Does a 10-Stock Portfolio Offer the Perfect Balance Between Risk and Reward?

Description

Diversification is widely viewed as a fundamental part of investing. The logic is relatively straightforward. Any company can experience difficult trading conditions which may lead to a falling share price. Holding more shares means the impact of such a disappointment on an investor's overall returns will be lower if he/she holds a larger range of shares.

However, not all investors are pro-diversification. In fact, Warren Buffett is apparently against it for investors who are able to spend time researching stocks. While tracker funds can have appeal in his opinion, diversifying can be a mistake for more experienced investors since it can dilute overall returns.

Risk vs reward

Of course, Warren Buffett has been hugely successful in his investing career. His ability to unearth good value stocks which can deliver high returns over a sustained period of time has been exceptional. Therefore, if an investor is able to replicate this ability, albeit to a potentially lesser extent than Buffett, then buying fewer stocks for a portfolio could make sense. It could allow an investor to generate returns which are higher than for the wider index.

Clearly, though, fewer stocks means that the risk of loss is higher. Buffett does not have a perfect track record and has experienced major losses at times. For example, he sold **Tesco** at a loss following its profit warning in the aftermath of the financial crisis, while his foray into the oil and gas industry via **ConocoPhillips** was less successful than he had hoped. On both occasions, the opportunity cost for his wider portfolio was significant, which would not have been the case had he sought greater diversity.

Ten stocks

Holding only ten stocks in a portfolio may also have an advantage in terms of efficiency. Most investors are time-poor individuals and this means that they may lack the ability to conduct in-depth research about a range of stocks. Therefore, holding a smaller number of companies could allow them to build more detailed knowledge in specific stocks or sectors. This may aid their ability to generate highreturns and to ultimately outperform the market.

However, for most investors, the risk of losing 10% of their portfolio value if just one of their stocks ceases trading could be too great. Therefore, one solution could be for investors to utilise a significant proportion of their portfolio for their ten best ideas. The remainder could be held in a tracker fund or in a larger number of a wide range of shares. This may allow an investor to have the 'best of both', in terms of benefitting from their own ability to a significant extent, while also having some diversification.

Clearly, an investor's own risk tolerance will have a major bearing on the level of diversification that they utilise. But for many investors, backing their own judgment while also having a degree of diversity could be a prudent option.

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