Unconventional Wisdom

In our experience, focused or concentrated mutual funds have the potential to outperform without increasing portfolio risk. Interest in funds with a narrower portfolio composition is gathering investors’ attention. The loss of an estimated $20 trillion of wealth from the Great Recession has caused many investment advisors to reassess the conventional wisdom that has guided portfolio allocation for decades. One solution that is receiving increased attention is the inclusion of focused mutual funds—either as satellite holdings or core replacement options—in portfolio allocations.

Executive Summary

Mutual funds that hold a relatively large number of positions are often thought to have less risk than funds that hold fewer positions. However, studies have shown that concentrated portfolios, generally those with fewer than 25 portfolio holdings, do not have a higher risk profile and can provide meaningful performance advantages over time.

Focused funds are generally comprised of a manager’s “best ideas” and include high conviction holdings that result from intensive proprietary research. Focused funds are high conviction portfolios that have outperformed the market by approximately 1 to 2.5 percent per quarter, depending upon the benchmark. These “best ideas” are often unique to one manager and are under-represented in more broadly constructed portfolios.¹
Much of the enthusiasm for incorporating focused funds into asset allocation strategies is being driven by academic studies. Concentrated portfolios, generally those with fewer than 25 holdings do not typically have a higher risk profile and may provide meaningful performance advantages over time. For the purposes of this paper, focused mutual funds are defined as portfolios that concentrate assets in managers’ best investment ideas. The research reviewed shows that:

1. **High conviction investment ideas have outperformed**: The highest conviction ideas of typical active mutual fund managers consistently outperformed the rest of the positions in their portfolios, and the market, by about 1 to 2.5 percent per quarter, depending upon the benchmark.¹

2. **Highly concentrated funds have outperformed**: Fund managers who concentrate portfolio assets in their highest conviction ideas have outperformed managers of more highly-diversified portfolios over a 24 year period.²

3. **Focused funds have not had higher risk**: Portfolios that included only managers’ “best ideas” generally delivered strong returns without added risk.³

In addition to providing a brief overview of academic findings, this paper will explore the advantages enjoyed by focused fund managers, examine the reasons focused funds are not more widely adopted in the mutual fund industry, and provide some recommendations for investment advisors to consider.

### I. High Conviction Investments Have Outperformed

Most mutual fund managers will acknowledge that they have greater conviction in their top five investment ideas than in ideas 25 through 100. So it should be interesting to learn that research shows managers’ “best ideas” systematically outperform other positions in their portfolios, as well as the market.

The magnitude of the outperformance is striking. “Best Ideas”, a study conducted by Bernard Cohen of Massachusetts Institute of Technology, Christopher Polk of the London School of Economics, and Bernard

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2. Klass Baks, Jeffrey Busse, and Clifton Green, Fund Managers Who Take Big Bets: Skilled or Overconfident, American Finance Association 2007 Meetings Paper.
3. Ibid.
Silli of Goldman Sachs, found that between 1984 and 2007, mutual fund managers’ “best ideas”—the ideas in which they had the greatest conviction—outperformed the market by about 1 to 2.5 percent per quarter, depending upon the benchmark.4

The study found that “best ideas” generated:

“...Statistically and economically significant risk-adjusted returns over time but they also systematically outperform the rest of the positions in managers’ portfolios... this result is consistent across many specifications: different benchmarks, different risk models, and different definitions of “best ideas”.”5

II. HIGHLY CONCENTRATED FUNDS HAVE OUTPERFORMED

Not all mutual fund managers are willing to make big bets by concentrating their portfolios’ assets in a few good ideas. Those who do, however, have the potential to outperform the market, as well as more highly diversified mutual funds.6 Baks, Busse, and Green, in a study known as, ‘Big Bets,’ found that domestic stock portfolios with strong weightings in a relatively small number of holdings delivered higher returns—both before and after expenses—than portfolios which held more uniformly weighted positions. These focused, ‘Big Bets’ portfolios delivered approximately 30 basis points of additional performance each month, or roughly 4 percentage points of additional return each year.7

III. FOCUSED FUNDS HAVE NOT HAD HIGHER RISK

Many financial professionals were taught that concentrated mutual funds expose investors to greater risk than more highly-diversified options. Generally, this is not the case. Research shows that holding 20 to 50 stocks

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7. Ibid.
can reduce unsystematic risk significantly. This concept is illustrated in Chart 2.

In late 2009, The Wall Street Journal published an article that included research from Morningstar, Inc., which demonstrated that mutual fund portfolios with 40 or fewer holdings “aren’t more volatile than more diversified funds, on average, and some are surprisingly steady despite their small number of holdings.”

In a separate study, Morningstar analyzed the standard deviation of the most diverse and the most concentrated mutual fund portfolios between 1992 and 2006. Their work showed that volatility was similar for the two groups, refuting the idea that concentrated portfolios, as a whole, are riskier than more diversified offerings.

### THE STRUCTURAL ADVANTAGES OF A FOCUSED APPROACH

Academic research shows that focused mutual funds have the potential to produce strong returns without added risk... but a key question is why? The answer may be quite simple. Focused funds hold fewer stocks than typical mutual funds, so focused fund managers have more time to research and understand the stocks they hold or are considering adding. This should give focused fund managers informational advantages that may aid in the identification of mispriced securities. Focused fund managers also can be more discriminating, avoiding stocks or sectors that they do not like, and focusing attention on a narrow band of companies or securities that meet their strict criteria.

In his 1993 letter to shareholders, Warren Buffet described the philosophy of many focused fund managers when he said:

> “Charlie and I decided long ago that in an investment lifetime it’s just too hard to make hundreds of smart decisions... Therefore, we adopted a strategy that required our being smart – and not too smart at that — only a very few times. Indeed, we’ll now settle for one good idea a year... The strategy we’ve adopted precludes our following standard diversification dogma. We believe that a policy of portfolio concentration may well decrease risk if it raises, as it should, both the intensity with which an investor thinks about a business and the comfort-level he must feel with its economic characteristics before buying into it.”

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10. Ibid.
11. Campbell, Lettau, Malkiel, and Xu.
RESEARCH PROVIDES EVIDENTIARY SUPPORT

While it makes intuitive sense that having better information may produce benefits for investors, academic research supports the idea, as well. It suggests that focused fund managers are more confident and have longer-term outlooks.

Information advantages:
In general, managers who hold fewer companies have more time and greater incentive to develop complete information about each company in which they invest. A study by Kaperczyk and Seru found that managers who rely less on public information when making buy and sell decisions deliver significantly higher returns.12

More confident stock selection:
Baks, Busse, and Green found that managers who invested a disproportionate amount of assets in their “best ideas” were confident about their ability to assess the merits of investment options both inside and outside of their portfolios.13

A long-term outlook:
A study by Kaperczyk, Sialm, and Zheng found that managers of concentrated portfolios are able to add value by exploiting long-term mispricings in the marketplace. As a result, they delivered strong performance with lower turnover during the 24-year period studied.14

WHY ISN’T FOCUSED INVESTING THE INDUSTRY STANDARD?

The “Best Ideas” study showed that “the typical fund manager has a small number of good investment ideas that provide positive alpha...the remaining ideas in the typical managed portfolio add little or no alpha.”15 This begs the question: “Why do managers include investments that are not “best ideas” in their portfolios? There are a variety of explanations.

Flawed financial incentives:
In general, mutual fund managers are paid a fixed percentage of total assets under management. This creates an incentive for managers to emphasize growth in fund assets over performance. Since investors tend to stay in mutual funds even when they deliver mediocre performance,16 few managers are willing to turn away new investors when cash inflows are more plentiful than high conviction investment ideas.

ON ADDING VALUE FOR INVESTORS

“Modern portfolio theory says that any portfolio of stocks that maximizes the Information Ratio is equally good for investors. But in truth, if the manager offers a portfolio with small weights in the good ideas and a very large weight in the market (or a near-market portfolio [that holds] zero-alpha or near zero-alpha stocks) the results for investors will be entirely unsatisfactory. The small allocation that investors make to any given manager combined with the small weight such a manager places in good ideas, means that the manager adds very little value.”17

Career risk:

John Maynard Keynes observed “Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally.” Managers who underperform their benchmarks for any one- or two-year period may face the threat of termination. As a result, many managers have incentives to avoid unsystematic risk, as well as a tendency to herd into popular sectors.\(^{18}\)

Legal and regulatory requirements:

The ‘Prudent Man Rule’ makes it attractive for portfolio managers to have well-diversified portfolios. Prudent protection of capital necessitates the avoidance of unwarranted risk.\(^{19}\) In addition, mutual fund managers are guided by specific regulations that were designed to prevent mutual funds’ assets from becoming too concentrated.\(^{20}\) As a result, managers cannot invest an unlimited amount of assets in a few holdings.

Managers who have the incentives, confidence, and ability to concentrate assets in their “best ideas” provide attractive opportunities for investment advisors seeking value-added active portfolio management.

Utilizing Focused Funds

While concentrated portfolios have potential to deliver outperformance without increasing risk, consider:

- Since “best ideas” tend to be smaller and less liquid, concentrated portfolios may be less nimble. Therefore, investors should plan to hold focused funds for longer periods of time.
- Concentrated portfolios may have little or no exposure to certain market sectors. Consequently, if a sector in which the fund has little exposure gets ‘hot,’ a concentrated portfolio may lag its benchmark for a period of time.
- The movement of a single stock in a positive or negative direction—based on rational or irrational investor behavior—may have a greater affect on a more concentrated portfolio.

Although these characteristics are unlikely to have long-lasting effects on performance, they may have a significant influence over shorter periods of time. As a result, more concentrated funds generally should be longer-term portfolio holdings.

At Hennessy Funds, financial professionals can find managers who are willing to buck conventional wisdom in order to create portfolios that have the potential to deliver outperformance. Boutique investment firms tend to have greater passion for markets and investing. Moreover, they have conviction in the investment processes they’ve developed a fervent commitment to disciplined execution of those processes.

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Consider Using Focused Funds As Satellites Or Alternatives To Core Holdings

Advisors who are looking for ways to improve performance potential may want to consider incorporating focused funds into their asset allocation strategies. Focused funds may be used as:

- **Satellite holdings**: A single focused fund may be used as a satellite holding to boost portfolio performance potential. The “Best ideas” study found that putting a modest percentage of assets in a concentrated mutual fund of “best ideas” was likely to improve performance potential.

- **Core replacement options**: Since portfolio managers’ “best ideas” rarely overlap, as you can see in Chart 3 below, several focused funds can be used in place of one highly-diversified core fund to improve performance potential without increasing risk. The Big Bets study provides support for the idea of replacing a highly diversified core holding with several focused funds. The study concluded that investing in portfolios of focused funds, instead of more highly diversified funds, could enhance overall portfolio performance.

**Chart 3: Fund Managers’ “Best Ideas” Rarely Overlap**

Mutual fund managers’ “best ideas” tend to be distinct. Over a 23-year period, about 62 percent of “best ideas” were unique to one manager, while just 7 percent were shared by five or more managers.

*Source: “Best Ideas”, April 2010*

**Final Thoughts**

Conventional wisdom is a set of beliefs that is accepted by a group of people. Once these beliefs become ingrained, few take the time to evaluate their substance. In the investment industry, conventional wisdom tells us that highly diversified mutual funds have the greatest potential to deliver attractive risk-adjusted returns. The review of research, however, shows that a more unconventional approach to mutual fund management—concentrating assets in managers’ “best ideas”—has the potential to provide investors with better risk-adjusted returns. If you would like to learn more about incorporating focused funds in your allocation strategies, please contact Hennessy Funds at 800.890.7118.

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22. Baks, Busse, and Green.

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About Hennessy Funds

Founded in 1989, Hennessy Funds has a longstanding track record of proven performance and offers a broad range of mutual funds, with strategies that can play a role in nearly every investor’s portfolio allocation. Our line-up includes traditional equity, specialty category and sector funds, as well as more conservative balanced and fixed income products. Each of the Hennessy Funds employs a consistent and repeatable investment process, combining time-tested stock selection strategies with a highly disciplined, team-managed approach. Our goal is to provide products that investors can have confidence in, knowing their money is invested as promised, with their best interest in mind.

Hennessy offers a number of funds with concentrated portfolios. The Hennessy Focus Fund and the Hennessy Japan Fund are actively managed and generally contain between 20-30 holdings. The Hennessy Cornerstone Mid Cap 30 Fund is quantitatively managed and includes 30 holdings.

Important Disclosure

Investors should consider the investment objectives, risks, charges and expenses carefully before investing. This and other important information can be found in the Fund’s statutory and summary prospectuses. To obtain a free prospectus, please call 800-966-4354 or visit hennessyfunds.com. Please read the prospectus carefully before investing.

Mutual fund investing involves risk; Principal loss is possible. A non-diversified fund, one that may concentrate its assets in fewer holdings than a diversified fund, is more exposed to individual stock volatility than a diversified fund. The Funds invest in small and medium capitalized companies, which involves additional risks such as limited liquidity and greater volatility. Investments in foreign securities involve greater volatility and political, economic and currency risk and differences in accounting methods. The Fund may participate in initial public offerings (“IPOs”) which may result in a magnified impact on the performance of the Fund. IPO’s are frequently volatile in price and may increase the turnover of the Fund, which may lead to increased expenses. Diversification does not assure a profit or protect against loss in a declining market.

Alpha is an annualized return measure of how much better or worse a fund’s performance is relative to an index of funds in the same category, after allowing for differences in risk. Basis Point is a unit equal to 1/100th of 1% and is used to denote the change in a financial instrument. Standard Deviation is a statistical measure of the historical volatility of a mutual fund or portfolio. Information ratio is a measure of the risk-adjusted return of a portfolio. Systematic Risk is the risk inherent to the entire market or entire market segment and cannot be avoided through diversification. Unsystematic Risk is the company or industry specific risk that is inherent in each investment and can be reduced through appropriate diversification.

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