many people have made this comment in similar forms over the years. Basically, it’s a “life is a journey, not a destination” sort of comment. In the end, my direct purpose as the Director of Research is not to provide an investment return, but to build, maintain, and enhance a top-notch investment process and team dedicated to multi-manager research and portfolio construction. If the process does what it’s supposed to do, there should be no surprises and the investment results should be satisfactory to the clients and all stakeholders involved.

“I prefer a lumpy 15% total return to a smooth 12% return.”

This may be one of the most useful Buffett comments for us to examine. It is an excellent comment in so many ways, and one we do not pursue at Kobren Insight Management. First off, it should be noted that this is not Buffett’s expectations for the stock market at present. His most recent views are much more modest – half that at best.

The main point of his comment, however, is that he can tolerate short-term volatility to attain higher returns. Typically, this is indeed how it works. To get higher returns, one needs to take higher risks.

That said, many people can’t ride that horse. Volatility is destabilizing. Most investors can’t handle a full time allocation to equities. Not only are the losses unsettling, but the gains can

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be as well. For example, “taking profits” too soon is often listed as a leading investor behavior flaw. Past studies have shown that it is easier for most investors, **particularly non-professional investors**, to stay with investment programs that offer superior risk-adjusted returns, not necessarily raw absolute returns. One may not think so at times, but volatility does matter. Controlling volatility often means one is better equipped to handle the emotions of up and down markets.

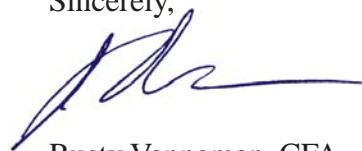
Obviously we want to attain the highest total return, but we will do it in a risk-controlled format, which may constrain our upside potential, but it will also “smooth out the ride” and make it easier for our clients to “stay the course.”

Of course everybody’s risk tolerance is different. It is dependent on each individual’s risk capacity and risk attitude. Risk capacity is defined as the financial capability to take on risk. Risk attitude meanwhile, is the emotional capability to handle market risks. Identifying a client’s overall risk tolerance is the most important element in building a successful relationship between an advisor and a client. Both parties have to work at understanding it and how it evolves over time (generally speaking, as one ages, less risk is typically desired – then again, risk tolerance typically goes up when the markets are moving higher and moves down when the markets are sinking – a constant battle we have to fight).

“It takes 20 years to build a reputation and five minutes to ruin it. If you think about that, you’ll do things differently.”

In the end, our investment product and service to you isn’t just about the return at the bottom of your client statement, it’s about the trust and confidence that you have in us to help you accomplish your long-term financial objectives. If there is anything that you have additional questions on, please feel free to contact me or your account manager.

Sincerely,



Rusty Vanneman, CFA
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Co-Portfolio Manager