

## Diversification works?

By **Ashley Owen** on August 15 2013

Every finance text book extolls the virtues of diversification. Diversification is the holy grail of investing, we are told. Diversification is said to be the only 'free lunch' in the world of investing. We are constantly being reminded that we must diversify – to not 'put all our eggs in one basket'. We need to spread it around, preferably into different sorts of things, into different types of assets, in different industries and in different markets, to give ourselves the best chances of success, and to minimise the chances of loss.

If any one thing doesn't work out or loses money or fails, then something else is bound to work if we spread it around into enough different things.

We need to have a fall-back plan, a plan B in case plan A doesn't work, and even a plan C in case plans A and B fail. The more fall-back plans we have the better. Three different asset classes with different characteristics are better than two, and four is even better than three, etc. The more different each one is, the better, so they are not all affected by the same adverse events.

### **My perfect plan**

All this sounds like it makes sense, so years ago I decided to follow the textbooks and diversify in order to give myself the best chance of succeeding in life and making money. Here is my ultimate diversification plan for success:

On Mondays I'm a magician in Mumbai, on Tuesdays I'm a tiler in Tunisia, on Wednesdays I'm a welder in Wellington, then on Thursdays I'm a thoracic surgeon in Thessalonica. But on Fridays I'm a fruiterer in Frankfurt and on Saturdays I'm a sax player in Sacramento. Then I sleep in Sydney on Sundays, before doing it all again the following week.

See? I'm diversifying across different skills, across different markets in different countries and even across different time zones and different regions of the world. It's the perfect plan!

If the market for magicians in Mumbai melts, I can always turn to tiling in Tunisia. And if that market turns turtle I can always work as a welder in windy Wellington, and so on. Actually the market for thoracic surgeons in Thessalonica is rather thin at the moment, but that's ok because fortuitously the market for fruiterers in Frankfurt is fantastic right now. Diversification works!

That's nonsense of course! By diversifying you end up being bad at everything. Nobody ever became good at anything by diversifying.

Nobody ever built a great business, or created a great nation, or amassed a great fortune, or became a great painter or musician or sportsperson or anything else, by diversifying. The only way to become good at anything, or to build wealth, or to build a great company, or become a great doctor or scientist, or to do anything else well in this world is to specialise, concentrate and focus. You need to specialise, concentrate and focus on a single skill, or a single idea or a single business, or a single sport or talent. You need to specialise, concentrate and focus on just one thing and then make that one thing your life's work.

Warren Buffett, the world's greatest investor, says: "put all your eggs in one basket, but watch that basket very closely". Buffett has been following and refining his investment strategy since he bought his first shares at age 11 in 1941. Broadly his strategy is to take big concentrated bets in a small number of companies that he makes it his business to know back-to-front and inside out. He almost always takes controlling stakes or large minority stakes in the companies he invests in, so he can dictate or at least influence their board, strategy and direction, and almost all of his investments have been in the US.

Specialise, concentrate and focus only on what you know best.

### **No safety nets**

Ever noticed how the people who built great companies and made great fortunes often dropped out of high school or college? Even in today's world when we are told that education is everything? Think Bill Gates (Microsoft), Steve Jobs (Apple), Larry Ellison (Oracle), Mark Zuckerberg (Facebook), Michael Dell (Dell Computers), Ted Turner (CNN), Larry Page & Sergey Brin (Google) and countless others. They didn't say "I'd better just finish this degree – just in case things don't work out." They ditched their fall-back plans and went after their dreams without a safety net, without a fall back plan and without any thought of 'diversification'.

The best way to go forward is to burn your bridges behind you! To have no plan B or plan C, "just in case". I'll bet Mao Zedong never said, "I'll give this long march thing a couple of weeks and see how it goes, but I can always go back to being a dentist, or tiler". The same goes for Alexander the Great, Napoleon, John D Rockefeller, or JP Morgan, or anybody else who built a great nation or a great business or a great fortune.

### **Australia**

In the case of Australia, take a look through BRW's 'Rich 200' list in any given year. Almost every single person in the list every year got there by their single-minded focus on their narrow field of expertise, by sticking to it and making it their life's work. Gina Reinhart, Andrew Forrest and Clive Palmer (iron ore), Harry Triguboff, Bob Ell, Lloyd Williams, Ron Walker, Lang Walker (property development), Frank Lowy, John Gandel and Maurice Adler (shopping centres), Len Buckeridge and the Grollos (construction), Len Ainsworth (poker machines), James Packer (selling his father's media empire at the top of the market and then focusing instead on casinos), Dick Pratt's family (packaging), Ivan Glasenberg (commodities trading), Lindsay Fox, Paul Little and Peter Gunn (transport), Solly Lew, Gerry Harvey, John Van Lieshout and Morry Fraid (retailing), Bob Oatley (wine), Bob Ingham (chicken farming), Graham Turner and Geoff Harris (travel agents), are good examples. All are the result of single-minded dedication and focus on their narrow area of speciality, and sticking to it for decades. Sticking to their focus, staying on the narrow path, and never allowing their attention to be diverted into *diversions* ('*Diversification*' after all is allowing oneself to be *diverted* into *diversions*!).

On the other hand there are only a few isolated examples of real success attained in more than one field. One is Kerry Stokes, who made his fortune in shopping centre developments first, and then in media, and more recently in mining services in China (via Caterpillar). Another is Ralph Sarich, who made his first fortune with his orbital engine and then used the proceeds successfully in property development.

## **Diversification usually spells trouble**

For most successful people, diversification gets them into trouble. Their life stories are littered with examples of diverting off the straight and narrow and into areas outside their narrow area of specialty. This is usually in booms when it is hard for even them to avoid getting caught up in the frenzy.

One prime example was Frank Lowy's failed adventure into television, retailing and oil via Westfield Capital Corp (1986) which collapsed in 1989, losing \$300 million. Even within the shopping centre industry, Lowy had several false starts in expanding into the US market – Westfield International (1988-9), Westfield America Trust (1996-2004), and Westfield America Inc (1997-2001). Investors in Lowy's companies since 1960 have done extraordinarily well, but only if they avoided these 'non-core' departures from his single-minded focus on shopping centre development in Australia.

## **What about ordinary people?**

Ok, at this point you may be saying to yourself – "I don't want to be a billionaire. I just want to make a bit more money."

This strategy of single minded specialisation, concentration and focus doesn't just apply to people who ended up being super rich and/or famous. It applies to everybody. Most people play a sport or an instrument or have some type of hobby. Everybody knows that the only way to become even half good at any sport or any instrument or any hobby is to specialise, concentrate and focus on that one sport or instrument or hobby. There are no short cuts. To be half good at anything still takes several years of focus.

This principle applies to people building even modest amounts of wealth. The biggest source of wealth for most moderately wealthy Australians (say \$2-5 million) is from their business or profession. Business success comes from specialising, concentrating and focusing on one specific customer need and then sticking to that single narrow focus for many years through thick and thin, through boom times and busts. Professional success also comes from specialisation – whether it is for dentists, architects, lawyers or doctors. In most cases the way to get ahead and build a profitable and valuable practice is to specialise.

Very often, where business people and professionals tend to blow up their money is when they try to diversify into other areas – for example when they venture into other things like a winery, or a property development, or a race horse, or forex trading, or shares in dot-coms, mining explorers, bio-techs or whatever the latest fad is.

I test this principle on people all the time, and readers can ask themselves the same question. When I am talking to investors who have accumulated say \$100,000 or \$1 million or even \$10 million so far in their lives I ask them how they started out with nothing when they were young and ended up with what they have today. In 99% of cases the wealth they have today has come from the fruits of their specialisation, concentration or focus. They built their wealth up to the current level by specialising in what they do best, whether they are a dentist or a boat builder or a plumber.

If I am talking to a lawyer I ask them what they would do if they wanted to make more money – invest some time/money in doing a course to get them into a specialist part of legal practice, or invest time/money in a dentistry course to become a dentist on the week-ends? The answer is simple – you make more money by specialising in what you know best.

So if they have built the wealth they have today from their specialisation and focus, what makes them think they could or should suddenly build the next stage of their wealth by diversifying into a new area

(or worse still, a whole bunch of new areas) about which they know very little or nothing. It doesn't make any sense.

### **Against human nature**

The very idea of expecting better results through diversification goes against the whole history of human advancement and development.

Specialisation, concentration and focusing on specific skills and roles is what got early humans out of caves and into agriculture, and then beyond agriculture into the industrial revolution, and then into the post-industrial information society we live in today. We are all better off today, individually and collectively, because our ancestors specialised, concentrated and focused instead of trying to be good at more than one thing.

The whole modern capitalist system and the standard of living it has generated for us all, is built on the principle of specialisation of each individual, firm and even each country. Each individual, firm and country specialises on what it does best and then trades with other individuals, firms and countries for everything else. For example, we live longer and healthier lives today because our forefathers (and foremothers) specialised, concentrated and focused on what developed into what we know today as the medical profession. Without specialisation, concentration and focus in all areas of human endeavour we would still be grunting to each other in the back of caves and living very short brutish lives.

So, if the key to success with building wealth, or building anything else of value to ourselves, our families or society is through specialisation, concentration and focusing on doing just one thing well, surely diversification is a backward step?

Why are we constantly being told that diversification is the key to building wealth?

In future articles I will explore what role diversification plays in investing – where it works and where it doesn't. But for now I gotta go. Tomorrow is Monday, so it's off to the Mumbai magic market for me!

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