The Value of Concentration

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At Focus Capital Management, we run a super-concentrated portfolio. Indeed, focus and concentration lie at the very center of our investment philosophy. In many ways, the rest of our investment approach flows naturally from this first decision to run a concentrated portfolio, and this paper explains why we view concentration as so important and why we see it as so valuable.

There are many benefits from running a super-concentrated portfolio. I would like to go through the main benefits one by one and then end off with comparing the virtues of concentration to the benefits of diversification.

Concentration lets you choose your most compelling investment ideas

Concentration allows an investor to choose their most compelling investment ideas. We're able to focus on our *best* ideas. We want to invest all of our resources into our best and greatest opportunities, and we don't want to dilute them with mediocre ideas or even merely good ideas. Naturally, your best and second-best idea will be significantly better than your twentieth-best or even your seventh-best idea, so it makes sense to concentrate your firepower on your best ideas. To steal a line from Warren Buffett, very few people have gotten rich on their seventh-best idea.

Concentration lets you research deeply and comprehensively

Concentration allows an investor to pour an immense amount of time, energy, and research into each investment they consider. If a person invests in a hundred stocks, that gives him just about three-and-a-half days per year to research and think about each of his positions. And that's without sleeping, eating, breathing, or pretty much anything else. Realistically, such an investor can only have a passing familiarity at best with the companies in which he is invested. Having a team of analysts ameliorates this slightly, but does not really solve the issue; at the end of the day, the buck stops with the investment manager, and he ultimately needs to be the one to understand the company and the investment thesis.

At Focus Capital Management, we strive to spend at least a month deeply researching a company before pulling the trigger on investing, and often end up spending much more than that. We want to deeply understand the company and what makes it tick, its industry positioning, the key metrics to be paying attention to, etc. It is a common occurrence for the market to react illogically to news items (in both directions) simply because the market does not understand the company on a deep level and is reacting mostly off of vibes. Reacting off of vibes may possibly be a defensible way of *trading* stocks, but that's no way to approach long-term *investing* in companies.

Concentration lets you build your conviction

As a corollary of the previous point, by spending the time to deeply research and understand a company at its core, if indeed the investor chooses to invest in the company, he will be doing so from a deep well of knowledge. The investor is able to build a deep conviction in his investment thesis and not be swayed by irrelevant news or even temporary business slumps that do not affect the core thesis. Having the conviction to stay strong through the inevitable temporary price swings, and even to take advantage of them, is an absolutely essential component of being a successful long-term investor.

Concentration lets you thoroughly vet and stress-test the investment

The increased focus and research not only allow the investor to concentrate on better ideas and to understand them more deeply, it also actually reduces long-term risk. By virtue of having the time to research the investment deeply and comprehensively, the investor can research the downside case thoroughly. This applies firstly at the outset, in that the investor can vet and stress-test the potential investment in a depth that would be simply impossible if the investor was running a more diversified portfolio. And this applies after the initial investment as well, by knowing what key signs to be looking out for to test the possible breakage of the investment thesis. In a way, the flip side of building conviction is that the deep well of knowledge gives you what you need to be able to turn on a dime and bail if the circumstances call for it.

Concentration lets you constantly monitor your portfolio

By having fewer investments to monitor, an investor can keep fully abreast of developments affecting each individual company and its future prospects. This doesn't mean just keeping on top of quarterly earnings releases, which is of course the most basic level. This includes keeping abreast of developments throughout the industry and in related companies, be they competitors, suppliers, or customers. It is not at all uncommon for an investor with a deep understanding of the innards of a company to glean extremely important data from far-out related news that to a person with a more cursory knowledge base does not seem to directly affect the company.

Concentration lets your winning investments really move the needle

By focusing and concentrating on your best ideas, when your investments ultimately succeed, the profit realized really moves the needle for the entire portfolio. If you invest in a hundred stocks, then even if a position doubles, that only equates to a one percent gain for the portfolio as a whole. If you invest in only a few stocks, the gains are much more meaningful. This advantage is, of course, a double-edged sword as losses are magnified as well, if the investor chooses unwisely.

The benefits of diversification — how much and at what cost?

Conventional wisdom says that an investor needs to be diversified, and the vast majority of mutual funds and professional managers take this to an extreme. There is undoubtedly a clear benefit from diversification. Diversification lowers the idiosyncratic, unpredictable risk from an individual investment — the risk that something goes wrong at the company with no advance notice at all, the proverbial earthquake under headquarters, where value is wiped out literally overnight.

Besides lowering risk of permanent loss from an individual position gone awry, diversification also lowers the overall volatility of the portfolio as a whole, making the journey less bumpy and more pleasant. There is no question that running a super-concentrated portfolio increases volatility over the cycle.

However, taken to the extreme that most professional money managers employ quickly goes beyond diminishing returns and becomes counterproductive. If you invest in a hundred stocks, you will indeed average out the ups and downs of each individual position, muting your overall volatility — by converging on the overall market's performance. The number of so-called "active" investors that are basically closet index funds is truly astonishing. If an investor wants to outperform the market over the long term, then he needs to have a different portfolio composition than the overall market. He needs to take a stance, built on research, knowledge, and conviction, and he needs to stomach the inevitable swings that his positions will incur as his thesis plays out. It can definitely be painful at times, and the investor needs the temperament and fortitude to see it through to completion, but the rewards at the end make it all worth it.

Even in theory, studies have shown that the vast majority of the benefits of diversification (in lowering idiosyncratic, unpredictable risk and reducing volatility) are reached with about ten investments spread across different sectors and market risks. Admittedly, at Focus Capital Management, we run a more concentrated portfolio than the theory ideally calls for. That is because we view the bigger risk to be the risk of investing in something that you did not research sufficiently and which you do not truly understand. Investing when you only have a passing or shallow understanding of the companies in which you are invested may possibly work out with dumb luck, but is more commonly a recipe for disaster. Even if in the end the investment thesis proves correct, often the investor is no longer there to reap the benefits, as he never understood the investment well enough to build the necessary conviction to hold through the volatility.

At Focus Capital Management, we view the benefits of concentration as vastly outweighing the downsides of the concomitant volatility. And if you listen to the greatest value investors — Benjamin Graham, Warren Buffett, Charlie Munger, Peter Lynch, Joel Greenblatt, Philip Fisher, John Neff, Seth Klarman, and the list goes on — they consistently say the same, that wide diversification is the road to mediocrity.

Conclusion

To recap, concentration allows you to research deeply and more comprehensively. This in turn allows you to build much higher confidence in your thesis, thoroughly stress test your investment ideas, and better monitor your investments and react to events. Most crucially, concentration allows you to mass your investments into your best ideas, resulting in better results when you are proven correct. At Focus Capital Management, we view these benefits of concentration to vastly outweigh the concomitant downside of increased volatility. It is for these reasons that we have made focus and concentration the cornerstone of our investment philosophy.