GUEST SPEAKER

Small Slam!

Charles D. Ellis

My father loved bridge and played often. He was impressed one evening when his bridge partner opened with a preemptive bid: "Small slam—in hearts!" He was astonished when his happy partner said, "It's a laydown!" Dad was astounded as his partner showed his hand: It was all hearts! Aghast, Dad asked the obvious question, "Why didn't you bid *grand* slam?"

He was not amused by the reply: "Because I wasn't sure how much trump support your hand would give me." Dad never fully recovered.

Bridge is a more even-handed game than investing. In tournament bridge, the penalty for *under*bidding is as severe as the penalty for *over*bidding, because both are equally "not right." Both are equally *wrong*.

The same should be true in measuring a portfolio manager's investment performance. For a client, the "opportunity cost" of a gain *not* made will be just as much a loss, over the long term, as any "real" loss. Inappropriate caution should be at least as concerning in investing as in bridge.

As investment managers, wouldn't we be more successful in achieving good results for our clients if we would force ourselves to have at least *some* strong convictions—and act boldly upon those convictions?

For example, why not begin by forcing ourselves to put at least 50 percent of a portfolio in 10 or fewer stocks? (Note that a client with several investment managers already has lots of diversification, *including* diversification of information gathering and decision making. Having each individual manager "fully diversified" results in an excessive number of holdings in the combined portfolio.)

So, our first question is the pervasive "unmentionable": To what extent are we all quasi-indexers? To put the question directly, how much do our actual portfolios truly differ from the index? An even harder question is, what fees are we charging relative to the assets composing this *differentiating portfolio*—or even to the incremental return earned from this differential portfolio?

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The reality is daunting. If the typical institutional portfolio is only 20 percent differentiated from an index fund, then a 0.5 percent *apparent* fee is a 2.5 percent marginal fee for the incremental "differential portfolio." And if this differential portfolio earns a table-thumping incremental 25 percentage points over the benchmark, then incremental fees are actually a daunting 10 percent of the actual value added. If value added on the differential portfolio is only 10 percent, of course, the marginal fee for the incremental portfolio is a deeply daunting 25 percent! At 5 percent value added, the marginal fee is 50 percent!

The publicly available data on institutional managers' investment results are not encouraging. On average, as we are all recurringly reminded, active managers do *not* beat the index—so the industry's average differentiating portfolio is not beating the market. It is getting beaten. Why? One answer may be "taking too much risk." Another answer may be "being too cautious."

The traditional answer to the inherent difficulty in investing is to *diversify*. I'm not so sure. Remember H.L. Mencken's admonition: "For every complicated problem, there *is* a simple answer. And it's *wrong*!"

We know investing is a complicated problem. Is diversification a too-simple answer? Diversification is widely regarded as providing a defense against uncertainty. But does it? Let's take another careful look. First, a long list of holdings is no more "portfolio diversification" than a huge pile of stones is Chartres Cathedral. Both need deliberate design and skillful construction.

Second, increasing the number of holdings dilutes our knowledge, disperses our research efforts, distracts our attention, and diminishes our determination to act—when really called for—decisively and with dispatch. If you work hard enough and think deeply enough to know all about a very few investments, that knowledge can enable you to make and sustain each of your major investments with confidence. The more you "diversify" by increasing the number of different investments

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you must understand, the more you risk increasing your *not* knowing as much about each investment as do your best competitor investors—particularly the most expert and thus the quickest to take preemptive action.

Only a surprisingly small number of well-chosen *different* positions are needed to provide diversification's protection against errors of commission. Usually, this protection can be achieved with fewer than a dozen different positions. After that, increasing the number of different investments in a portfolio increases *uncertainty* more rapidly than it reduces *risk*. Moreover, the *cost* of diversification accelerates geometrically, while the *benefit* of risk reduction decelerates inversely. So, the cost of "diversification" continues to grow at an increasing rate long after the benefit has virtually stopped rising. That is why surplus "diversification" can do more harm than good.

Ironically, the core problem with widely diversified portfolios is that their expected source of *safety* becomes, instead, a real source of *danger*. This phenomenon occurs virtually inevitably because in the fiercely competitive, fast-response, rough and tumble of the professional capital market, the expected defensive advantage of spreading our bets also incurs the central risk of contemporary investment management: the sudden "correction" in a stock's price resulting from the abrupt selling by "quick-reaction" fund managers as they notice and respond suddenly to subtle indicative harbingers of events we did not notice quite as clearly or as swiftly as they did. Anticipating the nascent actions of other potential sellers, those managers take a sudden preemptive action.

Meanwhile, investors who are preoccupied elsewhere—or whose attention is too dispersed for them to be sufficiently attentive to "first warnings"—are not ready or able to take prompt action. Disturbingly, the very portfolio diversification intended, in *theory*, to protect us from risk may, in *practice*, actually be increasing our true uncertainty. This greater uncertainty can cause investors to make errors of commission or of omission that might have been avoided if they had been able to devote enough time to each investment.

Any investor that "lengthens his or her list" will necessarily become increasingly dependent upon others, relying on their research and their analysis and being influenced by their evaluations and judgments—and less confident of the investor's own knowledge and own independent judgment. The ultimate consequence of "sharing" decision making is to become co-opted—a captive of the market where the short term dominates and trading "imperatives" so often drive behavior and prices.

The stock market may be a continuous demonstration of "economic democracy," but the decisions of the most successful investors are *not* democratic. Investing is necessarily—as are all sports, all arts, and all sciences—a *meritocracy*.

Philip Fisher has continued to champion—in writings and in practice during more than half a century—owning the stocks of a few truly outstanding companies and concentrating on becoming sufficiently expert in each of them to stay serenely committed for the very long term. Mies van der Rohe, understanding the distractions of too much detail, admonished his fellow architects that "less is more."

That is why Warren Buffett, the Great American Investor, advises investors to visualize themselves as having a lifetime "decision ticket" with only 20 numbers to punch. Each time you make a decision, punch your ticket. After 20 punches, you must leave the game. You are played out. Buffett has gone so far as to declare four of Berkshire Hathaway's investments *permanent*: Coca-Cola, Disney, GEICO, and the Washington Post Company. Buffett's exemplary results—from a very concentrated portfolio of very long-term holdings based on very thorough homework—give an encouraging indicator of our opportunity.

As investors, we will make better decisions if we concentrate our skills and energies on making fewer and better investments, deliberately searching for the Great Decisions. When turnover is as high as it is today, we are doing so many things that we do not make enough time to think through and resolve to do the *best* things in a very *big* way. That is what makes Warren Buffett and Phil Fisher so special. Larry Tisch is no slouch either. John Neff turned in a generation's best risk-adjusted return for large mutual funds by making astute and courageous long-term portfolio strategy decisions that were comparably concentrated on his best, most rigorously reasoned opportunities.

Consider life. How many truly important decisions do we make in our own private lives? Think of it this way: If the Magnificent Angel came to earth and offered to *eliminate* any major decisions you truly regret having made, conditional only upon your accepting as a substitute a decision of "random" quality, how many such decisions would you put on your list? And if the Magnificent Angel offered to guarantee that your best and most rewarding decisions would be sustained, while others would be subject to possible random-quality revision, how many would you feel you truly had to keep on your list?

Naturally, when addressing the Magnificent Angel, you would self-limit to the *majors*—two or

three key career decisions, your choice of spouse, perhaps a school choice or two, possibly where you live, and so forth. But you are unlikely to ask the Magnificent Angel to guarantee, or change, as many as 20 of your major life decisions—even a dozen would be a lot for most of us. (Another way to think about your list is to write your own obituary and then count the number of key items you have included.)

Most lists *are* short. How many scientists make a dozen important discoveries? How many authors write a dozen great books? How many composers write a dozen major works? How many close friends do you have—or *could* you have and keep?

As investors, how many of us truly understand the importance of our "slugging average"—making our *best* investments our very *biggest*? Are we doing sufficient analysis to make fewer, larger, and longer-lasting investments? Are we just "playing to play," or are we "playing to *win*"? The difference is decisive.

Dad would want to know whether, as investors, we are seriously looking for—and truly ready to bid—*"Grand Slam"*!

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