SILVERCREST
ASSET MANAGEMENT GROUP

DIVERSIFICATION VS. COMPLEXITY

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Starting a collection as a hobby can be quite fun. Whether it is baseball cards or classic cars, there is pleasure to be had in finding the next item for an ever-expanding collection. Unfortunately, when this mentality extends to investing, complexity ensues. It is all too easy to think that the next great idea or fund will make everything better. It is equally easy to cross over from diversification to di*wors*ification. We often deploy our risk analytic tools towards the task of simplifying portfolios by eliminating duplicative or deleterious holdings.

One reason complexity abounds is the endless stream of readily available investing information, paired with the vast universe of easily accessible investment opportunities. Another source of complexity is the desire to incorporate multiple voices in the investment selection process. Family members, advisors and board members are all potential sources of new ideas. Over time this may lead to investments that were made for sub-optimal reasons.

Some complexity is unavoidable, such as that which results from owning less liquid investments like private equity funds. These have long lives, exits that are not controlled by the investor, and managers that may have multiple active funds. In such cases, maintaining access to funds and diversification across vintages may require numerous fund investments.

Even in more liquid strategies, tax considerations may lead to an investment being exited in stages with both the new and old investments taking up spots in a portfolio. Capacity constraints may also lead to small, but beneficial, positions. While it makes sense to consider the tradeoffs of additional positions that occur for these reasons, these tend not to be the primary sources of complexity.

The primary factor behind the tendency for excessive complexity, however, is the laudable goal of diversification. Despite its inherent goodness—the only "free lunch" in investing—it is subject to a variety of pitfalls. The benefits, and the complexity that comes with diversification, are a matter of degree—going far enough without going too far. In many cases, diversification can be a convenient excuse for decisions that, while understandable, add little or no value and can cause or mask real problems.

The overwhelming number of investment options makes the selection process very difficult. Opting to be more diversified—a "strength in numbers" approach—is often the result, even if it brings with it unnecessary complexity. Often, it may simply be difficult to be selective enough when faced with so many choices. This feeds into the feeling that making a single choice is a worse outcome than choosing several options and increasing the likelihood that at least one does well. A less benign possibility is that inadequate due diligence or research may cause a lack of conviction.

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It is also easy to lose sight of the goals and constraints of the selection process, especially in the face of the storytelling ability of sophisticated and talented managers and marketers. At the same time, some large and successful portfolios, such as endowments, are highly complex, so it is understandable to conclude that mimicking them is defensible, if not justified. This may be a false analogy, however, either because they are succeeding despite being overly complex or because they are deploying substantial resources specifically to manage the complexity. Complexity is not a required ingredient for success.

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While having more investments is intrinsically more fun, few investors are called to task for having too many investments. A valuable first step in any effort to limit complexity is simply to acknowledge it and to evaluate how it might be having a negative impact.

WHAT TO DO?

1) Define objectives and build towards those. Don't collect investments, rather select them towards meeting goals.
2) Make each new investment earn a spot in a portfolio. Be sure it improves the profile of the portfolio, consistent with objectives.
3) Rebalance and prune—subtraction can be additive.

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