Financial Planning
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Concentrated Effort: Investing in Focused Funds

Advisors know that diversification should limit risk, but holding too many positions can dilute the benefit from having picked a big winner. In fact, many actively managed equity funds hold so many stocks that they become "index huggers," and simply mimic the performance of their benchmarks - at a higher cost to investors.

The answer for some planners is to use concentrated portfolios for some equity positions. Exactly what constitutes a concentrated portfolio is open to question. Some people would consider a fund holding 50 or fewer stocks concentrated. Certainly, a stock fund with fewer than 30 issues would qualify. According to Morningstar, 350 equity portfolios in its database recently held fewer than 30 stocks.

How well these non-diversified funds do depends on the skill of the manager or managers. Morningstar analyst Kevin McDevitt sees concentrated funds as a powerful tool in the right hands. "In the wrong hands, they can be an absolute disaster," he says.

Roy M. Blumberg, director of client portfolio management at the Philadelphia Group, keeps a majority of the firm's clients' equity assets in index ETFs, citing lower costs and the reality that "most managers don't outperform the benchmarks over time." Even so, Blumberg does occasionally use a fund that holds a limited number of positions "if we truly believe that what the concentrated portfolio is focused on will help us reach our goals and objectives."

TACTICAL APPROACH

He cites the firm's recent use of a concentrated portfolio of master limited partnerships that met dividend and cash flow goals and contributed to total return. But Blumberg sees concentrated portfolios as tactical rather than strategic. He holds such positions as long as they remain attractive, but will not make any one of them a permanent part of the mix. "I describe myself as a long-term renter," he says.

Robert Wander, a planner at New York-based Wander Financial Services, agrees with Blumberg on indexing in at least one equity category. "In the U.S. large-cap equity space, for example, generally speaking I would be more oriented toward an index approach," he says.

But Wander prefers more concentrated portfolios in just about every other equity category. He notes that with active managers, you want their strongest conviction stocks. Once you get beyond about 30 stocks, he says, managers "start getting into second-tier names" to just round out the portfolio.

That's a point that Edward K. von der Linde, portfolio manager of the Linde Hansen Contrarian Value Fund (LHVAX), would endorse. His fund, started last February, generally holds 20 to 40 securities. He doesn't see concentration as an additional management burden.

"That's where the opportunity is," von der Linde says. "That's how you build wealth."

And von der Linde does most of his searching for good investment ideas in the mid-cap area. "Large-cap, in general, is really well owned," he notes. At the other end of the size spectrum, small-cap equities provide too many choices. "It makes it more difficult to separate the opportunities from the dead ends," he says.

BEWARE OF VOLATILITY

When managers limit their portfolios to a few stocks, the result can be more volatility. But, Morningstar's McDevitt argues, that doesn't have to be the case. He cites the Sequoia Fund (SEQUX) and the Yacktman Fund (YACKX) as examples. "There are a lot of concentrated funds that tend to be more long-term oriented," he says. "They'll buy at value prices, but then they'll hold on for the long term."

But highly concentrated funds can and do stumble. How much leeway should advisors give these managers? When does it make sense to exit the position?

"I tend not to be trigger happy," says Wander, who tries to understand what's behind a fund's results. "Is there a reasonable explanation for why there is underperformance?"

For Blumberg, it comes down to a question of process. If the manager changes style, "that's always a concern to me," he says.

Sometimes, planners simply ask themselves an old question: Can you sleep well at night owning this investment? Stan Johnson of Comprehensive Financial Planning in Durango, Colo., once held the concentrated Fairholme Fund (FAIRX) in client portfolios. "I actually sold out of that ... because I saw the big bet in financials and wasn't comfortable with that," he says. Johnson admits that he has no formula to cite. "It's more an art than a science," he explains.

PROTECTING THE DOWNSIDE

A formula is very important to Rich Winer of Winer Wealth Management in Woodland Hills, Calif. He uses a concentrated portfolio for equities, picking the stocks himself using fundamental analysis. He then relies on a technical analysis program to tell him when to sell a position. "Protecting the downside is always job one," he says.

When Winer began his career as an RIA, he subscribed to modern portfolio theory and advised clients to hold a diversified portfolio. He tried different strategies, including low volatility and long-short portfolios. "It hedged out the return," he observes.

Eventually, he found other advisors using the technique he now employs. Winer selects 24 stocks, equally divided among large-, mid- and small-cap issues. The issues are diversified by sector and industry. Most of the names are

U.S. equities, and although Winer occasionally buys a foreign stock, he holds no emerging market issues. He manages risk by moving more into cash when the computer program indicates it is prudent to do so.

He acknowledges he was whipsawed during a short period of extreme market volatility in 2011. "We're back on track," Winer says. "It's not going to be perfect all the time, but the long-term results have been fabulous."

Winer's technique isn't likely to be copied by a large majority of planners, who use other methods to manage risk. "At the asset-class level, I think that more diversification is better," Wander says. "The issue with most portfolios is that they don't have enough asset classes."

Johnson also favors asset allocation strategies. "I'm more of an asset allocator than a fund picker," he says.

WHAT CLIENTS NOTICE

But whatever the investments selected, concentrated or not, they probably don't register on the radar of most clients. Wander notes than many clients don't have the knowledge or interest to engage in that conversation, or they just prefer to delegate. Johnson agrees that clients don't notice if they are in concentrated equity portfolios. "I haven't had a single client bring it up," he says.

What clients do notice is the performance of their overall holdings. And von der Linde believes that is part of the case for using concentrated equity funds in client portfolios. He notes that bonds don't grow and an acre of land can't double in size. "Common stocks are the only things you can invest in that grow," he says.

But Blumberg notes that advisors have to use some caution in selecting nondiversified funds. "If you're betting on a concentrated portfolio, you'd better understand in great detail how this person makes his decisions," he says, "because each holding is going to mean a lot more."

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