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The Fallacy of Broad Diversification

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"I used to own one great company. Now I own eight hundred mediocre ones. My accountant calls it progress."

In modern investing, few ideas are as universally accepted - and as poorly understood - as diversification. It is recited as gospel by investment advisors, woven into the very fabric of asset allocation models, and often portrayed as the single most effective way to manage risk. "Don't put all your eggs in one basket," we're told. Yet, in practice, broad diversification for the sake of diversification can devolve into what it was meant to prevent: a false sense of security, diluted conviction, and the underperformance of mediocrity.

The Original Intent of Diversification: Risk Reduction Through Independence

The principle of diversification, as articulated in Harry Markowitz's Modern Portfolio Theory (MPT), was elegant and powerful. By combining assets with imperfect correlations, an investor could reduce portfolio volatility without necessarily sacrificing expected return. The theory held – mathematically - that risk could be minimized through intelligent combination, not through randomness.

But what began as a disciplined optimization of correlated risk factors has, over time, been transformed into a doctrine of excessive breadth. Investors and institutions now equate diversification with safety, and safety with size: hundreds of stocks, dozens of funds, multiple asset classes, and endless geographic exposures. What was once a method for achieving efficient risk-return tradeoffs has become an excuse for complexity and complacency.

In drinking the diversification cool aid, it eventually stops protecting capital and starts diluting performance.

The Dilution of Conviction

Broad diversification frequently leads to "index hugging" - the quiet mimicry of market indices under the guise of active management. The portfolio that holds 100 or 200 securities is unlikely to possess genuine insight about each. Instead, it tends to replicate the return of the market, minus fees, while offering no real prospect of outperformance. Diversification often replaces judgement with diffusion.

In behavioral terms, over-diversification allows managers to hide behind the law of large numbers. The failure of one holding is immaterial when its position size is one percent - or less - of the total portfolio. But so too are the successes. Broad diversification dilutes both risk and reward, leading to an "averaging out" of results that can quietly erode performance over time. And a portfolio made up of multiple "diversified" ETFs only compounds the issue.

By spreading capital too broadly, investors:

- Avoid a deep understanding of any one domain,
- Dilute exposure to their highest-conviction insights, and
- Sacrifice alpha in pursuit of pseudo-safety.

The result is the "diworsified portfolio" - a collection of average ideas producing average results. Charlie Munger summarized it perfectly:

"Wide diversification is only required when investors do not understand what they are doing."

In practice, a well-researched, concentrated portfolio often outperforms a diversified index because skill compounds faster than the noise it's averaged with.

The Myth of Safety Through Quantity

Owning more securities does not always mean less risk. During periods of systemic stress - such as the financial crisis of 2008 or the pandemic drawdown of 2020 - correlations between asset classes tend to rise sharply. What seemed like a diversified portfolio of equities, credit, and alternatives can suddenly behave as a single, highly volatile exposure to global risk.

In such times, the illusion of diversification is laid bare. The investor who believed they were insulated through quantity discovers that liquidity, leverage, and behavioral herding override statistical diversification. True risk management lies not in the number of positions held, but in the quality and interaction of those exposures under stress.

Concentration and the Power of Insight

Some of the greatest investors in history - Warren Buffett, Charlie Munger, Bill Ackman, and Peter Lynch - have all expressed skepticism toward excessive diversification. Buffett famously called it “protection against ignorance.” His point was not to dismiss risk management, but to emphasize that deep understanding of a few businesses can be far safer than superficial knowledge of many.

Concentrated portfolios, when constructed through rigorous analysis, often outperform diversified ones because they align capital with conviction. Each holding is studied, understood, and continuously monitored. The portfolio becomes a deliberate reflection of insight, not an exercise in statistical comfort.

Behavioral Diversification: The Modern Reframe

Rather than diversifying by quantity, investors should consider diversifying by behavior. A portfolio can be diversified across time horizons, liquidity needs, and sources of return (growth, yield, inflation protection) - without losing focus. Behavioral diversification recognizes that the investor’s temperament and decision process matter as much as the assets themselves. Much like one would ladder a bond portfolio, one’s entire portfolio of investments could or should be laddered to anticipate time horizons, liquidity needs and inflation protection.

The goal is not to own everything but to understand why each holding exists - and what role it plays in the portfolio’s long-term narrative.

The New Discipline

In today’s environment of low expected returns and high correlations, broad diversification has lost much of its protective value. Investors should replace it with intentional concentration – or better yet, well-conceived diversification: fewer positions, higher conviction, and constant re-evaluation of each asset’s contribution to the overall objective.

True diversification is not breadth; it is balance. It is the art of constructing a portfolio that can withstand stress without sacrificing purpose. The fallacy lies not in the theory, but in its misapplication - a warning as relevant today as it was when Modern Portfolio Theory was born.

Diversification Creates Hidden Frictions

With diversification, each additional asset introduces costs and inefficiencies: trading and rebalancing costs, tax inefficiency, governance complexity, and dilution of attention and analytical bandwidth.

Complexity compounds faster than protection. True portfolio resilience comes from simplicity with purpose, not complexity for its own sake.

Diversification Is Backward-Looking

Diversification relies on historical correlations - but those are products of yesterday’s regime. As macro structures change (monetary policy, globalization, technology), past relationships become meaningless.

Static diversification is therefore an act of faith in the past, not an adaptation to the future. Adaptive concentration - dynamically adjusting exposure based on regime signals - is far more aligned with Post-Modern principles.

The Post-Modern Alternative: Dynamic Concentration and Asymmetric Defense

Post Modern Portfolio Theory does not reject diversification outright; it redefines its purpose.

- Replace static diversification with dynamic risk allocation.
- Replace many small bets with fewer, asymmetric positions protected by downside hedges.
- Replace mean-variance efficiency with adaptive resilience.

Concentration amplifies skill and conviction. Optionality and adaptive hedging mitigate downside. Together, they achieve the very stability diversification only promised.

Summary — Why Diversification Is Bad for Real Returns

Modern Portfolio Theory Logic	Real-World Reality
More assets reduce risk	Correlations rise in crisis; risk persists
Diversification smooths returns	It dulls compounding and alpha
Broader exposure ensures safety	Complexity hides fragility
Risk reduction improves utility	Return dilution reduces wealth
Efficient frontier is optimal	Fragile frontier collapses under change

In short, diversification protects the illusion of safety at the cost of real performance. It transforms potential energy (conviction) into entropy (mediocrity).

Conclusion

Diversification is not evil; it's just obsolete when applied statically. In the post-modern world of reflexive, adaptive markets, investors need:

- Concentration in understood risk.
- Optionality against unknown risk.
- Flexibility under changing risk.

The future belongs to portfolios that are not diversified but *designed* - structured around asymmetry, adaptability, and resilience.

"Diversification is protection against ignorance. It makes little sense if you know what you're doing." – Warren Buffett

"Diversification may preserve wealth, but concentration builds wealth." – Warren Buffett

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