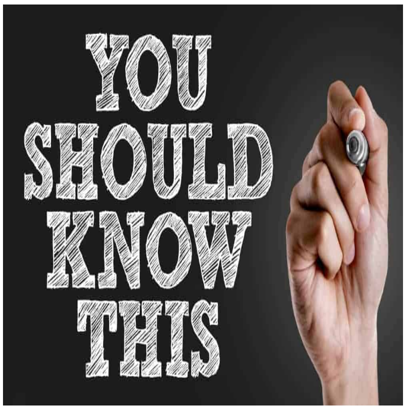

1 Controversial Investment Strategy Wall Street Pros Don’t Want You to Know

Description

Among the most hackneyed mantras in investing that is constantly pushed by financial advisors, stockbrokers, fund managers, and the financial media is diversify, diversify, diversify. While diversifying across asset classes and industries can reduce risk, overdiversification dilutes returns and leads to mediocre performance.

What many investors don’t realize is that many professional money managers are doing the exact opposite, making billions from managing concentrated stock portfolios that typically contain 10-15 stocks. This because concentrated portfolios typically outperform those that are highly diversified. The mantra of diversification is wholly aimed at boosting fee-earning activities for advisors rather than providing any real benefit for investors.

Let me explain why a concentrated portfolio is superior and present two must-own blue-chip Canadian stocks that should be core holdings in any portfolio.

Overdiversification reduces performance

Essentially, diversification reduces the specific risk that a single stock poses to a portfolio and mitigates the financial impact should that company fail. It does, however, diminish the capital returns that a portfolio can generate and fails to reduce market risk.

You see, the more diversified the portfolio, the greater its exposure to overall market risk. This means that a correction or market-wide rout will have a significant impact.

Concentration enhances returns

There is considerable research demonstrating that concentrated stock portfolios deliver better investment outcomes, including higher returns. As historically acclaimed economist and father of modern economics John Maynard Keynes stated: “It is a mistake to think one limit’s one’s risk by spreading too much between enterprises about which one knows little and has no reason for special confidence."

The tradeoff, however, is increased risk, but this is largely mitigated by the higher returns that can be earned as well as a notable decrease in the monetary and other costs associated with managing large volumes of stocks. It also makes it easier to identify, understand, and manage investments in quality companies that possess impenetrable economic moats and steadily growing secure earnings.

One such stock is **Enbridge** (TSX:ENB)(NYSE:ENB), which received some bad news regarding the permitting for its Line 3 Replacement project, with the Minnesota Court of Appeals demanding further environmental assessments. This shouldn't deter investors. The midstream giant operates in an oligopolistic industry, has a wide, unassailable moat, and generates most of its earnings from contracted sources.

Enbridge has also made considerable headway in lowering costs by simplifying its capital structure and reducing debt to less than five times EBITDA. When these factors are coupled with rising demand for pipeline infrastructure because of growing hydrocarbon production as well as the inelastic demand for energy, Enbridge's earnings will expand at a steady clip. This has allowed Enbridge to hike its dividend for the last 23 years straight at an impressive compound annual growth rate (CAGR) of 11%, and it intends to expand that payment by 5-7% annually from 2020.

Lower expenses

A concentrated portfolio enhances returns by reducing transaction and management costs. By trading more stocks to achieve the desired level of diversification, transaction and other related expenses rise incrementally, while the overall burden associated with managing the portfolio becomes significantly greater.

Research from Australia's University of Technology shows that large funds, as a group, typically underperformed smaller funds because they experienced higher transaction costs. This highlights how significantly additional transaction costs can impact the performance of a stock portfolio over the long term.

A single stock that gives exposure to a broad range of markets, jurisdictions, and industries is **Brookfield Asset Management** (TSX:BAM.A)(NYSE:BAM). Over the last three decades, the alternative asset manager has become a household name. Brookfield manages US$150 billion of fee-bearing capital, which is invested globally across real estate, renewable energy, infrastructure, and private equity assets. It rewards loyal investors with a regular sustainable dividend yielding just over 1% and has an impressive history of growth.

Brookfield boasts an impressive growth rate. By the end of the first quarter 2019, its assets under management had a five-year compound annual growth of 15%. For fee-related earnings, it had expanded by 23%. Its ongoing acquisition and capital-recycling initiatives, along with its considerable liquidity, will ensure that assets as well as earnings keep expanding at a solid clip. The latest deal being the US$4.8 billion purchase of a 62% interest in Oaktree Capital Management.

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