Focus vs. Diversification: Why Trading Fewer Companies Might Be the Key to Your Portfolio's Long-Term Success

Description

As investors, we are generally conditioned to reduce risk by diversifying our portfolios — to avoid keeping all of our eggs in too few baskets, so to speak.

Frankly, it's a perspective that has a lot of merit; when you hold positions in enough widely diversified companies across different sectors, you greatly reduce the chances that a piece of bad news or an unimpressive earnings report (causing a tumble in the value of any one position) might wipe out too much of your portfolio.

Diversification carries sound logic and is a concept (and practice) that has withstood the test of time.

But what if I told you that diversification, which in and of itself is concerned solely with reducing risk, comes with risks of its own?

There is a contrarian school of investment thought based on *focus* (as opposed to diversification), and it dictates that "less is more" when it comes to the number of companies you hold in your portfolio. The theory goes like this: although diversification offers mitigation against market- and company-specific risk, it does so at the expense of developing intimate expertise in the specific companies you're trading, thereby watering down the investment decisions you're making related to each of your positions and holdings (decisions like which companies to trade, when to get in, when to get out, and at what price points).

Diversification overlooks the importance of having intimate knowledge and expertise focused on the specific companies you're investing in. And so focus theory challenges diversification theory by asking, how can an investor know enough about 15 or 25 companies to ensure they are employing the best possible strategy in relation to each?

Instead, if you spend time getting to know fewer companies more intimately, say three or five of them, then over time, you'll be better equipped to reliably read those companies' charts (and act on market- and company-specific news).

As a focus investor, you will carefully select a small handful of your favourite companies that you believe in on a fundamental business operations level (i.e., you believe in their underlying products or services and in the people who manage the companies).

You will then dedicate yourself to studying the behaviour of those companies' stocks over time, noting how their stock prices behave in relation to news, earnings, trading volumes, seasonality, technical indicators of all types, and both market and sector-specific events, news, and trends. You'll become a bona fide expert in those few companies, proficient at effectively reading their charts specifically (and not just charts in general), and you'll keep abreast of every possible piece of news and analysis relating to each of them.

After some time and focus, you'll naturally develop a deep intimacy with the small handful of companies you've chosen to trade and invest in.

Many highly successful investors who employ this school of thought already know that it's impossible to be an expert in too many companies on a deep and meaningful enough level, and the information overload of investing in too many companies can cause you to make less-than-informed investment decisions relating to each of them.

Focus theory helps to uncover the risks associated with diversification, or at the very least to put diversification into perspective. If your aim is to invest in quality companies, employing sound strategy and maximizing the likelihood of safe, long-term appreciation across your holdings, then you owe it to yourself to consider the value of finding focus in your portfolio to avoid the pitfalls of too much diversification.

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