

## DIVERSIFICATION: HOW MUCH IS ENOUGH?

As a risk management tool, the meaning of the word “diversification” is rarely disputed among investors. The application of the practice of diversification is so universal that the conservative message conveyed is intuitively obvious. In lay terms, it is generally believed that the greater the number of securities (now interpreted to include a multiplicity of asset classes, industries, countries, etc.) in a portfolio, the less vulnerable it is to the effect of any *one* individual security’s decent in price. Diversification is accepted as a means of reducing the unwanted consequences of so-called *random* events.

Consider the commonly referred to analogy of placing eggs in a basket. As the saying goes, to be properly diversified, or protected, one should not place all eggs in one basket, but rather *diversify* by securing a large number of baskets, placing just a few eggs in each. This reasoning points to *protection* of the overall egg portfolio by increasing the number of baskets, which in turn, limits the negative consequences any one broken basket will have on the entire portfolio.

Rarely considered as an alternative to employing a legion of baskets is to find a select few baskets that are well crafted, sturdy and have a proven track record of successful egg carrying. The smaller the number of baskets used, the easier it is to monitor the condition of each basket. We recognize that there are events, however remote, which may result in the breaking of one of these superior baskets, and thus find security in utilizing 10-15 outstanding baskets.

From a risk standpoint, both methods should prove reasonably sound in protecting one’s eggs. If both methods protect the egg portfolio from random risk, then which method is preferred? From our perspective, we would rather own 10 outstanding businesses, each of which hold defined prospects for delivering above-average expected returns, than 100 companies where our confidence level is more indefinable. After all, what is the real value in adding the 100<sup>th</sup> stock to a 99-stock portfolio? Simple logic would suggest that the probability of achieving *above-average* investment

results is systematically reduced as a portfolio becomes more like the market. We feel strongly that owning the 10 best businesses we can find is superior to owning a plethora of stocks across a myriad of industries, many of which may have poor economic characteristics. Over the long-term, the returns we achieve for our clients will approximate the growth in intrinsic value of the businesses we own. So, a constant focus on those great businesses where we can determine the absolute worth of and growth in intrinsic value will afford us a number of advantages over a broadly diversified portfolio. If an investor is satisfied with *average*, or market, investment results, or feels ill-prepared to legitimately expect more, then spreading one’s eggs across a number of baskets (stocks) is an absolutely prudent course of action.

Obviously, in order to practice a concentrated approach to equity investing, one must possess exceptional skill, discipline and patience in identifying, assessing and valuing businesses to be included in the concentrated portfolio. In reality, we are looking for one or two great ideas throughout the course of an entire year. Our equity selection discipline employs three basic *filters* through which we pour each and every idea. Only when the idea passes through all filters do we move on to the next step in the due diligence process. The filters we use might seem to be fairly straightforward, but only a small number of all publicly traded businesses pass through all of them. The three filters we use on a potential investment candidate are as follows: 1) the business must have a long-term, proven track record of superior returns on invested capital, 2) the business must operate a stable business model where market shares are stable and product life cycles long, and 3) the business must be run by a highly competent, shareholder-oriented management team. These three filters help us develop a high degree of confidence that a positive outcome carries with it a high probability.

M A R T I N

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