CAN LESS REALLY BE MORE?
CONCENTRATING ON FAVORITES

By Albert J. Fredman

Focused funds have grown in popularity in the belief that a hot-handed stockpicker who focuses on a few dozen favorite companies may have a better chance of beating the market than one who must invest in 100 or more names. But concentration is a double-edged sword.

Less may be more with stock portfolios, according to a growing number of fund managers. Their logic is simple: Find a few wonderful companies, take big positions, and hold on—a manager's first 10 picks are bound to be better than choices 101 through 110.

This thinking, in part, has been in reaction to the popularity of the S&P 500 index funds, which incur far lower fees and trading costs than the typical actively managed fund. Critics claim that managers holding 100 or more stocks basically are closet indexers attempting to keep pace with a benchmark such as the S&P 500, but the majority of managed funds lag the market, in part due to their higher expenses. Is there still a place for savvy managers?

THE BUFFETT EFFECT

Enter focused funds. A keen interest recently has developed in these concentrated portfolios, which may own two dozen or fewer companies. A hot-handed stockpicker who focuses on one or two dozen favorite companies may have a better chance of beating the S&P 500 over a span of years than one who must invest in 100 or more names to meet diversification requirements. Although wide diversification is prudent for funds that own volatile small or micro-cap stocks, it's not crucial with big blue chips. And some feel it may not be important with a carefully selected portfolio of medium-sized companies either.

Warren Buffett achieved legendary investment results by focusing Berkshire Hathaway on less than 10 of his favorite businesses. The value-oriented Sequoia Fund has delivered market-beating results since its 1970 inception by concentrating investments. This $4.2 billion portfolio, which recently had about 34% of its assets in shares of Berkshire Hathaway, has been closed to new investors since 1982. Janus Twenty also has produced eye-catching returns with a focused approach since its 1985 inception.

About 105 of the 1,630 actively managed diversified domestic stock funds in Morningstar's database recently held 30 or fewer stocks, whereas the average number of stocks for most funds is more than 100. Fidelity Magellan, the largest fund in the world with more than $70 billion in assets, recently held about 350 stocks. Thus, it's easy for an individual who owns several domestic stock funds to have positions in hundreds of companies. It's likely that no single issue will amount to more than 1% of the investor's total assets. The more funds and companies you own, the greater the chance that your results will lag the market. That's because mutual funds hold some cash, incur trading costs, and shoulder management fees and other expenses typically totaling from 1.2% to 1.4% of assets for a domestic stock fund.

Concentration is a double-edged sword, however. Big bets can reap spectacular rewards when a select few favorites deliver exceptional returns. Conversely, the leveraged impact of a bad apple or two can cause a fund's net

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asset value to spiral downward.

DEFINING DIVERSIFICATION

Most mutual funds are classified as "diversified" under the Investment Company Act of 1940. At least 75% of a diversified fund's assets must be invested in accordance with the following guidelines:

- No more than 5% of assets can be invested in any one stock. If, however, a position appreciates to more than 5%, the excess need not be sold.
- No more than 10% of the voting stock of any company can be owned.

Funds that don't follow these two guidelines for 75% of their assets are classified as "nondiversified." However, to qualify for the customary tax treatment as a regulated investment company under the Internal Revenue Code of 1986, nondiversified funds must follow the above two guidelines for at least 50% of their assets. In addition, no more than 25% of a nondiversified fund's assets can be invested in any one corporate issuer. Thus, at the extreme, a nondiversified fund could concentrate 50% of its portfolio in just two stocks!

Most—but not all—focused funds are nondiversified, so they can take extra large positions in a handful of companies. For example, the 14-stock Yacktman Focused fund recently had 18.2% of its assets in Department 56, its top holding. Its second largest position, Philip Morris, amounted to 14% followed by First Data Corp. at 9.7% of assets. Gintel's top three included Mercury General Corp. (19.1%), Checkfree Holdings (17.3%), and Checkpoint Systems (8.2%). The breakdown for Clipper Focus was Philip Morris (14.1%), Freddie Mac (11.5%), and Fannie Mae (11.5%). In addition to focused funds, sector funds often are nondiversified. A fund's prospectus will tell you if the portfolio is nondiversified.

The managers of diversified funds that hold many stocks can and often do overweight their top picks. This could happen if a fund builds meaningful positions in favored companies or holds onto winners that mushroom into dominant positions. In order to beat the market, a manager must overweight some stocks and underweight others. But diversified funds keep the majority of their assets in a diverse mix of other stocks that will offset unpleasant surprises in larger positions and reduce the portfolio's volatility.

CONCENTRATION RISKS

While focusing on a dozen or two favorites gives a talented manager greater potential to produce better long-run returns, it also tends to increase volatility. Further, if a handful of the securities perform poorly, a tightly focused portfolio could incur greater losses than a widely diversified fund. Because of their heavier weightings, the ups and downs of individual issues have an amplified impact on the portfolio.

The risks of a concentrated fund include the following:

Company risk: Academic research has determined that with at least 12 and preferably 20 *randomly selected* stocks in a portfolio, most company-specific risk is eliminated. In other words, the odds of being wiped out by just one or a few stocks are minimal. The misfortunes that weigh heavily on some companies are offset by the good fortunes of others. Focused funds hold more than a dozen stocks; however, the investments are not randomly chosen. They mesh with the manager's style and sector preferences, if any. And, 20% to 25% of the fund's assets may be parked in a single company that could fizzle out.

Sector risk: Effective diversification is dependent not only on the number of stocks owned but also on the differences among them. Spreading money across industries is another way risk is controlled. Although focused funds normally have far more industry diversification than sector funds, some managers take big industry bets.

Liquidity risk: Concentrated funds normally hold large positions in their target stocks, especially if assets have surged due to a successful track record. Thus, if a holding deteriorates, the fund may face a large price concession when selling a big block of its shares. Conversely, the price could be driven up when the manager accumulates a large position in a new favorite.

Management risk: Concentration can work wonders for a hot-handed stockpicker such as Warren Buffett, but it can spell disaster for those with icy fingers. Unfortunately, only a handful of truly brilliant stockpickers exists. According to the efficient-markets hypothesis, it's very difficult for a manager to do better than average, particularly with large actively traded, heavily researched companies. That's because stock prices are said to hover near their true values.

Redemption risk: Because nondiversified funds often exhibit heightened short-term volatility, they can experience substantial withdrawals by panicky investors during turbulent times. This could force a manager to sell shares to meet redemptions, which could lead to additional capital gains distributions from the sale of appreciated securities and the premature sale of other investments that have not had time to bear fruit. For example, redemptions forced Donald Yacktman to sell nearly 10 of Yacktman fund's 30 stocks in 1998, according to Morningstar.

Of course, the sector, liquidity, management, and redemption risks apply to other categories of stock funds besides those that concentrate. But their impact may be greater with a nondiversified portfolio.

FUND CHARACTERISTICS

Table 1 provides selected

Morningstar data on a group of focused funds. With the exception of Janus Twenty, all have fewer than 30 stocks and nearly all have 50% or more of their assets in the top 10 holdings. Twelve of the 27 funds have started since 1996. Acorn Twenty, the newest, began on November 23 and invests in 20 to 25 mid-cap domestic stocks. Focused fund assets range from $1.4 million for the tiny Mosaic Focus to $10.4 billion for Janus Twenty. The funds have either a mid-cap or large-cap orientation—a concentrated small-cap fund could be very risky because of the greater vulnerability of small stocks to investment risks.

Table 1 also lists recent turnover rates. Some focused managers may hold onto their favorites and thus have lower turnover rates than their more diversified peers. But styles vary and turnover rates fluctuate from year to year.

The managers of CGM Capital Development, Clipper, Mosaic Mid-Cap Growth, Papp America-Abroad, and Yacktman have recently introduced portfolios with the word "focus" in their names. These funds are even more concentrated than their older siblings. The new Clipper Focus, which expects to hold 15 to 35 stocks, is a fully invested version of the older Clipper Fund. The latter could have 40% or more of its assets in cash when the management feels stocks are pricey, whereas the former is limited to a 5% cash stake. Both Clipper funds are team managed.

Howard Moss, manager of Harbor International Growth, provides pure foreign-stock exposure with his 27-stock portfolio. The fund's 88% stake in Europe also is extreme compared with the typical, geographically diversified international fund.

In addition to his 16-stock Papp

TABLE 1. SELECTED FOCUSED FUNDS

Fund	Inception Date	Category	Number of Stocks	Net Assets ($ Millions)*	Assets in Largest Holding (%)	Assets in Top 10 Holdings (%)	Portfolio Turnover Rate (%)
Acorn Twenty	11/98	MG	20	20.0	—	—	—
Berger Select	12/97	MG	23	62.1	7.0	76	—
CGM Capital Development**	6/61	MB	24	753.0	6.3	54	230
CGM Focus	9/97	MB	22	154.0	11.1	58	—
Clipper	2/84	LV	23	962.1	12.3	75	31
Clipper Focus	9/98	LV	23	14.0	—	—	—
Gintel	6/81	MV	15	118.1	27.0	73	52
Harbor International Growth	11/93	Foreign (LG)	27	1,054.5	6.2	51	76
Janus Twenty	4/85	LG	34	10,376.8	10.0	57	123
Longleaf Partners	4/87	MB	23	3,700.0	12.9	74	38
Marsico Focus	12/97	LG	23	892.3	14.6	63	—
Mosaic Focus	12/97	LB	15	1.4	12.1	—	—
Mosaic Mid-Cap Growth	7/83	MB	26	9.7	5.4	51	—
Oak Value	1/93	MG	26	462.4	9.2	55	15
Oakmark Select	11/96	MV	17	1,227.9	11.7	71	—
Papp America-Abroad	12/91	LG	26	271.8	9.2	62	5
Papp Focus Fund	3/98	LG	16	3.0	9.7	71	—
PBHG Large Cap 20 PBHG	12/96	LG	20	381.2	6.6	64	98
PBHG Select Equity	4/95	MG	25	246.5	6.9	70	72
Philadelphia	3/23	LB	23	117.1	6.6	53	17
Sequoia**	7/70	LV	16	4,190.3	34.2	94	8
Stein Roe Large Co. Focus	6/98	LG	21	42.7	7.0	61	—
Strong Growth 20	6/97	MG	26	53.1	7.7	52	—
Vontobel U.S. Value	3/90	LV	17	190.4	9.7	68	90
White Oak Growth Stock	8/92	LG	24	824.6	7.0	58	8
Yacktman	7/92	MB	23	422.7	13.5	69	69
Yacktman Focused	5/97	MV	13	44.2	18.0	79	—

**As of October 31, 1998, or more recent date for some individual funds.*
***Closed to new investors.*
Source: Morningstar, Inc., and individual funds.

Key to Categories:
LB = large-cap blend MB = mid-cap blend
LG = large-cap growth MG = mid-cap growth
LV = large-cap value MV = mid-cap value

Focus Fund, L. Roy Papp and his daughter-in-law Rose manage three other concentrated funds, which own 30 or fewer stocks. All invest in large U.S. companies, such as General Electric, that derive at least one-third of their revenues from foreign sales. Thus, the Papps get international exposure with less risk than they would by investing directly. [An interview with Mr. Papp on his America-Abroad Fund starts on page 27.]

So-called “focused” funds that target about 50 stocks are not included in Table 1. For example, Royce Premier, a small-cap value fund, typically holds 50 stocks. In contrast to the typical nondiversified focused fund, it is a diversified fund and its top 10 holdings normally amount to about 30% of its assets. The recently introduced Acorn Foreign Forty invests in 40 to 60 mid-cap companies traded in developed foreign markets. Montgomery Select 50, launched in January 1996, holds at least 50 stocks, with each of the company’s five investment teams choosing 10. The areas represented include foreign stocks in both developed and emerging markets as well as a variety of U.S. stocks, including micro caps. Neuberger & Berman Focus, a large-cap value fund, takes a sector approach by going with its best picks in six out-of-favor sectors. The fund normally holds 40 to 50 stocks. The manager of Janus Olympus, a nondiversified aggressive growth fund, recently has focused on 45 to 55 stocks.

PERFORMANCE

Table 2 provides performance and volatility numbers for eight focused funds with at least a 10-year history. The performance numbers of each are compared with its respective peers. In addition, the Vanguard 500 Index fund is included as a benchmark. As you might expect, performance variations are wide, but four of the funds outperformed both their peer groups and the Vanguard 500 Index over the 10-year span. Management tenure also is provided in Table 2. Tom Marsico of Marsico Focus built his reputation as manager of Janus Twenty, having produced a 21% average annual return over the 10 years ended December 1997. The buy-and-hold, large-cap investor then left Janus to establish the Denver-based Marsico fund family in December 1997. Scott Schoelzel now manages Janus Twenty.

While past performance is not necessarily predictive, these numbers at least demonstrate that concentration can work well in the hands of a deft stockpicker. Nevertheless, a concentrated fund could lag its peers for an extended period, as is evident in Table 2. Thus, investors may have assumed greater risk for lower returns. Finally, the results in Table 2 were produced during an unprecedented bull market, as evidenced by the abnormally high returns on the Vanguard 500 Index fund. How would these funds have fared in more normal times?

The highly focused American Heritage, which does not appear in Table 2, is a very extreme example of the perils of concentration. This $7.5 million offbeat fund returned a stunning 75% in 1997, making it the top-performing fund that year. Conversely, it declined 56% in 1998 (through December 7). And it had an annualized return of –2.76% over the 10 years ended November 30, 1998. Because it mainly focuses on small companies and recently had 81% of its assets in its largest holding, this aggressive growth fund certainly is not a typical focused fund.

If you are intent on finding the next decade’s celebrity focused fund managers, here’s a word of caution: Don’t bet too heavily on the so-called “hot-hands” phenomenon. While confining your search to managers and funds with exceptional records makes sense, it could result in disappointment. You never can know for sure who the handful

TABLE 2. PERFORMANCE AND VOLATILITY OF OLDER FOCUSED FUNDS

		Annualized Total Returns (%)* and Differences from Category Averages			Standard Deviation (%)
Fund	**Manager (since)**	**3 yrs.**	**5 yrs.**	**10 yrs.**	
CGM Capital Develop	G. Kenneth Heebner (1976)	30.8 (+7.4 high)	17.3 (+0.3 av)	20.0 (+2.3 abv av)	17.1—high
Clipper	James H. Gipson, Michael C. Sandler (1984)	31.2 (+5.3 high)	19.6 (+2.2 abv av)	17.6 (+1.1 abv av)	9.6—av
Gintel	Robert Gintel (1981)	30.4 (+4.5 abv av)	13.5 (–3.9 low)	15.0 (–1.5 blw av)	11.0—abv av
Janus Twenty	Scott W. Schoelzel (1997)	31.2 (+7.8 high)	16.8 (–0.2 av)	21.1 (+3.4 high)	14.2—high
Longleaf Partners	O. Mason Hawkins, G. Staley Cates (1987)	25.5 (–0.4 av)	21.3 (+3.9 high)	19.9 (+3.4 high)	10.3—av
Mosaic Mid-Cap Grth	Jay R. Sekelsky, Frank Burgess (1996)	15.2 (–8.2 low)	11.0 (–6.0 low)	11.7 (–6.0 low)	13.2—abv av
Philadelphia	Donald H. Baxter (1987)	24.9 (–0.3 av)	16.1 (–1.2 blw av)	13.7 (–1.7 blw av)	10.6—av
Sequoia	William J. Ruane, Richard T. Cunniff (1970)	35.0 (+9.1 high)	23.0 (+5.6 high)	19.4 (+2.9 high)	13.2—abv av
Benchmark Portfolio					
Vanguard 500 Index	George Sauter (1987)	31.0 (+5.8 high)	20.1 (+2.8 high)	17.8 (+2.4 high)	11.2—abv av

**For periods ended 12/31/97.*
Source: American Association of Individual Investors

of superstar stockpickers and their funds will be going forward.

USING FOCUSED FUNDS

Investors in focused funds should have a time horizon of at least five to 10 years. Before committing a substantial slice of your assets to a focused fund, recognize that you would be making a big bet that the manager will deliver outstanding returns over an extended period. Could you accept the potential risk of having held a more volatile fund for five or 10 years that underperformed the market? Yet, it's important to give a manager a fair chance. This means holding on for, perhaps, at least two years.

Finally, investors in concentrated funds face a dilemma. If you take too large of a position in one fund you face considerable management and company risk. Conversely, if you invest too little, a manager who delivers stellar returns might not do much for your overall portfolio. If compact funds are for you, it's advisable to limit your stake in any one focused fund to 25% of your total stock allocation.

SELECTION GUIDELINES

Here are eight factors to weigh when considering investing in a focused fund:

- *Total assets*: Think carefully about investing in a fund that counts its assets in the billions. To be successful, a focused fund has to limit its size, otherwise it would be forced to take huge positions in its 20 or 30 favorite stocks. Big trades lead to high transaction costs. That's why some compact funds have closed to new investors.
- *Sector concentration*: Be wary of focused funds that make large sector bets. The portfolio will be hit hard if overweighted sectors get in trouble. Look for a fund that diversifies into at least seven industries.
- *Portfolio turnover*: High-turnover funds incur greater transaction costs and tend to be less tax efficient. Ideally, very low turnover goes hand in hand with concentration because a manager who is deeply committed to a handful of companies should remain loyal.
- *Management*: Brilliant stock picking is crucial. Even though top performers often lose their luster, it still makes sense to invest in funds with better track records, all else equal. If a focused fund is new, look at the manager's track record with other funds.
- *Number of stocks*: Some focused funds might hold 40 to 60 stocks. If such a fund is classified as nondiversified and its top 10 holdings amount to 50% or more of its total assets, it still meets most of the criteria for being focused. However, if you want a true focused fund, confine your search to those holding 30 stocks or fewer.
- *Percentage of assets in top holdings*: Some funds may bet heavily on just two or three stocks, greatly increasing company-specific risk and volatility. The overall portfolio could suffer significantly if just one of those should fizzle. Conversely, the fund's returns could far outdistance its rivals if a big position happened to soar.
- *Cash position*: Does the fund remain fully invested or will the manager retreat to cash when stocks appear pricey? Clipper did this about a year prior to the market downturn in 1987 and also in the last several years. As a consequence of selling stocks, Clipper made a large capital-gains distribution in 1998. To maintain control over their asset-class weights, many investors prefer to stick with funds that remain fully invested.
- *Management ownership*: Robert Gintel, Thomas Marsico, L. Roy Papp, and Donald Yacktman are among the managers who are heavily invested in their own funds. Managers with a significant slice of their personal assets in their funds should have more incentive to do their best. Of course, there are no guarantees. You might be able to find out about management ownership by calling the fund company or checking the Statement of Additional Information. However, this information is not always available because legally funds are not required to provide it.

CONCLUSION

Mutual funds have a reputation for lagging market benchmarks. In part, this is because they are so widely diversified that the manager's favorite stocks don't have that much impact on performance, even if they do well. Conversely, focused funds may give a skilled stockpicker a better shot at outperforming the market. However, betting heavily on the manager of one compact fund can be risky because such funds can underperform for lengthy periods due to their greater management and company risks.

In sum, there are three things to remember about focused funds:

- By itself, holding fewer stocks leads to more volatile returns but not to higher average annual returns. Just because managers say they are focusing on their best ideas doesn't mean they will succeed.
- Buffett-like stock picking is the key to success. However, there are only a handful of truly great stockpickers, and it is very difficult to know who those stars are in advance.
- A manager's past record is not necessarily predictive even though it is an important consideration for prospective investors. Be sure to avoid focused funds with bad long-term performance records because poor performance tends to persist. ✦