



Hosking Partners[®]

Hosking Post

The investment case for diversification

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THE INVESTMENT CASE FOR DIVERSIFICATION

“Diversification is the only free lunch in investing.”

Harry Markowitz

“A well-diversified portfolio needs just four stocks.”

Charlie Munger

Diversification’s benefits in terms of optimising risk-adjusted returns are generally recognised, yet the fashion in investment has increasingly been for managers who have concentrated portfolios. How does this paradox get resolved? In short, we see a huge opportunity for diversified yet actively managed portfolios, particularly in today’s concentrated markets.

Seventy years after Harry Markowitz famously said that diversification is “the only free lunch in investing,” many investors find it difficult to track down the restaurant where this legendary meal is served. Historically, passive funds have been considered the smart way to diversify a portfolio, but they have become increasingly concentrated - technology, media and telecom stocks now comprise an even larger share of the S&P 500 market cap than during the 1990s dotcom bubble.¹

On the other hand, active fund managers have shunned diversification in favour of concentration in a small number of stocks. The sentiment voiced by David Tepper that you “can’t make money with a diversified approach” has become the conventional wisdom. Active funds advertise their concentration as a measure of their conviction and, with it, implied skill.

For a long roll call of famous managers promoting a concentrated approach and criticising diversification, of which the Charlie Munger quotation at the start of this piece is just one example, see <https://mastersinvest.com/diversificationquotes>. It will not escape notice that concentrated portfolios result in greater volatility, and therefore asymmetric outcomes in terms of fees paid to managers.²

¹ Bloomberg.

² This calls to mind another Charlie Munger quotation: “Show me the incentive and I’ll show you the outcome”.



Concentration therefore seems to be the *menu du jour*, even as some wonder whether the larger stocks which dominate concentrated portfolios are approaching their ‘best before’ date. If tastes are in fact about to change, the kitchen at Hosking Partners has been open for more than a decade, and reservations are available. As we set out our stall for a diversified offering, we take the opportunity to address the arguments made against diversification by those who say that concentration is the only way.

“Diversification is simply index-hugging in disguise, offering passive returns for an active fee”

We would submit that diversified portfolios can (and do) look very different from the index. In a universe of 40,000 listed stocks, the number of possible portfolios containing 400 names is

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which is more than the number of atoms in the universe. Similarly, the dispersion of returns from diversified portfolios shows outcomes can be very different from the index.



As just one example of this point, Hosking Partners' portfolio of c. 370 stocks returned 33.5% (net) in 2025, outperforming the ACWI index by some 1,114 bps, driven by strong performance across a number of materially different exposures that we have selected and scaled over time.

“A concentrated portfolio is a demonstration of a manager's confidence in his or her stock-picking ability”

The implication here is that concentration risk is correlated with superior returns. We would say that the aim of an investor should be to maximise returns rather than to maximise risk. We prefer the ‘fat tail’ over the ‘fat pitch’.

“Only a concentrated manager has sufficient time and resource to research and monitor stocks with the necessary attention and detail”

In a world of complex adaptive systems, beware confusing knowledge of inputs with control over outputs. We call this the illusion of control. Often gathering more information suffers from diminishing returns in terms of predictive accuracy, yet is accompanied by increasing, but undeserved, confidence.³ Better to spend finite time identifying more opportunities with the same attractive odds, than to invest it in ever deeper research into the same stock.

“In a diversified portfolio, no individual stock can make a difference”

Just as it is not simply the case that diversification results in lower volatility – recall how many diversified portfolios it is possible to construct from the universe of listed stocks – so it is the case that a diversified portfolio is not a ‘closet indexer’.

The selection and weighting of individual stocks in a diversified portfolio can make a large difference, particularly for an active manager like Hosking Partners that is able to deviate significantly from benchmark weightings.

Ultimately it is the cumulative alpha of the portfolio's constituents, rather than the returns of any individual stock, that determine the overall outcome.

³ In a study, eight expert horse-race handicappers were shown a list of 88 variables. They were asked to select the five most important items of information, then to select the 10, 20 and 40 most important variables. They ranked the top five horses in order of expected finish using the data in increments of 5, 10 and 40 variables. More information resulted in no increase in predictive accuracy, despite higher confidence. *Behavioural Problems of Adhering to a Decision Policy*, Slovic, Paul, paper presented at the Institute for Quantitative Research in Finance (1 May 1973)



Our diversified approach

Having addressed the primary arguments *against* diversification, we outline below why we at Hosking Partners believe so strongly in having an actively managed portfolio with a large number of stocks.

First, it reduces exposure to crowded trades. Years of momentum mean that passive strategies are increasingly concentrated in large companies. At the same time, concentrated active managers are similarly attracted to large-cap companies, because they need the liquidity on offer to accommodate the larger-sized bets which are the result of owning fewer stocks.

Diversified managers are better placed to avoid this congestion and its associated overvaluation – they have the freedom to fish where the fish are, rather than where the fishermen are.

A diversified portfolio can make more room for risk at the level of individual stocks. This so-called idiosyncratic risk may take the form of liquidity, size or even information availability, provided the price is sufficiently attractive to compensate. Non-correlated idiosyncratic risk in a diversified portfolio should contribute to incremental returns.

It is dynamic. As markets evolve, a diversified manager can adjust their portfolio faster and more easily than the process involved in switching between concentrated managers.

Academic literature supports our views. Various studies have shown that expected risk-adjusted returns continue to increase with the number of stocks beyond what is the conventional wisdom of 18 to 50 stocks. Put another way, investors in concentrated portfolios are not compensated for the extra risk that they could have diversified away by investing in more stocks.

In a 2010 study,⁴ Bennett and Sias note that “conventional wisdom, the CFA curriculum, the SEC, and nearly every finance textbook holds that investors can easily form well-diversified portfolios by owning a relatively small number of securities—typical estimates range

⁴ Bennett, James A. and Sias, Richard W., Portfolio Diversification (January 15, 2010). Available at SSRN: <https://ssrn.com/abstract=728585> or <http://dx.doi.org/10.2139/ssrn.728585>



between eight and 30 stocks, although more recent estimates suggest 50 stocks are needed. Conventional wisdom is wrong.”

Which brings us to the perennial question: how many stocks are enough? We would caution against the comforting idea that as few as 30 or 50 names can diversify away the non-systemic risk in a portfolio. Diversification benefits continue well beyond that point, with improvements in risk-adjusted returns observed as portfolios expand into the hundreds of holdings. The number of stocks held should be limited only by the availability of genuinely good ideas at attractive prices.

Hosking Partners’ multi-counsellor framework harnesses the efforts of our generalist portfolio managers, using the lens of the capital cycle, to create a truly differentiated diversified global portfolio with c. 370 stocks. Our portfolio provides opportunistic exposure across regions, sectors and market caps, having outperformed the MSCI ACWI Value index with lower volatility over every trailing period since inception in 2013, while materially outperforming both the MSCI ACWI index and MSCI ACWI Value index in 2025, again with lower volatility.

The strategy continues to be well positioned to generate long-term strong results for our clients in an ever-more-concentrated market where many are seeking something different to complement their current equity allocation.

LUKE BRIDGEMAN

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