Hutchinson
CAPITAL MANAGEMENT

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INVESTMENT PERSPECTIVES

The Value of Diversification

Every thoughtful investment plan should have a clear, suitable diversification strategy, and it's something we take very seriously. We cannot think of an instance where a client has told us that they don't think diversification is a good idea. There are many clear benefits of diversification, and in this Investment Perspectives, we will explore different approaches to achieve it. While there's no exact right way to diversify, there certainly are wrong ways to go about it. We believe the most dangerous failure is to be under-diversified, but neither do we subscribe to a Mae West approach, ***"Too much of a good thing can be wonderful!"***

We diversify our clients' investment portfolios with a process that adapts to both the markets and the client. At HCM, we certainly have our own opinions about diversification, but how each investor approaches it really depends on one's investment philosophy. With each client, we begin the financial planning process with the diversification decision across asset classes (e.g. stocks, bonds, and cash). This first tier of the process depends on the client's specific risk/return objectives. There are many theories and opinions about the right mix of stocks/bonds/cash, as well the right number of stocks to hold in a portfolio; but is there an exactly correct number that fits all investors' risk/return needs? Some would say, yes absolutely, and provide a mathematical formula to prove it. We would say, it depends. The right mix of stocks, bonds, and cash depends on a client's risk tolerances and life goals. How we diversify within our stock portfolio is a function of market conditions, integrated with our investment viewpoint. We employ an adaptive and flexible portfolio construction process with an emphasis on preservation of capital. By this, we mean that we purchase a broad array of high-quality companies that we understand well. Our risk management process ensures that we do not allow any individual stock or sector to become too large, and our investment process leads us to build position sizes based on our fundamental view. We use a proprietary valuation framework which strives to make our largest positions those which have the greatest risk-adjusted return potential. This diversification style differs markedly from the more common mean-variance strategy introduced by Mr. Harry Markowitz in the 1950s. Mean-variance diversification employs strategies to find the optimal portfolio that generates the highest return for the level of risk assumed by the investor. This usually results in a portfolio with enough stock positions to keep each individual position from being large enough to influence the portfolio. The underlying theory is that more individual positons of smaller size lowers the overall volatility of the portfolio; for investors employing mean-variance optimization strategies, volatility is the key investment risk that the investor is trying to reduce.

As long-term investors, we view capital preservation as our measure of risk, but we are not immune to volatility. Even though short-term fluctuations in portfolio values may be lowered by adding more positions of smaller size, we would not alter our investment process merely for the sake of diversification. So, in this current environment, we have adapted to a lower opportunity set of value ideas by investing in our analytical capabilities. We recently added a new research analyst and invested in new software systems that enable us to expand our portfolio by adding new holdings while maintaining adherence to our investment philosophy.

Our framework employs a rebalancing process which constantly maintains portfolio diversification. If any individual stock, or small group of stocks, appreciates disproportionately relative to the total portfolio, there are actions we may take to control risk. When a stock price rises without a corresponding improvement in valuation, we may liquidate the position when it grows too large. If the higher price coincides with improved fundamentals, we will reduce the size of the position until it matches our risk/return framework. This rebalancing process keeps risk in check by capping position sizes and

adjusting the asset allocation when markets dictate. For instance, in an expensive market like we currently find ourselves, it's natural to see a gradual build in our cash levels. By selling stocks in a market with sparse value opportunities, cash levels may rise temporarily while we search for new ideas. Above average cash levels reduce risk and give us dry powder for future purchases.

Why Diversify?

Diversification should be considered from both the return perspective as well as for downside protection. Buying quality assets that will appreciate in price, sufficient to maintain purchasing power, while also preserving capital, requires balance. A portfolio can be imbalanced by owning either too few or too many securities. Proper balance is achieved by holding few enough stocks that each decision matters, but not so few that the cost of being wrong is unbearable. Either condition subjects the investor to behavioral risks. These are risks which cause an investor to make poor decisions under emotional stress.

1. Owning too few securities can impair decision-making when one of those holdings declines meaningfully
    a. Over-concentration of publicly-quoted securities, without a long-term investment horizon, can increase the susceptibility to temporary price fluctuations
2. Owning too many securities can mean insufficient knowledge of one's holdings; during market declines, this disconnect can leave investors feeling out of touch with what they own
    a. Very small positions create indifference to individual investment decisions

By spreading risk exposures across assets that are uncorrelated, investors should earn stable returns amid various market environments. Broadly speaking, diversification strategies seek to enhance returns and lower risk by purchasing assets that do not move in the same direction at the same time. Diversification occurs across and within asset classes, but we will focus on diversification within stock portfolios. There are many different theories about diversification, and the strategy an investor chooses depends on their investment philosophy and cognitive style. Some investors prefer quantitative, rigid, and statistically-based models, while the others choose flexible and adaptive frameworks.

Many popular methodologies rely on elegant mathematical formulas and complex statistical models to find an optimal level of diversification. These investors draw assurance from equations that give a discrete number of stocks to hold. Among statistically-based investors, a fully-diversified, optimal portfolio is one in which the investor is equally ambiguous about all its assets. This is a way of saying: '*What is the minimum number of securities an investor must hold so that no single position is large enough to pose a meaningful risk to the portfolio?*' By minimizing the position sizes, the investor is forced to focus on the total portfolio. In this way, we agree that focus should be on the total portfolio rather than on any single investment. The elegant math is comforting to many investors, but there are some risks associated with relying on equations over common sense. Its creator, Harry Markowitz, was utterly certain that mean-variance was the ONLY way to achieve diversification and was not receptive to alternatives. In his words, **"*Diversification is both observed and sensible; a rule of behavior which does not imply the superiority of diversification must be rejected both as a hypothesis and as a maxim."***

It can be argued that there is no such thing as an optimal level of diversification that can be applied universally. Of course it makes sense to minimize the risk required to earn the expected returns, but we don't think it's wise to build a portfolio out of assets about which we don't have an informed view. John Maynard Keynes, famously said, ***"...the right method in investment is to put fairly large sums into enterprises which one thinks one knows something about…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."***

The investment policy must be flexible enough to adapt to changing conditions. Making marginal investments for the sake of diversification is not an optimal investment strategy. Having more securities across multiple asset classes is a good tactic for earning average returns during tranquil markets, but may not work as advertised in declining markets. In recent years, within the asset management industry, we have seen a trend toward over-diversification. This may be a manifestation of the 2008-2009 crisis -- the thought that risk can be reduced by owning tiny pieces of many different companies. "*In the financial crisis, as equities collapsed and bonds seemingly offered little upside, some asset allocators became intolerant of inflexible strategic asset allocations that did not seem to work at that moment in time. The development of a plethora of novel alternative asset classes and techniques may have hindered rather than helped asset*

allocators by offering additional and often untested choices which many institutions lacked the proper resources to evaluate and which had immature advisory infrastructures."[1]

We agree that risk should be viewed in a portfolio context, but we look at risk and reward a bit differently; as a measure of risk, the variance of returns is neither intuitive nor particularly useful for long-term investors. Correlation, the common indicator of the benefits of diversification is not stable enough to be dependable across different market environments. Newer, behavioral theories are more flexible, assuming that different people make different decisions because they have different circumstances and risk tolerances. Behavioral portfolio construction is better suited to tailored solutions crafted by advisors with definitive insights into each client's needs. Using knowledge and sophisticated systems enables us to build portfolios that represent both our ability to select superior individual securities and to ensure that we achieve genuine diversification. Underlying this belief is the notion that volatility is not the primary risk for long-term investors; real investment risk comes from deploying a strategy that fails to meet an investor's stated goals.

Math is comforting, and human beings are receptive to shortcuts and rules of thumb. However, some things that seem conceptually simple may embed hidden complexities. What seems like an ironclad plan during a period of market tranquility, can unravel under market duress. The statistically optimal level of diversification is premised upon risk reduction through minimized idiosyncratic risk; however, under stressful market conditions, the benefits of such diversification can erode as correlations rise with increased volatility and a preponderance of selling. At HCM, we believe that a key to weathering adversity is understanding what you own and having a plan in place to adapt to adversity by employing a portfolio construction process that is coherent and flexible.
"*Financial innovation has created many new investment products with old investment risks, while financial advisers are often relying on increasingly complex statistics to measure diversification. This makes it important for you to be on the lookout for diworsification in your investment portfolio. Working with your financial adviser to understand exactly what is in your investment portfolio and why you own it is an integral part of the diversification process*."[2]

Factors Make More Sense to Us

Once upon a time, diversification meant setting a suitable asset mix and limiting exposures to an arbitrary number of individual stocks or percentages of each sector. This is still largely true, but stocks don't always react similarly to information just because they share the same sector or industry. Advances in technology and data analytics allow us to be more precise in evaluating risks and more capital efficient in pursuing opportunities by analyzing the factors driving stock prices. There are three major macroeconomic factors that affect all asset prices: real interest rates, inflation, and expected growth. We can weigh each of our stock's sensitivity to changes in these factors and many more. Prior to adding a new security to our portfolio, we test that stock's sensitivity to numerous factors to evaluate how its addition to the portfolio would marginally impact our overall risk/return. Our approach is to use our information and research advantages to select securities, and weight each portfolio holding based on fundamental analysis. This differs sharply from the optimization strategy – or the idea of avoiding idiosyncratic risk[3] by finding the optimal number of stocks necessary to avoid the influence of any individual holding.

The idea of diversification is intuitive to most investors, but how it is employed to reduce risk may not be so clear-cut. Whatever its cause, investment risk means losing money. Investors all have different sensitivities and time horizons. If an investor views risk as the deviation from the average market return, then holding securities closely matching the general market, makes Markowitz's mean-variance approach appealing. At HCM, we view risk as being wrong in our fundamental analysis, prompting a loss of capital. Our knowledge of company fundamentals, coupled with data analytics, enables us to add a layer of sophistication to our diversification strategy. Rather than using pure statistical measures, we evaluate the sensitivity of a company to various fundamental factors. Factors that drive risk and return can be broken into three distinct groups:

1. ***Internal Company Fundamental Factors***: Earnings Variables: (EPS growth, volatility, and momentum); debt
2. ***Company Share-Related Factors***: Valuation and Trading Characteristics; these factors directly incorporate investor expectations; all have a price component embedded: P/E multiple, earnings yield, dividend yield, price to book ratio, price momentum, share price volatility, and trading liquidity

[1] Diversification or Diworsification; Harrison, Mark; CFA Digest; 17 December 2013
[2] *Diversification vs. Diworsification*; Duggan, Patrick; Investec Wealth & Investment; 30 November 2017
[3] Total Risk in stock market investing is defined as Systematic Risk (+) Unsystematic risk. Systematic Risk is the risk taken by having exposure to the market in general, while Idiosyncratic Risk is the exposure to individual securities.

3. ***Macroeconomic Factors***: these include Sector/Industry classification, stock beta[4], yield curve sensitivity

Before a company can get into our portfolio, it is evaluated based on the quality of its business, the strength of its balance sheet, and its competitive status within its industry. We assess qualitative factors such as management skill by diagnosing their efficiency (how well they manage the business), and their skills at allocating capital. Other company factors include business cyclicality, complexity and transparency. These factors are then weighed against the stock price relative to our calculation of intrinsic value.

Conclusion

The diversification of an investment portfolio is multi-faceted process and touches all aspects of the investment process. Nearly every investor diversifies as part of the return generation process as well as for risk management. So, while that's generally true for most investors, how each investor approaches it is unique. Statistical approaches look to lower volatility by owning many small positions. We think it's risky to put too much faith in mathematical equations without questioning why they work. Our own process employs more behavioral factors and relies on our fundamental view of each company in our portfolio. It has proven adaptive to higher market volatility and tough market conditions for fundamental value investors, by indicating the need for a broader number of less-concentrated positions. Despite the prospect of owning more stocks, we always want to know what we own, why we own it, and how each piece of our portfolio fits into the whole. Neither a statistical style or adaptive-behavioral style is better than the other, they just reflect different philosophical approaches to the risk/return trade-off. However, regardless of the investor's preferred style, the portfolio construction process should be durable enough to survive good markets and bad.

[4] Stock Beta is measure of historical price volatility relative to the overall market; a beta of 1.5 implies that a stock price should move 1.5% for every 1.0% that the market moves.

HCM's investment decision making process involves a number of different factors, not just those discussed in this document. The views expressed in this material are subject to ongoing evaluation and could change at any time.

Past performance is not indicative of future results, which may vary. The value of investments and the income derived from investments can go down as well as up. It shall not be assumed that recommendations made in the future will be profitable or will equal the performance of the securities mentioned here. While HCM seeks to design a portfolio which reflects appropriate risk and return features, portfolio characteristics may deviate from those of the benchmark.

Although HCM follows the same investment strategy for each advisory client with similar investment objectives and financial condition, differences in client holdings are dictated by variations in clients' investment guidelines and risk tolerances. HCM may continue to hold a certain security in one client account while selling it for another client account when client guidelines or risk tolerances mandate a sale for a particular client. In some cases, consistent with client objectives and risk, HCM may purchase a security for one client while selling it for another. Consistent with specific client objectives and risk tolerance, clients' trades may be executed at different times and at different prices. Each of these factors influence the overall performance of the investment strategies followed by the Firm.

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