

How many stocks should you have in your portfolio?

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The 2007-08 financial crisis proved to be a heartbreak for many an aspiring investors. In fact, it was not just the average investor who suffered badly. Even the so called experts found the going extremely tough. And amongst the ones that prevailed, they were nothing but a pale shadow of their earlier selves.

To be fair though, a loss of a certain size was all but inevitable. Simply because the magnitude of the crisis and the asset deflation that followed was one of the biggest that the world has ever seen. But some of the portfolios capitulated really badly. This even includes managers with stellar long term track records. And that was perhaps unacceptable we believe.

We are sure that a lot of analysis would have gone into finding out why some of the well known stock portfolios fared so miserably. We believe that the poor relative performance could be put down to two main things. One is of course insufficient diversification and the second would be staying fully invested i.e. not having a sufficient enough cash buffer.

At first glance, both of these criteria would appear to be subjective. In other words, there isn't a single number to which all investors would want to converge. However, we can study the principles followed by some of the most successful investors of our times to get an idea as to what should be the ideal number stocks in a portfolio and also the optimum cash level.

As for the first factor, thoughts from Seth Klarman, a very successful investor and author, would be useful we guess. Klarman has argued a lot of times that a stock should form no more than 5%-6% of one's portfolio. And only in cases where the confidence with respect to a stock is very high should the size reach 10%. Anything more than that and we are exposing ourselves to risk he believes. Besides, if a stock forms only 1% of a portfolio, then it is too small a position to make any meaningful difference to the overall performance as per him.

Then there's Mohnish Pabrai who suffered very badly during the crisis. One of the big lessons that he learnt from the crisis was the fact that no position should make up more than 10% of one's portfolio. Clearly, a thought very similar to that echoed by Klarman.

We believe even research has shown that in order to ensure sufficient diversification, around 12-15 stocks are sufficient. The risk reduction trade off really does not work in investor's favour beyond these numbers. There is also the additional problem of difficulty in keeping track of each investment if the number of stocks go too high. Thus, from all possible angles, having a portfolio of no more than 12-15 stocks looks like the ideal way to go.

If the issue of determining the correct level of diversification was tricky, we believe arriving at the right level of cash is even more difficult. This is because while some investors swear by the habit of remaining 100% invested at all times, others like to maintain a healthy cash level no matter how attractive the opportunities out there.

However as the financial crisis has shown, remaining 100% invested at all times may not be the best of strategies. Market downfalls happen without prior notice and the extent of correction

too can go lower than most people can imagine. Thus, in order to take advantage of such occasions, having a sufficient cash buffer is must we believe. Agreed that holding cash at all times may lead to slightly lower returns than an all stock portfolio when the markets are cheap. But we should be willing to accept this scenario in exchange for not letting our portfolio suffer too much during a strong market correction along with the opportunity to make further investments.

Thus, having cash balance to the tune of 15%-20% of one's portfolio value at all times does look like a prudent strategy to adopt. Of course, during times when the number of attractive ideas is not big enough, the cash holdings could go up even further.

To conclude, as Joel Greenblatt has pointed out, one must be diversified enough to survive bad times or bad luck so that skill and good process can have a chance to pay off over the long term. Very wise words indeed.

http://www.moneycontrol.com/news/investing/how-many-stocks-should-you-haveyour-portfolio_751982.html