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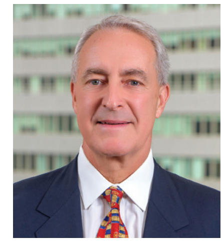

Thoughts for Investors

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The Eaves of Concentration and Diversification

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Advice on meeting investment goals is often positioned as right or wrong. We believe both sides should be heard. Hence our motto: *Audi Partem Alteram*, "Hear the Other Side." In the past, we wrote, *"like the eaves on the roof of a house if your portfolio doesn't contain 'growth' as well as 'value' you will eventually get wet."* In this letter, we examine why "prudent investing," especially during times of renewed inflation, should include the eaves of both concentration for wealth creation and diversification for wealth conservation. Both are important and complementary. Furthermore, switching can be costly in time, taxes, and lost returns when one discovers each's shortcomings.

"Diversification is a protection against ignorance. It makes very little sense for those who know what they're doing."

– Warren Buffett

Diversification seems one of the most "settled" tenets of "prudent investing" and risk reduction. But *risk is an opinion not a calculation.* How do you quantify the risk of a roller coaster or the future of the economy or inflation? Buffett is suggesting diversification isn't a substitute for learning. Diversification also has side effects. Owning multiple stocks in the same industry, as happens with index funds, can be duplicative and dilute returns. Having multiple advisors can also create unintended tax consequences, as when one sells the same thing another buys.

"The great personal fortunes in this country weren't built on a portfolio of fifty companies. They were built by someone who identified one wonderful business."

– Warren Buffett

Concentration creates wealth and can be a hedge against inflation. Buffett understands personal fortunes cannot be built on 500 companies in an index fund. Some investors even own multiple index funds, potentially totaling thousands of stocks! Eight stocks (Apple, Amazon, Alphabet, Meta, Microsoft, Netflix, Nvidia, and Tesla) currently dominate S&P 500 performance and support Buffett's observation. Furthermore, many of the remaining 492 stocks minimally contribute and perhaps collectively detract from wealth creation. It's not until a stock becomes big and successful, and its price reflects past accomplishments, that it "moves the needle" on the index, too late for new investors.

"I think that the modern investor, to get ahead, almost has to get in a few stocks that are way above average…. They try and have a few Apples or Googles or so on, just to keep up, because they know that a significant percentage of all the gains that come to all the common stockholders combined is going to come from a few of these super competitors."

– Charlie Munger (Warren Buffet's partner)

For example, as of this writing, the stock of Netflix, the revolutionary on-demand subscription video service, rose 2,000% before it was added to the index on December 10th, 2010,[1] a benefit to individual shareowners but not index fund investors. It rose another 1,500% after being added to the index, to the benefit of both.[2] Yet today, Netflix constitutes nearly one-half of one percent of the index. As of this writing, $1,000 invested in an S&P 500 index fund since May 23rd, 2002 (the date of Netflix's IPO) is worth $4,415.24. On the other hand, $1,000 invested directly in NFLX stock on that date is worth $373,821.[3] Obviously, you could also have chosen Bed, Bath and Beyond stock and lost all $1,000. A "wonderful business" clearly creates considerably more wealth for individual shareowners than for index fund investors. Even if you don't care about building a "personal fortune", a lack of concentration can increase the risk of not meeting goals, especially in the presence of inflation. Incidentally, most investors under age 50 have never seen inflation.

"Behold, the fool saith, "Put not all thine eggs in the one basket" - which is but a matter of saying, "Scatter your money and your attention"; but the wise man saith, "Put all your eggs in the one basket and - WATCH THAT BASKET."

– Mark Twain, Pudd'nhead Wilson

Missing out on the benefits of concentration, such as in the aforementioned stocks, has not gone unnoticed by Wall Street. A recent Charles Schwab ad announced, "Introducing investing you can personalize like your latte order" and pictures a large latte cup on which is scribbled "large cap index." Or you can add extra artificial intelligence or cannabis exposure if you fear missing those "flavors."

At the end of a recent, lengthy WSJ editorial on index investing, Princeton professor Burton Malkiel, a colleague of index investing pioneer Jack Bogle, explains, "If you do decide to alter your portfolio from market weightings, you can do so with much less risk if your active bets are made around a core portfolio that is broadly indexed." Is the urge to "personally index" or "alter your portfolio" an admission that, after nearly 50 years, index investing has failed to create any "personal fortunes" or adequately help investors meet goals? Add "emotional actions" about politics/inflation/interest rates/economic conditions to the mix, and the "scattershot" approach of 500 (or more) stocks in an index fund portfolio assures mediocrity.

[1] FactSet, NFLX Total Return from May 23rd, 2002 to December 10th, 2010, with dividends reinvested.

[2] FactSet, NFLX Total Return from December 10th, 2010 to November 10th, 2023 with dividends reinvested.

[3] Netflix Investor Relations, Investment Calculator, https://ir.netflix.net/stock-information/investment-calculator/default.aspx, Investment Amount: $1,000, Start date: May 23rd, 2002, End Date: November 10th, 2023.

"The first rule of compounding is never to interrupt it unnecessarily."

– Charlie Munger

How does one *prudently* include both concentration and diversification in a portfolio? Buffett and Munger spell it out. Saving and investing in "wonderful businesses" starts the process. Patiently letting that money compound "uninterrupted" provides concentration over time and helps fight emotional urges such as to "take a profit" and sell too early based on "headlines." Don't worry, a company with strong management will do the day-to-day worrying for you.

"I lost more money on the stocks I sold than the ones I bought."

– Anonymous

Many young investors go to sleep having a high level of risk tolerance but little money to invest and wake up older with money but little tolerance! Look at retirees of many public companies. Many contributed small amounts to stock savings plans over their careers and let them compound uninterrupted. In these particular cases, their portfolios are a testament to concentration's benefits.

"It's not whether you're right or wrong, but how much money you make when you're right and how much you lose when you're wrong."

– George Soros

In summary, diversification is an important hedge against losing money. If Soros (and Buffett and Munger) are correct, concentration is equally important as it is the source of wealth creation. We believe it is the best hedge against inflation and aid in meeting goals (other than reducing spending). Like the eaves on the roof of a house, having both concentration for building wealth and diversification for conserving it could keep you dry.

Growth of $1,000 Investment

Dividends Reinvested

Breakdown	NASDAQ:NFLX	IND_SPF:SP500
Start Date	May 23, 2002	May 23, 2002
End Date	Nov 10, 2023	Nov 10, 2023
Start Price/Share	$1.20	$1,097.08
End Price/Share	$447.24	$4,415.24
Total Return	37,282.15%	302.45%
Compound Annual Growth Rate	31.78%	6.70%
Starting Investment	$1,000.00	$1,000.00
Ending Investment	$373,821.46	$4,024.54
Years	21.5	21.5

Source: Netflix Investor Relations, Investment Calculator, https://ir.netflix.net/stock-information/investment-calculator/default.aspx,

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Thoughts for Investors is a quarterly client letter written for clients since 1997 by this author. The purpose is twofold. First, it is meant to help explain the investment philosophy that guides the author's approach to portfolio management. Second, it is meant to remind readers of important behavioral skills that the author believes are necessary to help them become successful investors. The author welcomes comments and criticisms, especially if they can be shared for the betterment of all investors. Quotation is permitted with full attribution.

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*https://www.usinflationcalculator.com/inflation/current-inflation-rates/#:~:text=The%20annual%20inflation%20rate%20for,data%20published%20March%2014%2C%202023.