OSTERWEIS
CAPITAL MANAGEMENT

The Case for Concentrated Portfolios

"We started the firm in 1983 with the philosophy that focus is more important than breadth, and that managers perform best when they invest in only their most promising ideas."

John Osterweis, Founder and Chief Investment Officer

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SUMMARY

For generations, investors have debated the merits of concentration versus diversification. Proponents of concentrated strategies claim they generate higher returns, while advocates of diversified portfolios cite their risk management advantages.

Osterweis has always utilized concentrated strategies, and there are three main reasons:

1. Good ideas are hard to find
2. Managers can only know so many companies well
3. Diversification dilutes results

At the same time, we appreciate that too much concentration increases risk, so we generally hold 30-40 positions per portfolio. Our own experience, combined with extensive academic research, suggests this is sufficient diversification to safeguard against extreme losses.

GOOD IDEAS ARE HARD TO FIND

We use concentrated strategies primarily because we believe there are a limited number of truly compelling investment ideas at any given time. As Warren Buffet once quipped, "very few people have gotten rich on their seventh best idea."

At Osterweis, we generally look for misunderstood companies with asymmetric risk/reward characteristics. Such companies are in short supply. Likewise, we prefer firms with strong growth prospects that are selling at reasonable valuations, and again those are rare. Not surprisingly, it is even harder to find firms that exhibit all of those characteristics simultaneously. Thus, we have always felt that concentrated portfolios align best with the available market opportunities.

EXPERTISE DRIVES ALPHA

Expertise is the foundation of any worthy investment idea. Managers need detailed knowledge of the companies they invest in, but even the best managers can know only so many companies well.

Constructing a comprehensive view of a company's prospects is a time-consuming, dynamic process that is rooted in a thorough understanding of each business. Before buying or selling a security, managers need to evaluate firm-specific details (financials, strategy, executive team, etc.), the industry in which the firm operates, macroeconomic trends and any regulatory constraints. Once a company is added to a portfolio, managers need to monitor the news surrounding the firm and determine what information is relevant and whether it alters their previous view.

Given the complexities involved, we feel that concentrated strategies give managers the best opportunity to develop and maintain the focus and knowledge required to make informed, wise decisions consistently.

DIVERSIFICATION DILUTES RESULTS

Concentrated strategies also ensure that each security has enough weight in the portfolio to make an impact on performance. In diversified strategies, individual position weights can be so small that even the best performing stocks have a negligible effect on portfolio returns.

To illustrate the point, we reviewed the past ten years (2008 - 2017) of constituent returns for the S&P 500, comparing the Top 10 Contributors to the Top 10 Performers. Note that the *Top Performers* are the securities that delivered the highest returns in the index, independent of their portfolio weight, whereas the *Top Contributors* are the stocks that actually drove the performance of the index based on a combination of their return and their weight.

Although the breadth of the S&P 500 is greater than most diversified actively managed portfolios, the results are still instructive. During each of the past ten years the Top Performers have substantially outperformed the Top Contributors, but the overlap between the two cohorts has been negligible most years.

	TOP 10 PERFORMERS		TOP 10 CONTRIBUTORS		
	Average Return (%)	Weight (%)	Average Return (%)	Weight (%)	Overlap
2017	93.7	1.8	44.9	17.6	1
2016	98.0	1.0	24.6	16.2	0
2015	67.8	2.0	53.5	9.5	3
2014	80.3	1.3	33.6	13.1	0
2013	157.6	1.6	46.4	14.0	1
2012	111.5	1.5	39.8	14.7	1
2011	67.9	1.2	27.2	15.5	0
2010	93.8	0.7	29.7	14.3	0
2009	294.3	0.7	69.5	13.0	0
2008	23.3	2.8	14.6	4.9	5

Source: Osterweis Capital Management, Factset

Note that the results would be similar even if the portfolio were equally weighted. In that case the Top 10 Performers would still only represent 2% of the portfolio, which would have only a minor impact despite their outsized returns.

FOCUS ON THE LONG TERM

The core challenge with concentrated strategies is that it takes only a handful of laggards to impact performance. Active managers are expected to beat their benchmark, and when they don't, investors can become impatient.

While it's tempting to compare results quarter to quarter, we feel investors should consider returns over a complete market cycle. The correlation between a company's stock price and its fundamentals is imperfect. Strong firms can fall out of favor, just as mediocre companies can become popular.

We are constantly weighing the costs of holding an out-of-favor security versus our belief in its prospects. When we stay in positions that are trailing the market, we do so because we have confidence in the firm's underlying business. Despite the old adage that it doesn't help to be right when the market is wrong, we find high quality companies generally rebound from short-term price swings.

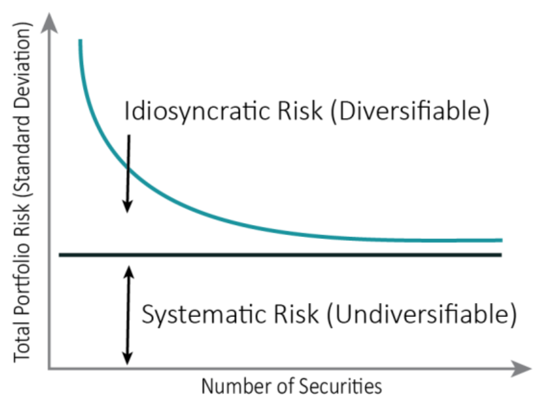
RISK MANAGEMENT CONSIDERATIONS

From a risk management perspective, concentrated strategies present a bit of a conundrum. On the one hand, diversification is generally accepted as the most effective way to protect against extreme losses – Harry Markowitz famously called it "the only free lunch in finance." On the other hand, too much diversification limits a strategy's upside.

What is The "Golden Number"?

Finance professionals have spent considerable effort trying to find the point at which full diversification is achieved, allowing managers to safeguard a portfolio without sacrificing the opportunity for alpha. Burton Malkiel, in his pioneering book from 1973, "A Random Walk down Wall Street," claimed that "twenty is the golden number."

The curve to the right demonstrates the basic concept – as more securities are added, portfolio risk approaches an asymptote. The area beneath the asymptote is systematic risk (i.e., undiversifiable), which is why there is no benefit to adding additional positions.



The research began fifty years ago, when John Evans and Stephen Archer (1968) published their seminal paper, "Diversification and the Reduction of Dispersion: An Empirical Analysis." The authors concluded that full diversification can be achieved with as few as 15 stocks.

A more recent study called, "Evans and Archer, 40 Years Later," conducted by Hicham Benjelloun (2010), looked at this question again. In his review of the literature, Benjelloun found that most researchers since Evans and Archer have determined that the asymptote lies closer to 50 stocks, while a few outliers have said the number is in the hundreds. However, Benjelloun persuasively argues that when standard deviation is used as the measure of risk, full diversification is generally achieved at 40 stocks. He conducted his analysis over 5, 10 and 20 year periods, covering dates from 1980 through 2000, using both equally weighted and market weighted portfolios.

In practice, we have found that holding between 30-40 securities generally provides enough diversification to protect our portfolios while still allowing sufficient flexibility to invest in only our highest conviction ideas.

Valuation Matters

We have always maintained that measuring a strategy's risk based solely on its breadth is an oversimplification – we feel valuation discipline is also critical for limiting potential losses.

When we consider new holdings, we look for companies with strong fundamentals that appear to be undervalued relative to our long-term expectations. Because these firms often have lower multiples they tend to weather downturns better.

Once we enter a position, we constantly monitor its valuation. We like to let our winners run as long as possible, but we keep them only if their fundamentals remain attractive relative to their price. Likewise, we are patient with our underperforming positions, but when their fundamentals fall outside our comfort zone we look for an exit.

INSTITUTIONAL DEMAND IS INCREASING

Although we have always believed that concentrated strategies are best, institutional investors have historically been divided on the matter. It appears that a consensus may be forming.

According to a 2018 study by Greenwich Associates, the "vast majority" of survey respondents said that the optimal number of securities in both large and small cap strategies is 50 or fewer. In addition, the demand for high conviction strategies has been growing recently – 56% of institutional investors surveyed said they have increased allocations to focused strategies over the past 12 - 18 months.

This is an important issue, particularly among pension funds, as they need to address widening shortfalls following years of reliance on passive strategies. According to Greenwich, the pension situation in the United States has actually worsened since the pre-crisis levels.

> *U.S. public pension plans with at least $5 billion in assets report average funding levels of just 74%. That's down from 82% in the pre-crisis year of 2006. With little hope of taxpayer-funded cash contributions, many underfunded public pension plans are banking on investment performance to fund future liabilities.*

The study also points out that even fully funded plans are moving into concentrated strategies, simply to keep pace with growing liabilities.

CONCLUSION

We welcome the shift in institutional attitudes about concentrated strategies since our opinion on the matter has been unchanged for over three decades. We believe that over the long run, concentrated equity portfolios provide investors greater opportunities for return. Although we appreciate the risk management challenges they present, our own experience (combined with copious academic research) has repeatedly demonstrated that portfolios of 30-40 holdings provide sufficient diversification.

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ABOUT THE AUTHORS

John Osterweis is the firm's Founder, Chairman, and Chief Investment Officer. Prior to launching OCM in 1983 he served as a senior analyst for several regional brokerage firms, including E.F. Hutton & Company, and managed equity portfolios for over ten years.

Jim Callinan, CFA, is the lead portfolio manager for the firm's Emerging Growth strategy. Prior to joining OCM in 2016, he was the CEO of Callinan Asset Management and Portfolio Manager of Emerging Growth Partners, LP. He began his career at Putnam Investments in 1987.

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Alpha is a measure of performance on a risk-adjusted basis. Alpha takes the volatility (price risk) of an investment and compares its risk-adjusted performance to a benchmark index. The excess return of the investment relative to the return of the benchmark index is an investment's alpha.

The S&P 500 Index is an unmanaged index that is widely regarded as the standard for measuring large-cap U.S. stock market performance. The index does not incur expenses, is not available for investment, and includes the reinvestment of dividends.

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