MORNINGSTAR Managed Portfolios

Investment Insights
The Case for Focused, Concentrated, Bottom-Up Holdings

Morningstar Investment Management LLC
January 2020

John Owens
Senior Portfolio Manager
john.owens@morningstar.com

For General Public Use

How Many Stocks is Enough?

In constructing a portfolio for a Select Equity Portfolio, we typically invest in 20-40 individual stocks. We believe this focused approach provides an investor with several clear-cut advantages.

First and foremost, it allows us to concentrate the portfolio in our highest-conviction ideas. Second, a concentrated portfolio allows us to follow our individual investments much more intensively, which gives us a special confidence in seizing opportunities to buy low and sell high. Third, this approach allows us to help minimize the cost of trading, including taxes andbid-ask spreads.

To sum up, we believe that investing in this manner gives us the best odds of delivering superior returns for investors over the long haul.

Key Takeaways

- At Morningstar Investment Management, we build Select Equity Portfolios from the bottom up, seeking to hold the most attractive stocks for the long run.
- By embracing volatility, rather than fearing it, an investor can benefit from buying low and selling high. This improves the case for concentration.
- Many of the greatest investors think the same way. By focusing on your best ideas and managing risks, you can improve the likelihood of delivering strong returns.

Concentration Versus Diversification. Or Both?

While we favor concentrated portfolios, we still believe in the benefits of diversification. Putting too many eggs into one basket raises the risk of wiping out most, if not all, of an entire investment. The question is how many stocks would reduce as much of the company or industry-specific risk as possible, but, at the same time, still provide an opportunity to deliver market-beating returns?

This is a much debated issue. In a 1968 study, Evans and Archer concluded that a portfolio of 15 randomly chosen stocks would be no more risky than the market as a whole. Recent academic research, however, indicates that upward of 40 or 50 stocks may actually be needed, because stocks are a lot more volatile than they used to be.

That said, we don't measure risk in the same manner. While academics consider volatility a bad thing, we embrace it, because volatility provides more opportunities to buy stocks at low prices and to sell them at high prices. When it comes to risk, we're much more concerned about a permanent impairment of capital, than mere volatility. We believe our strategy of focusing on select stocks with durable competitive advantages, which trade well below our intrinsic value estimates, helps to minimize that risk.

In addition, we do not randomly select stocks, as the academics do in their studies. Our Select Equity Portfolios generally consist of stocks from a variety of industries, with a diversity of investment characteristics. While we may overweight or underweight certain industries or sectors, based on their relative attractiveness, we do not "bet the farm" on any individual stock, industry, or sector.

We'd also note that Select Equity portfolios generally include several global mega-cap stocks. These firms have multiple business lines selling numerous products/services in various geographies to a broad base of customers. They offer more diversification than the typical stock. So, there are many more factors to consider than just the absolute number of stocks. We believe our approach of investing in 20 to 40 of our highest-conviction stock ideas across numerous industries provides sufficient diversification for the equity investor, but still retains the potential for attractive returns over the long run.

Don't Take Our Word for It

Several legendary investors as well as a renowned economist also favor concentrated portfolios. We share some of their thoughts on this subject below:

(The opinions expressed below are those of the authors and are not necessarily those of the Morningstar Investment Management group).

"In my view, it's best to own as many stocks as there are situations in which (a) you've got an edge; and (b) you've uncovered an exciting prospect that passes all the tests of research … There's no use diversifying into unknown companies just for the sake of diversity. A foolish diversity is the hobgoblin of small investors. That said, it isn't safe to own just one stock, because in spite of your best efforts, the one

you choose might be the victim of unforeseen circumstances. In small portfolios, I'd be comfortable owning between three and ten stocks." -- Peter Lynch

"We believe that a policy of portfolio concentration may well decrease risk, if it raises, as it should, both the intensity with which an investor thinks about a business and the comfort-level he must feel with its economic characteristics before buying into it." -- Warren Buffett

"Usually a very long list of securities is not a sign of the brilliant investor, but of one who is unsure of himself. If the investor owns stock in so many companies that he cannot keep in touch with their managements directly or indirectly, he is rather sure to end up in worse shape than if he had owned too few companies. An investor should realize that some mistakes are going to be made and that he should have sufficient diversification so that an occasional mistake will not prove crippling. However, beyond this point he should take extreme care to own not the most, but the best. In the field of common stocks, a little bit of a great many can never be more than a poor substitute for a few of the outstanding." -- Philip Fisher

"As time goes on, I get more and more convinced that the right method in investment is to put fairly large sums into enterprises, which one thinks one knows something about and in the management of which one thoroughly believes. It is a mistake to think that one limits one's risk by spreading too much between enterprises about which one knows little and has no reason for special confidence. One's knowledge and experience are definitely limited and there are seldom more than two or three enterprises at any given time, in which I personally feel myself entitled to put full confidence."
-- John Maynard Keynes

Disclosures

Opinions expressed are as of the current date; such opinions are subject to change without notice. Morningstar Investment Management shall not be responsible for any trading decisions, damages, or other losses resulting from, or related to, the information, data, analyses or opinions or their use. This commentary is for informational purposes only. The information, data, analyses, and opinions presented herein do not constitute investment advice, are provided solely for informational purposes and therefore are not an offer to buy or sell a security. Please note that references to specific securities or other investment options within this piece should not be considered an offer (as defined by the Securities and Exchange Act) to purchase or sell that specific investment. Performance data shown represents past performance. Past performance does not guarantee future results.

All investments involve risk, including the loss of principal. There can be no assurance that any financial strategy will be successful. Morningstar Investment Management does not guarantee that the results of their advice, recommendations or objectives of a strategy will be achieved.

This commentary contains certain forward-looking statements. We use words such as "expects", "anticipates", "believes", "estimates", "forecasts", and similar expressions to identify forward-looking statements. Such forward-looking statements involve known and unknown risks, uncertainties and other factors which may cause the actual results to differ materially and/or substantially from any future results, performance or achievements expressed or implied by those projected in the forward-looking statements for any reason. Past performance does not guarantee future results.

Morningstar® Managed Portfolios℠ are offered by the entities within Morningstar's Investment Management group, which includes subsidiaries of Morningstar, Inc. that are authorized in the appropriate jurisdiction to provide consulting or advisory services in North America, Europe, Asia, Australia, and Africa. In the United States, Morningstar Managed Portfolios are offered by Morningstar Investment Services LLC or Morningstar Investment Management LLC, both registered investment advisers, as part of various advisory services offered on a discretionary or non-discretionary basis. Portfolio construction and on-going monitoring and maintenance of the portfolios within the program is provided on Morningstar Investment Services behalf by Morningstar Investment Management LLC. Morningstar Managed Portfolios offered by Morningstar Investment Services LLC or Morningstar Investment Management LLC are intended for citizens or legal residents of the United States or its territories and can only be offered by a registered investment adviser or investment adviser representative.

Investing in international securities involve additional risks. These risks include, but are not limited to, currency risk, political risk, and risk associated with varying accounting standards. Investing in emerging markets may increase these risks. Emerging markets are countries with relatively young stock and bond markets. Typically, emerging-markets investments have the potential for losses and gains larger than those of developed-market investments.

A debt security refers to money borrowed that must be repaid that has a fixed amount, a maturity date(s), and usually a specific rate of interest. Some debt securities are discounted in the original purchase price. Examples of debt securities are treasury bills, bonds and commercial paper. The borrower pays interest for the use of the money and pays the principal amount on a specified date.

The indexes noted are unmanaged and cannot be directly invested in. Individual index performance is provided as a reference only. Since indexes and/or composition levels may change over time, actual return and risk characteristics may be higher or lower than those presented. Although index performance data is gathered from reliable sources, Morningstar Investment Management cannot guarantee its accuracy, completeness or reliability.

About Morningstar's Investment Management Group

Drawing on our core capabilities in asset allocation, investment selection, and portfolio construction, Morningstar's Investment Management group provides a global point of view and local market experience. Our investment professionals, located around the world, are guided by core principles focused on long-term investment results and helping end investors reach their financial goals. Built around world-class investment strategies and harnessing the global resources of Morningstar, Inc., our investment offerings support financial advisors, institutions, and the investors they serve.

For More Information

Phone: + 1 877 626-3227
Email: ManagedPortfolios.US@morningstar.com
Online: www.mp.morningstar.com

MORNINGSTAR®

22 West Washington Street
Chicago, IL 60602 USA