Back to Basics: Concentration vs Diversification - Crafting Your Investment Strategy

Dave [00:00:00]:

All right, folks, welcome to Investing for Beginners podcast. Today we're going to do one of our back to the Basics series. So this is a series of shows that we're going to do every week for about a few months. And we're going to talk a lot about back to basics investing. Today's topic, we are going to talk about portfolios, setting up a portfolio, and diversification. So I guess without any further ado, let's just dive on in. So let's talk, talk about portfolios, construction and diversification. What does that mean to you? Maybe we can define those and then we can start from there.

Andrew [00:00:35]:

Yeah. To me, diversification is important because you don't want all your eggs in one basket. And if that basket falls over, all your eggs crack. There goes your life savings. So any financial person who is financially literate, with a grain of salt will tell you that you want to be diversified. If you are depending on this money for your retirement, your life savings, you want to be diversified. And so that kind of like you implied at the beginning, that can mean so many different things to so many different people. But the bottom line is you want resilience against unexpected bad events.

Andrew [00:01:23]:

I don't have to remind us, not too long ago, just a few years ago, we had a very unexpected global event. And those things happen. They take one form or the other. And so if your portfolio is not resilient, then all of your hard earned money, savings, investing can all go to waste if you're not diversified.

Dave [00:01:47]:

Yeah, exactly. And to your point, in the last 24 years or so, we've had three pretty drastic global events that have rocked the stock market. We have the.com bubble. We had the great financial crisis, and we had the pandemic. And of the three, you could probably argue maybe we saw the.com bubble bursting. But I would hazard to say, back in 1999, not a lot of people had that on their bingo card. And certainly the great financial crisis came out of nowhere. And the pandemic, of course, obviously came out of nowhere as well.

Dave [00:02:24]:

So to your point, you just never know when things are going to go south. And you have to prepare for that eventuality, because at some point it will. History has shown us through how many centuries, decades, millennia, have we seen upheaval in the world? And as it gets more and more connected with technology, those things happen faster and probably within shorter time spans between one to the other kind of thing. So it behooves you to have your portfolio diversified enough that you can withstand those. There's no perfect diversification that I'm aware of. Is there one that I'm not aware of?

Andrew [00:03:06]:

You're good. You're good.

Dave [00:03:07]:

Okay. All right. I guess when you were thinking about diversification, does that exist outside of an idea like building a portfolio or is that part of the construction?

Andrew [00:03:18]:

Yeah, I mean, for some people, right. Diversification means multiple asset classes. Some people like to have a little bit of stocks, a little bit of real estate. Maybe they have some equity stake in the small business. It really depends on your own personal preferences. Ive been studying the stock market for a little while now and so ive become comfortable with the risks that come with the stock market. And so like ive said on the show before, Im happy having 95% of my net worth in the stocks that I pick for the value spotlight newsletter. But, you know, thats not for everybody.

Andrew [00:03:57]:

And Im also in an accumulation phase of my wealth building. So I think age can play a part in what your diversification strategy is. I think it can and should probably change for most people as you age closer to the retirement, your financial goals obviously play a role in that. And then how much risk tolerance you just generally have and how confident you feel about your knowledge about the risks you're taking. Those can all be kind of factors into it. What about your side? How do you feel about thinking of diversification inside of our portfolio and outside?

Dave [00:04:37]:

Well, I certainly think of it as it's part of the risk equation when I'm investing for sure, because I need to ensure that I'm not putting all my eggs in one basket. And that's something that I was doing and I saw it happening to me in real life, even though I could have stopped myself. But I didn't. Building up a bigger part of my pie occupied with the financial services and trying to kind of diversify away from that because I saw how having a big position in a company that doesn't perform well and then the whole sector is not doing great, it can definitely drag your portfolio down. And I'm talking about PayPal. PayPal at one point was around 7.58% of my portfolio and it was doing quite poorly. I saw somebody on Twitter define it as pain pal and I was like, thats beautiful. Thats what its felt like.

Dave [00:05:37]:

But the rest of the financial sector, it was struggling too. So it made a lot of sense to start to try to move away from that, to help offset those losses and also bank for a better day someday in financial services. And that day is now starting to arrive and the portfolio overall is doing better. But part of that is because ive diversified away from being 70% financial services and now im down to 45%. So ill keep working on that. But to me, thats part of building up the portfolio. When youre new, when youre starting off or youre newer to this, I think you have, you're going to have some concentration just kind of naturally if you pick four, only have four or five companies, but as you get to 15 to 20, then you can start moving away from having such a large concentration. So, like when you are starting off a portfolio, do you think it makes sense to go down the list, so to speak, from the, you know, this asset class to this asset class and blah, blah, blah, blah, blah? Or does it make more sense to just fish where the fish are and then start working from where, working from there?

Andrew [00:06:46]:

Yeah, I think obviously if youre first starting out, the advice that we would give to anybody is if you have a 401K, make sure youre using it. And, you know, I dont want to say every single 401K plan, but I have a pretty decent feeling if I were to throw a dart at a 401K allocation, theres a pretty good chance that the allocation will be diversified. So just by having a decent chunk of your net worth in the 401K, you're probably going to have the diversification all played out. When it comes to building a portfolio. If you're just trying to be a stock picker and kind of do what I'm doing, where most of my net worth is in individual stocks, I do like that idea of fishing where the fish are with a bit of understanding that things in moderation tend to be a good policy. I think that applies as well as an example. I think a lot of us can agree commercial real estate is very much in a bear market right now. There are arguably some great deals and arguably exponentially more value traps.

Andrew [00:07:47]:

But no matter how bullish I am about commercial real estate, if I were to pick five months in a row of different commercial real estate companies in my portfolio, thats not really going to be great. Diversification. The goal for all investors is to stay in. We want to run the race. We don't want to have to quit or be so discouraged that we throw up our hands and give up. And so as somebody who's starting for the first time, maybe building their own portfolio, I would say that sacrificing the optimal choice for the choice that's going to keep you in the game longest is probably the best move. And that's one reason why, even if I have the conviction to say, oh, you know, I'm smarter than everybody else. And I know commercial real estate's a huge bargain right now.

Andrew [00:08:41]:

Even with my experience, I would still temper down my optimism because I've been humbled by the market before where it has shown me that, hey, you might be missing something. And to your point, David, when you have a heavy concentration in a company or industry, trying to come back from that, going from severe underperformance and trying to turn that around to make it out performance, it's hard and it can take a long time, very long time. So, you know, luckily I haven't given up on it, but it would have been nice to not have to dig such a deep hole. And by diversifying, you can very simply do that right out of the gate.

Dave [00:09:23]:

So how far into, let's say, portfolio construction do you need to start thinking about the idea of diversifying? So let's say you're starting from zero and you've built a portfolio up to like, say, let's say six companies. Is that the point where maybe you want to start thinking about, okay, I need to start trying to look in these other sectors to see if there's other opportunities in there to try to get away from maybe the natural concentration you've developed because you're super into semiconductors, for example, and so maybe you've picked four or five companies that are in that industry. Do you think that's a good time to start moving away from that?

Andrew [00:10:02]:

Yeah, I mean, there's certain things in investing that are kind of cut and dry. This is one of those you can skin a cat million ways. It's funny we're talking about this because literally this morning I was updating my portfolio rankings for value spotlight subscribers. And one of the parts of that report that I give every quarter is four stocks that if I was starting a new portfolio today, and for whatever reason, I would just had to have all four stocks, I wanted to build a portfolio. I can put this in, and out of the microwave comes a portfolio thats decently diversified. I look at that composite and its stayed pretty much the same for the last three quarters. There's a consumer cyclical, there's a healthcare stock, there is a commercial real estate stock, and there is financial services. Okay, so that feels very balanced, right?

Dave [00:11:01]:

Yeah.

Andrew [00:11:01]:

Where you get, I mean, I wasn't intending to do the asset classes that way with the commercial real estate mixed in there, but, you know, it's a balance of what I think is attractive now versus also just keeping some sort of healthy mix in there. So that's one way to do it. Honestly, I felt like forced to put that build a portfolio out there because so many people asked for it. For me, I've always argued for just buy one stock every month and worry less about the portfolio concentration because over time that diversification will happen. You just have to be patient. But I understand people want to check boxes and say, okay, I got my portfolio diversified and there's something to say for that, too. So, yeah, I mean, could take it a lot of different ways. Is there a way you did it when you started and is there a way you think works best for a beginner?

Dave [00:11:57]:

Yeah, that's a good question. When I first started, I was kind of in the same mode of just trying to find the best thing I could and just buy whatever is going to work and just try to go from there. And then as I continued to build up the portfolio, then I started thinking about, you know, I have two banks, I have something in the commercial landscape. I have something, you know, I have a REit. Maybe I need to start looking at maybe some possible technology or thinking something outside of the area that I've started to look. And thats how I started to naturally evolve it. I know that the optimal portfolio is 20 stocks, 5% each kind of thing. And theres an idea around that, especially in the 401k, rebalancing ideas that always trying to keep everything within a certain parameter of this percentage of this and this percentage of that.

Dave [00:12:57]:

Im not here to bash that, and I think theres probably some good to that. But I think I also go back to this idea, and this is something I've learned more recently, is kind of letting your winners run. And so if you get a good company and it's performing well and it's executing well, then why trim that to give more to something that's not doing as well? You know, that whole Peter lynch idea, you know, why are you cutting the flowers to water the weeds kind of thing? Or, you know, as Charlie likes to say, like throw a million anecdotes at this. But, you know, Charlie always liked to say, never unnecessarily interrupt compounding, you know, and that's something that I've kind of grown into more. Our friend Brian Ferraldi, I remember him saying that he liked to buy things around two to 3% and let them grow into a larger position because they perform well. And I think there's something to that as well. But I think all those ideas kind of work around the idea of diversifying. And to me, diversifying is not necessarily something I put really high on the list to do.

Dave [00:14:00]:

It's just something I naturally do because I try to look around for different ideas and when I feel like I'm well represented in the financial space. So unless something comes along in that arena that is like so obviously awesome that I have to own it, then I may look at replacing it with something else as opposed to just adding it to the portfolio. Maybe one of the companies, PayPal. PayPal is underperforming and I could replace it with said company. But for me, it's just something that's just kind of naturally evolved. And I try to keep my eyes open when I'm trying to determine what kind of new investments would be pensions, and I just naturally gravitate away from the financial services now just because it's become a larger portion of my portfolio. But I also try to not just plug a hole, just to plug a hole. We've talked about this in the past.

Dave [00:14:51]:

I'll bring it up briefly. Just because there's a list of seven to nine different asset classes you should have doesn't mean you have to have them. And it doesn't mean that doing that will automatically diversify your portfolio. Portfolio. Because if you pick two really, really bad things in that particular asset class, just to air, quote, fit a hole, then you're just, you're doing yourself a disservice and you're going to hurt your performance over a longer period of time. Because once you buy a company, it's a heck of a lot harder to sell it because of our emotions.

Andrew [00:15:21]:

I feel like you dropped so much like, time tested wisdom in there that I hope it doesn't go past people who are trying to learn from this. Maybe on that second point, since it was most recent one, I feel that getting over the idea that I need to have everything in my portfolio, it's a lot harder to do than to say, because FOMO is one of those things that you have to fight every day, just like you have to fight laziness and, you know, physical pain. But I think FOMO being able to fight FOMO, fear of missing out can really do a lot of things for your portfolio. Because if you can fully step away and say, I mean, I love your thoughts on fighting FOMO, but for me, I think a big realization is there is no investor who can call every single hot fad. There's always one, right? Cathie Wood was first to the innovation. Ron Baron was first to Tesla. Dan Ives has been raving about Apple. Right? Everybody kind of has their one thing, Bill Miller, Amazon and bitcoin.

Andrew [00:16:30]:

Right? Everybody kind of has their one or two things, but nobody's gotten Nvidia first and got Amazon first and got Google.

Dave [00:16:37]:

First and bitcoin for.

Andrew [00:16:39]:

Yeah, nobody has. And so if nobody has, and yet there's still so many investors who've done well and beat the market, maybe that tells you that I can have more reassurance, that the market's not going to just pass me by. I just have to find my place in it. Is that kind of how you beat FOMo? Is there a different way that kind of helps you? Because it's hard. It's really hard.

Dave [00:17:02]:

It's really hard.

Andrew [00:17:03]:

Especially we feel like we have to keep up with everything because we're out there looking at stocks every day. How do you fight that, and how does that fit into portfolio construction?

Dave [00:17:14]:

For me, it's actually a lesson learned, so it makes it easier. So I felt under the sway of fomo when I bought pain, pal. And, you know, I bought it at 300 some bucks a share. It's now trading around 60 something, and it was at a 50 some pe or something crazy like that. And I bought into the FoMO. And it has been a painful lesson. And it's, you know, it's a stark reminder every time I look at my portfolio and I see that company and I see that return, oh, you know, it just reminds you that there is not an infinite price you can pay for anything. So whether you're looking at Nvidia right now, for example, it's shot up from, I don't know the exact numbers, $400 some to eight or $900, whatever it's trading at, I don't pay much attention to it.

Dave [00:18:04]:

And it will be really easy to fall into the fomo because you see all these other people, especially on social media, you see all these other people gloating and taking victory laps because they've done so well with buying that company, and hats off to them. That's awesome. I missed the boat, okay? I missed the boat. And I try to have this mindset that I can't swing at every pitch, I can't know everything about every single company, and I can't know everything about every single sector. And that also means that you're gonna miss things. You're gonna miss out on Nvidia. And who knows if that goes on to become, you know, the next Amazon for the next 15 years? Who knows? It may, it may not. And Ty will tell on that.

Dave [00:18:46]:

But I will say this, that I guess being a student of history and knowing enough about the stock market history that even though we missed out, you know, you and I missed out on Nvidia, for example, there's going to be another opportunity for something, whatever it may be. It could be Nova Nordisk, which I missed on, too, but it could be the next whatever, and we guess right on this particular thing, and that becomes the next thing. And so there's always, you know, mister Market shows up every day. And I know that's something that we talk a lot about, but for me, I feel like I've internalized it, especially because in the light of making the mistake with paying pal and doing that dumb thing, falling for fomo just now, whenever I have that automatic break in my head every time I go, it helps me tamp down that temptation, because I don't want to go through that again. I'd rather miss. For me, the missing doesn't hurt as much as taking the swing and missing badly, if that makes sense.

Andrew [00:19:46]:

Oh, yeah, for sure.

Dave [00:19:48]:

That's how I help, you know, work around it.

Andrew [00:19:50]:

Yeah, I love that. Yeah. So now you got to keep it in your portfolio, right?

Dave [00:19:55]:

Well, I did reduce it. I got some good advice from our friend Brian Withers, and. And I did reduce it. So it's, I think, only 1% of my portfolio now, and I took that money and put it into other, better things that you were suggesting, so. But I still own it, and it's partly for that as a painful reminder that, hey, this is what happens when you do the dumb things.

Andrew [00:20:18]:

Right? It's like the bass or the buck on the wall, except.

Dave [00:20:21]:

Right. Yeah.

Andrew [00:20:22]:

Upside down or something.

Dave [00:20:23]:

Yeah. Right. It's a painful reminder of what you did, for sure.

Andrew [00:20:28]:

That's good.

Dave [00:20:28]:

So I guess maybe kind of pivoting a little bit off of that idea. What do you feel like is maybe too much concentration? Like, at what point do you get to a point where it's like, okay, either one company is this much of your portfolio, or I'm in this much of the sector, whether it's financial services like Dave, or whether it's something else, retail, or something of that nature.

Andrew [00:20:55]:

Yeah. I mean, if the first couple questions weren't hard enough, here's where practice it up. The difficulty scale. My goodness. You know, I struggle because, like I said in the past, I had a 2020 5% concentration on things, and that took my portfolio for a wild, wild ride. And arguably, I could have ended up a lot worse if american eagle didn't rebound like it did.

Dave [00:21:20]:

Right.

Andrew [00:21:21]:

I don't even want to know. But that said, like, I shouldn't let my experiences necessarily paint a negative picture on concentration in this. I think this particular topic, because taking the Nvidia example again, someone might have a special insight into the technology and just really understand that company way better than I ever will. And so maybe for that person, 40% makes all the sense in the world, right. But for someone like me, maybe five or 10% is all I'd be comfortable with. It's a comfort level. I mean, I tried to look at, like, Warren Buffett, I feel like is a good template for a lot of things. And he's done.

Andrew [00:22:09]:

It's somewhere between when, like, when he loads up into something, he goes anywhere from 25% of his portfolio into, I think his biggest was like 40 of his portfolio, and he lets it ride, too. I think thats interesting that hes never started a position over 50%. And I think theres some math behind it. But I just find that interesting, that idea that 40% seems to be near the high range of what you tend to see. And thats just kind of anecdotally looking at what ive observed with a lot of big investors.

Dave [00:22:48]:

Right.

Andrew [00:22:48]:

That's not counting somebody who maybe never made a name for themselves, but had a even bigger concentration. So that all said, like, what about you? Do you have an upper range for yourself or for the average investor?

Dave [00:23:05]:

Yeah, that's a good question. I feel like what I've seen on social media and just studying other investors and people we've talked to, it feels like 20% is like an upper limit for most people. And when you start to get above that, then it starts to become, you really got to be the expert in this particular space or this particular company. And some of it is, some of it can just be that the performance is driven it that way. I know the buffet, the example people always like to throw out there is with Buffett. And like you said, he's gone up to 40% for a portfolio size. But even Apple wasn't. He didn't back the truck up.

Dave [00:23:51]:

Initially. He started small, and then he built up to it. But the company, the stock also performed and really took off. And so it became 50% of his portfolio. And even since then, he's trimmed it a little bit, and so it's kind of stayed in that roughly 50% range. And so he obviously has a lot of confidence in that investment. I don't know that I could get to that level of confidence with a company. Maybe I could if it was something that I owned for ten or 15 years.

Dave [00:24:24]:

If I bought Berkshire Hathaway in eighties, for example, I'd probably be okay with that being 2025, 30% of my portfolio. And I think if it starts to creep above that, then I would probably start to get nervous and have to figure out how I'm going to, how am I going to mentally deal with this, you know, because you're going to deal with, if you sell any part of it, then you're going to feel that loss even as the company continues to perform. And so then there's that loss aversion, or that not loss aversion, but just the pain that you feel from not still owning, you know, this extra 2% of the company, I think that can set you back, too. So, you know, for me, I think it's probably, I havent had this happen yet, so Im hoping it happens soon. But 25 is probably my 25, 30% is probably my range. And then ill start to have serious conversations with myself about what do I do with this.

Andrew [00:25:20]:

Yeah, I struggle saying whats a good policy as well, because I feel like my objective even is different than the average investor. If I was an average investor who is already at their retirement number and I had 50% ready on something, who cares, right? Your retirement's already set. We're talking about completely different ballgame than someone like me who's trying to hit 11% annualized for 40 years. Two completely different ballgames.

Dave [00:25:48]:

Yes. Yeah. Two completely different ball games. And that has a big bearing on your portfolio, your construction of the portfolio, diversification, how much you're going to take, what kind of risk you take or don't take. You know, those all have to be factored into it. And I would hazard to say the more experience, this is just a guess on my part, the more experience that you get with investing as well as particular companies that you own for a long period of time. I think your comfort level of owning them at larger parts of your portfolio probably increases exponentially as well, which is scary, right? Yeah. Right, right.

Dave [00:26:27]:

Exactly. There's a couple guys on fintwit that I follow, one in particular. He's 100% a palantir. That's his only position. Yeah. And, you know, I applaud him for that concentration. I couldn't do it, but he certainly knows the company. And if you ever have any questions about Palantir, he's the person you're going to want to ask.

Andrew [00:26:47]:

Yeah, it's amazing.

Dave [00:26:49]:

Yeah.

Andrew [00:26:49]:

Any last thoughts? Takeaways for really? Maybe like this? How can someone think about the basics of everything we've talked about today. Look at some core takeaways when it comes to portfolio construction, some core basics.

Dave [00:27:05]:

Oh, well, I guess a couple things. A couple logs out of three on the fire is, number one is when you're first starting out, worry more about trying to find the best companies that you can. If you're first starting out, take the step off the ledge first and buy one company and then you can start worrying about the other stuff after that. Then once you have your feet wet, you own a company or two, then you can start looking around to try to find things that you think are going to be the best fit for you. And then once you start to get to like six or seven companies, then I think you probably need to start looking around to see if there's other opportunities. Like try to notice if you're investing in a narrower space. And if you are, then try to look and see if there's other opportunities that you may be missing because you're being so focused on a particular area and that can happen. And I think once you kind of get to that point, then I think you need to start looking to see if there's other opportunities as well as just in reinvesting in the things that you already own.

Dave [00:28:02]:

Sometimes the best investment is one you already own. And so instead of worrying about acquiring a new company, you just reinvest more in Microsoft, for example. And I think that's a great way to go. And then once you start to get to the point where you maybe want to start expanding your circle, if you will just try to stay within your circle of confidence or the things that you can understand, well, try not to reach and go, okay, I'm going to buy, you know, Nvidia just because I think I have to have semiconductors and it's a super popular company. You know, all the other things that we teach, I think need to kind of coalesce with that as well. And then I guess the last thing is, I know tech lists are awesome, I love them. And going down lists and crossing off things is awesome. I love that feeling.

Dave [00:28:44]:

But when you're investing, don't build a portfolio just because you have to have a commodity to go out and buy a commodity, just cause it needs to be a good investment. And buying an energy sector company just cuz is, is not the way to build a portfolio. Uh, if you find a great opportunity, by all means jump on, jump on it. But if not, then just don't, don't buy a company, don't buy gold, for example. Just because I want to have a commodity that may not be the best investment for you. Not really a mineral, but maybe copper is a better choice than gold, for example. I don't know. That's not my space.

Dave [00:29:24]:

But anyway, those would be three things that I would throw out there. What about you?

Andrew [00:29:29]:

I mean, what else can I throw out there? If you throw out all the good.

Dave [00:29:32]:

Ones.

Andrew [00:29:35]:

I think it's good. Keep diversified. Put eggs in more baskets rather than just one. And remember all those things.

Dave [00:29:43]:

Yep. Yep. Okay.

Andrew [00:29:45]:

All right.

Dave [00:29:45]:

Well, with that, we will go ahead and wrap up our conversation for today. I hope you enjoyed our back to the basics series. Again, this is going to be something that we're going to release once a week. We have 20 episodes planned, and we'll just release them every week. I think it's on Thursdays. So just come back to learn more about back to the beginner basics of stock investing. With that, we'll go ahead and sign us off. You guys go out there and invest with a margin of safety.

Dave [00:30:09]:

Emphasis on the safety. Have a great week, and we'll talk to you all next week. Bye.