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SSRN-Portfolio Concentration and the Performance of Individual Investors by Zoran Ivkovich, Clemens Sialm, Scott Weisbenner

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It is always nice when research confirms what we had theorized. For instance Ivkovich, Sialm, and Weisbenner show that when investors take highly undiversified positions, they on average earn higher returns than when they are diversified. However before you scrap all diversification theory, these higher returns come at the expense of added risk.

Why would investors hold a "concentrated" portfolio? It could be because of fixed transaction costs or because of information advantages, or because of what collectively could be called behavioral reasons.

"There are a few key reasons why households might hold poorly diversified portfolios. First, a lack of diversification could be prompted by behavioral biases such as familiarity, overconfidence, or risk-loving behavior such as holding stocks in "entertainment accounts." Second, individual investors might hold concentrated portfolios because they are able to identify stocks with high expected abnormal returns."
Overall the authors find that "Consistent with Odean (1999), we find that, on average, the stocks bought by individual investors underperform the stocks they sell by a wide margin."

However, when larger portfolios (over $25,000) are examined concentrated investors earn higher returns. "Regardless of portfolio size, the purchases made by diversified households underperform the appropriate Fama and French (1992) benchmark portfolios based on size and book-to-market deciles by one to two percentage points in the year following the purchase....the purchases made by concentrated households with large portfolios do substantially better, exceeding the appropriate Fama and French benchmark portfolios by 1.3 percentage points for those with relatively large portfolios (i.e., $25,000 or more) and by 2.3 percentage points for those with the largest portfolios (i.e., at least $100,000)."
However, before you scrap diversification plans (A DEFINITE NO-NO in my book!), these added returns come at the cost of added risk. While acknowledging problems with the Sharpe Ratio, the authors find that "wealthy households holding highly concentrated portfolios perform significantly better than the wealthy households holding widely diversified portfolios, we also find that their levels of total risk are larger and the Sharpe ratios of their stock portfolios are lower."

So why would investors take on this added risk? While some argue behavioral reasons (see above), however, such a view would have predicted no higher returns for the concentrated investors. Thus given the higher returns, the best explanation seems to be that the investors have superior information for these stocks and are trying to take advantage of this information.
Consistent with the information explanation, the authors write that "The excess return associated with concentration is stronger for investments in local stocks and stocks that are not included in the S&P 500 Index (which tend to have less analyst coverage and national media attention), potentially reflecting concentrated investors' ability to exploit information advantages. In sum, these findings are consistent with the hypothesis that skilled investors can exploit information asymmetries by concentrating their portfolios in the stocks about which they have particularly favorable information."

True. However, to get this excess return the concentrated investors (a term I like more than "skilled investors") do take on added risk. It is unclear whether they can earn an excess return on a risk adjusted basis.

VERY Interesting!

As an aside, does anyone else note the irony of a paper that essentially comes to the defense of investor rationality, resting on less than perfectly efficient markets.

Suggested citation:

Ivkovich, Zoran, Sialm, Clemens and Weisbenner, Scott J., "Portfolio Concentration and the Performance of Individual Investors" (February 2005). **http://ssrn.com/abstract=568156**