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Advisers are over-diversifying: panel



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A panel of investment experts and academics, led by Delta Research and Advisory managing director Michael Furey, has agreed that over-diversification is handicapping returns for private wealth clients and warned that the burgeoning managed accounts market is in line for a large share of damage.

Presenting at the 2018 Investment Management Research Conference, which is part of the Portfolio Construction Forum fronted by Graham Rich, Furey put forward research he had conducted, which he said showed managers were putting too many funds into their portfolios.

The problem, he noted, was that this proliferation of funds did not offer enough idiosyncratic or ‘non-asset class-based’ risk.

“The research shows that managers are putting too many funds into their portfolios, which is creating a lot of risk,” Furey said. “We’re diversifying away that idiosyncratic risk and producing ne

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managers into a portfolio, I believe you are moving towards that over-diversification.”

“Looking at the idiosyncratic risk of a combined portfolio should play a bigger role in portfolio construction,” he asserted. “And I think we want more idiosyncratic risk, not less.”

The issue, he says, is especially prevalent in the world of financial advice, where portfolios aren’t monitored as effectively as institutional funds.

“What I see in the private wealth world, where I’m working with advisory firms, is a lot of over-diversification in terms of the number of managers,” Furey explained. “The problem with private wealth is that the client portfolio’s performance isn’t monitored like a lot of the funds are, where there is regular reporting of the performance and it is compared with a benchmark. It might be compared with a benchmark but it’s a risk adjusted one. But for individuals and for the ‘growth’ part of managed accounts, there’s no database collecting these portfolios and assessing the problem.”

Furey noted that while his studies were not yet completed, he wanted to further the discussion as to whether it was worth moving forward.

“I don’t have a paper associated with this – this is very much preliminary work,” he said. “I’m looking forward to getting hammered on it.”

Significant support

After Furey’s presentation, members of a discussion panel voiced universal support for his assertion.

Jack Gray, former head of AMP Asset Management and chief investment officer of Sunsuper, said he “always thought multimanager portfolios were overdiversified”, and quoted Berkshire Hathaway’s Charlie Munger in saying that “diversification is a veil to hide behind”.

Ron Bird, director of the Investment Management Research program and curator of the conference, referenced a study in the US that illustrated how money managers were overextending themselves.

“In the states, the typical manager at any point and time can identify only 15 to 20 under-priced stocks,” Bird explained. “The median [number of stocks held by] US equity managers is 79.

“We’ve taken so much that’s wrong from what great minds have told us, and diversification is one of them,” Bird said. “If we’re made up of an industry that doesn’t know anything, then diversification makes a lot of sense. But if we think we know something, diversification – to the extent that we do it – is a mad idea.”

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