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Devina Mehra: Diversified or concentrated portfolio? It’s an easy choice

Devina Mehra | 7 May 2025

Diversification reduces the element of luck and increases the contribution of skill in the performance of a portfolio or fund. (istockphoto)

SUMMARY

Investing in stocks is a game of both luck and skill—and diversification assures the latter a larger role to play. Performance predictability goes up across large numbers and holding a wide range of equities reduces the element of luck.

If you talk to people who have read so-called investment gurus or at least summaries of their books, they will earnestly tell you that the way to outperform the market is to have a concentrated portfolio of so-called high conviction bets. The logic goes something like this: If you are buying a number of stocks for your fund or portfolio, then you are replicating the market. How then can you do better than it?

Most market players, especially in the portfolio management services (PMS) industry, pitch themselves as providing value because they buy only around 15 stocks. This is also supposed to distinguish them from mutual fund schemes, which hold a large number of stocks.

The question is: Is it possible to outperform with a diversified portfolio? And how likely are you to do it?

First the data. In most years, more than 50% of listed stocks outperform the market index. The average is more like 55%. The numbers are pretty similar whether you look at India or other markets like the US—wherever a large number of stocks are traded.

There are roughly 750-800 stocks listed in India with market capitalization greater than ₹1,000 crore and each year, close to 400 of them outperform the market.

If you are holding, say 40 or 60 stocks, and they are mainly from this outperforming bucket, your portfolio as a whole will outperform the index. You do not need to be super concentrated to ensure outperformance.

Therefore, it is clear that you can theoretically outperform the market with a diversified equity portfolio. But let us invert the question.

Does a diversified portfolio lead to outperformance?

What is the magic formula for such success? Is it that if you hold 40 rather than 14 stocks, your portfolio will automatically outperform and deliver 'alpha'?

There is a nuanced answer to this. People talking about diversification versus concentration often do not understand the logic of a diversified portfolio. They only know of it as a term and not what its underlying first principles and logic are.

The reality? It is not that if you hold more stocks your performance will be better. So, what is the logic for diversification?

Why is it that I speak about diversification and advise it? Why is First Global's equity PMS scheme called India Super 50? It aims to hold around 50-60 stocks at most times. Is holding a large number of stocks the magic formula?

Not quite. It is not as if buying a higher number of stocks gets you performance.

What diversification does is simply this: It reduces the element of luck and increases the contribution of skill in the performance of a portfolio or fund.

In other words, it ensures that a portfolio's returns are closer to the expected value of those returns, or that the results are close to what you can expect, given your or your fund manager's skill levels.

Let me explain. It might sound complicated, but is actually quite simple.

Think of this. You know a coin is expected to have a 50% probability of heads or tails when tossed.

Nevertheless, if you toss it only ten times, it may happen that you might get only two heads, or you might get eight or nine heads. Basically, the predictability is not very high when it comes to a small number of tosses. However, if you toss it 100 times, it is going to be closer to that 50:50 number.

Now, investing is a game of both skill and luck. Diversification increases the component of skill and reduces the element of luck.

Suppose you are skilful enough to pick the right stocks 60% or 65% of the time. Why only three-fifths of the time? Because no fund manager or investor in the world is ever right 80%, 90% or 100% of the time—so forget about that. So, even if you get your picks 60% or even 55% right, actually it is pretty good.

What diversification does is that if you are buying, say, 50 stocks instead of 15, you are more likely to get close to that 60% or 65% hit rate in the real world.

In short, if you actually have the skill, diversification will ensure that it shows up in your results.

But if you do not have the skill, then just increasing the number of stocks is not going to help.

On the other hand, with only a few stocks in your portfolio, you are playing luck mainly. With fewer stocks, what happens is that the element of chance increases.

So if you are buying only 12 or 15 stocks, there is a great element of chance that comes to play—and at times, it may even favour you—so there might even be one or two years when that kind of strategy does extremely well. But that is neither predictable nor replicable.

On the other hand, diversification increases predictability and makes the results more foreseeable as they are closer to reflecting your skill level.

In summary, diversification works only if you have the skill. Only if your system is designed such that it gives you outperformance will it ensure that you'll have outperformance in the real world too.

It is that simple!

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