Portfolio Concentration: Sleep With One Eye Open

“Doubt is not a pleasant condition, but certainty is an absurd one” - *Voltaire*

Supposedly Ben Graham used to say *“You can get in way more trouble with a good idea than a bad idea”*[1]. What makes this so true is that we are often biased with respect to our good ideas. We may be blind to obscured risk factors and sub-consciously expect that what makes this good idea so good will remain intact. This over-confidence may subsequently be reflected in an excessive position size in the portfolio. As we know, this has not deterred Buffett and Munger from managing their investment portfolios with extreme concentration; investing with supreme confidence in only their very best ideas. Munger’s and Buffett’s advice: wait for an exceptional opportunity and back it confidently and courageously. As an illustration of confidence in his investment appraisal skills the following quote from Munger is striking;

“*...I have in my files an early National Cash Register company report in which Patterson describes his methods and objectives. A well educated orangutan could see that buying into partnership with Patterson in those early days, given his notions about the cash register business, was a total 100% cinch.”*[2]

Confidence indeed. Peter Lynch apparently coined the term “diworsification” in reference to companies that destroy capital by investing in business activities far removed from their circle of competence. This term is now sometimes applied to the practice of perceived excessive-diversification by some stock investors, who may be deemed to have invested too much capital outside of their most favored stocks. Munger and Buffett have scorned this practice. And they are certainly not alone in their approach; other exceptional investors such as Glenn Greenberg, Francis Chou, Bruce Berkowitz and Bill Ackman are also known to invest heavily in their best investments.

As we have pointed out before, Buffett in particular often makes investing sound so easy. We believe it is not. Producing good risk-adjusted returns is difficult. It seems likely that Buffett and Munger possess exceptional intellect and a particular mindset wonderfully-suited to investing. Munger after all has referred to Buffett as “no ordinary human being”. Unfortunately most of the rest of us *are* ordinary human beings and we should not necessarily expect to achieve good risk-adjusted investment returns by adopting heavily-concentrated portfolio strategies. Every now and again good ideas turn bad. Buffett and Munger have proven exceptionally adept at routinely isolating and avoiding such investments, save for very infrequent lapses. Most of the rest of us may not be so adept.

[1] “The Snowball” (pg 12); Alice Schroeder
[2] Charlie Munger: Art of Stockpicking

Adequately appraising investment risks requires thorough analysis, which in turn requires skill and experience. So for starters, investors without exceptional skill and experience are asking for trouble in choosing a concentrated investment strategy. But skill and experience alone will not engender success.

In his book, "Psychology of Intelligence Analysis", former CIA Intelligence analyst Richards J Heuer Jr., describes how our individual "mental models" determine how we process information and form judgments. Everybody's models are unique and are shaped by myriad factors such as education, experiences and cultural factors amongst others. Heuer contends that our models process information in a manner unique to our own individual perspectives. This explains how two people presented with the same information can form completely different conclusions. Unfortunately mental models contain unavoidable biases which can produce poor decision-making. In many cases we just can't help ourselves jumping to the wrong conclusions. Heuer highlights various psychological dispositions that can greatly distort analysis. Let's look at a few examples:

Anchoring: in stress testing, for example, a baseline (annual sales run-rate or profit margin) is adjusted for various upside and downside scenarios. All too often the adjustments are inadequate as the baseline anchors the analyst's efforts to think independently about the effect of genuine upside and downside scenarios.

Availability Bias: studies suggest that potential scenarios that are perceived to fit with one's own experiences are deemed more likely to occur than those that don't. Here our experiences distort our ability to "objectively" estimate the probabilities of certain events occurring.

Randomness: people appear to struggle to accept the idea that events can occur because of utterly random factors. Instead humans are inclined to seek-out causal explanations, and attempt to identify patterns where there are in fact none. Consequently, we can formulate erroneous hypotheses, which then lay the ground work for further problems.

Evaluation of Hypotheses and Conformation Bias: when problem-solving, instead of seeking out all potentially explanatory hypotheses and seeking to identify those which are most difficult to invalidate, analysts tend to latch on to the first credible hypothesis and attempt to identify evidence to support this. Furthermore, the brain seems adapted to assimilate and retain information that supports our beliefs and discard that which does not.

Stickiness of Erroneous Beliefs: Studies suggest that beliefs are difficult to shake-off even after the evidence that fostered the belief has been invalidated. Our minds appear to manage information differently depending on whether or not new information fits with previous experiences and existing expectations.

RogersCasey[3] recently published a study that attempted to assess the performance of concentrated funds versus diversified counterparts. They assessed only concentrated funds that had a diversified counterpart managed by the same team using the same investment

[3] "Best Ideas, Better Returns?" March 2011

process. In all there were 57 concentrated funds that had a five year track record and 30 concentrated funds that had a 10 year track record. They concluded that the concentrated equity funds achieved only marginal excess returns versus the diversified counterpart over five- and ten-year time-periods "in exchange for significantly more relative risk" (i.e. tracking error). Most value investors would agree that tracking error and price volatility do not equate with risk per se. However the trouble with price-volatility and tracking error is that they can exploit an investor's psychological weaknesses and cause an otherwise rational mind to exaggerate concerns about the merits of individual investments. This in turn may lead to the disposal of under-performing investments that actually remain attractive if only analysed with unencumbered thought. Additionally it seems likely that survivorship bias may have inflated the de facto returns of the concentrated strategies in the above study. Highly concentrated funds are likely to be more volatile and incur higher tracking error than diversified comparators. It is therefore conceivable that this may have resulted in a higher rate of closure of under-performing concentrated funds well before the five year minimum term was reached, as per the study. Actual real-life returns of concentrated funds may be worse than the RogersCasey study indicates.

Investors tend to feel a sense of satisfaction in observing the collapse of stocks that don't fit with their particular approach. This can seem to vindicate their choice of investment style. What is particularly disconcerting for an intelligent investor is to witness the collapse of a stock that he/she *could* have owned or worse still did own. Observe the catastrophic fraud at companies like **Parmalat** or **Healthsouth**; even diligent investors may not have been able to identify warning signs in advance. Neither the impact of the Gulf of Mexico disaster on **BP** nor the effect of the recent earthquake and tsunami on **Tokyo Electric Power Co**. could have been anticipated by most investors. Product withdrawals or safety-alerts have greatly impaired drug companies like **Wyeth** and **Elan** in the past; again most investors could not hope to have predicted these occurrences. The quoted telephone directories sector in Europe has been shattered (look at **Yell** or **Eniro**), principally by the effects of the internet but also by catastrophically-poor executive decisions on strategic and financing matters. Likewise the quoted UK retail sector has been devastated by the collapse in demand since the so-called Great Recession took hold. Consider **Dixons** and **JJB Sports** or, for a more extreme example, the now-bankrupt **Land of Leather**. The upheaval in the mobile handset industry over the past decade has been remarkable: **Motorola**, **Ericsson**, **Siemens** all brought to their knees by an extraordinary transformation of the competitive landscape as new competitors emerged from nowhere. Industry leader **Nokia** seemed to be well-insulated not so long ago; this is no longer the case. We can readily see how value investors, cognisant of the need for rigorous analysis and a margin of safety, could still easily have been burned by many of these affected stocks. To have deployed excessive capital into any of these stocks would likely have proven debilitating.

Value investors understand that the margin of safety is there in part to provide a buffer against shocks. Occasionally however, almost no margin of safety is adequate. To emphasise this point further, two recent examples are worthy of mention. In September 2010, **Takefuji**, not so long ago the largest Consumer Finance company in Japan, filed for bankruptcy. Equity investors have almost certainly lost everything. Just ten years earlier however Takefuji was thriving. Takefuj and its peers had carved-out a highly profitable business in the provision of unsecured loans to consumers. In exploiting the failure of the

commercial banks to cultivate this segment, the top four operators controlled about half of the industry. Interest rates charged often approached 30% and in 2000 Takefuji produced a return on Equity of 20% despite enjoying "excess capital" (equity was about one third of assets; a much higher ratio than that of a traditional bank). In 2006 however there was a change in the legal environment. Takefuji and peers were forced to reduce the maximum rate of interest that could be charged and to reduce the maximum amount that could be loaned to a customer. More seriously the consumer finance companies were deemed to have been charging excessive interest. This opened a floodgate of legal claims for refunds, which has completely overwhelmed the company's entire equity capital. As recently as 2005, before any of the debilitating legal amendments were announced, this company was trading for just 1x book value with equity capital equating to about 50% of total assets. We can easily see how even a disciplined value investor could have been tempted to invest in this company. In fact we know of at least one highly successful value firm that was just so tempted.

Recently **Seahawk Drilling** filed for Chapter 11 Bankruptcy protection. Seahawk owned rigs, which it leased to oil and gas exploration companies in the US Gulf of Mexico. Due to the deterioration in the economy and the regulatory impacts of the Macondo well blowout, customer demand had collapsed and with it the stock. Whilst the company was burning cash, it had credit lines in place and retained a modest net cash asset on its balance sheet. In January 2011, at $7 per share Seahawk traded at just 0.2x stated book value and using management's estimate of the scrap value of the company's rigs, the stock was trading at just 0.5x book value. However in February 2011, former parent **Pride International**, itself in the process of being acquired by **Ensco**, informed Seahawk that it would no longer indemnify it against outstanding tax claims in Mexico, due to the failure of Seahawk to pay credit support fees. Pride also demanded payment of capital it had provided as guarantees. This development probably resulted in default of Seahawk's credit facilities, which meant that the company could no longer finance itself. On February 14th 2011, Seahawk hurriedly announced it was selling, for a price significantly below scrap value, all of its rigs to **Hercules International**, predominantly in exchange for Hercules stock. At the time of writing Seahawk traded at around $6 per share. It would appear that the only reason the stock was not much closer to zero was the fact that Hercules stock had risen by over 80% since the deal was announced. As in the Takefuji example, we can easily see how a value investor could have deployed capital into this investment long before these incapacitating events occurred.

The use of the above examples is not to suggest that these outcomes were utterly unpredictable, but rather to highlight the risks. Every investment is subject to risks. The skill in achieving good long-term returns is the ability to identify and price investment risks appropriately. Identifying and appraising risks associated with businesses operating in a complex and dynamic environment is far more difficult than many appreciate. Investors that fail to identify and appraise risk adequately are unlikely to achieve good long-term returns. And those that fail to do so whilst employing a concentrated investment strategy may find their capital so impaired as to make the attainment of good long-term returns near impossible.

This article questions some fundamental building blocks of value investing. It is our opinion

that sound investing is far more difficult than most commentators and practitioners believe. Indeed, investing is possibly well-suited to only a relatively small number of people i.e. those who possess the requisite technical skills but who also are hard-wired to avoid the biases that affect the vast majority of the population. Moreover, even those with the necessary investment attributes need to recognise the potential for unforeseen risks. Against the advice of Munger, we caution the skilled-few to think long and hard about concentrating capital in a small number of investments.

The Value Investment Institute, April 2011