Diversifying, How Much Is enough?

This is an issue of continuing debate. Some mutual funds carry over a thousand shares. Others, like Trimark only hold a few high quality shares (most of their funds hold about forty different companies). In the "Warren Buffet Way," the author claims that Warren Buffet does not worry about this at all, and that sometimes he is holding as few as five different companies. Also, many of the most successful portfolio managers use a bottom up philosophy, and they ignore industry sectors. They buy quality shares wherever they find them.

We often hear these conflicting arguments. However, we think that any of them can be taken too literally. Investment management is both a science and an art, to be successful you have to apply both.

So what about diversifying? There are two ways to diversify, by economic sectors and by geographic location. Traditionally, this means holding stocks in companies from many different regions and different industry sectors. Taken literally, if you held five Canadian stocks, you would hold one from the Maritimes, one from Quebec, one from Ontario, one from the Prairies and one from the West coast. Of these companies one would be in each of the following five sectors finance, utilities, consumer products, resources and manufacturing. Then again, the Bottom up theorist would say ignore this, and pick the best five companies available.

We think that there is a happy medium. We consider ourselves Bottom up investors, yet we pay a lot of attention to proper diversity. To us, this does not mean following the above literal example, and if there are not any companies in a sector or region that we like, we will not have holdings in

those areas. On the other hand, we continually review how much of our portfolios are in a given industry or geographic region. This is to ensure that we are not over exposed in any one area. If we are holding too high a percentage in say resources or Alberta, we reduce our holdings in that area. Otherwise we are at risk, if Canadian resources are dealt a serious blow, we could be over exposed and might suffer unacceptable losses.

This brings up another question. What constitutes overexposure? In theory, you should have your portfolio spread over the five industry groups. That would mean twenty percent in each group. Realistically, we would expect that at any given time there would be at least one group around thirty, and you might not become concerned until the percentage got closer to forty. This is part of the art. As for Geographic diversification, you can follow the above approach, but you should also compensate for the different populations and economic impact of the regions.

The other question is how many shares to hold? The trick is to find a balance between enough shares to provide adequate diversity, and few enough that you can adequately follow them. Also, while holding a large portion of your portfolio in any given share increases your exposure to loss, if an individual stock makes up only a small portion of your portfolio and it turns out to be a winner, its impact will be watered down.

Here are some suggestions. If you are just starting out, start with about five shares and slowly increase to ten. Eventually, you may want to hold more than that, but we suggest that you be hesitant to go over twenty. Studies have shown that in portfolios of twenty or more common stocks, diversification almost eliminates unsystematic risk. This means that if you are holding twenty different stocks, your risk is nearly all associated with the market, and not with any specific one. Therefore, once you have close to twenty, there is little benefit in holding more and if you hold more, it will be harder to stay knowledgeable about each company.