

PERSPECTIVES
VIEWPOINTS FROM THE ACADIAN TEAM

Concentrated Equity: Standing Out but Not Outstanding

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- Concentrated equity strategies, i.e., discretionary portfolios that hold a very small number of stocks, have gone mainstream in recent years.
- While the concept has some intuitive appeal, it preys on the behavioral vulnerabilities of asset owners.
- Moreover, in a novel study of institutional equity investments, we find no evidence that concentrated equity strategies outperform. We also highlight special challenges that they pose for asset owners who mistake them for an easy path to “high conviction.”

Investment managers have great incentive to stand out from their peers—or more precisely—to *have stood out* from their peers. Institutional asset owners hire managers *who have produced* large positive excess returns.¹ Searches are kicked off by scanning databases for strategies that *have delivered* top-quartile performance. Managers that *have outperformed* receive fawning attention in the media, both social and traditional.

This focus on demonstrated performance is natural and has some benefits. It fuels managers’ relentless search to discover mispriced assets, which, in turn, is what produces (reasonably) efficient markets. But in a world where distinguishing investment skill from luck is no easy task, hindsight bias has fostered the disturbing normalization of an investing approach that leans into noise—highly concentrated equity strategies.

Preying on Investors’ Behavioral Biases

Concentrated equity strategies, i.e., discretionary strategies that hold a small number of stocks, have been gradually gaining acceptance among institutional asset owners for over a decade. To be sure, there is a substantive aspect to their appeal. The premise of investing with stock pickers who focus on a limited set of “high conviction” holdings tempts many asset owners who are hungry for active returns and wary of paying material fees for “closet passive” products.

The approach also has indirect support from academic literature showing that mutual fund managers’ largest active positions outperform; their other holdings seem dead weight.

But concentrated investing also preys on investors’ tendency to chase performance. Relative to their better-diversified counterparts, concentrated strategies generate noisier returns, i.e., higher active risk. This noise induces greater dispersion in their performance, which means that, whether or not they have superior skill, concentrated managers are likely to be overrepresented among outperformers and, therefore, more likely to attract the eye of performance-hungry asset owners.

What Does the Evidence Show?

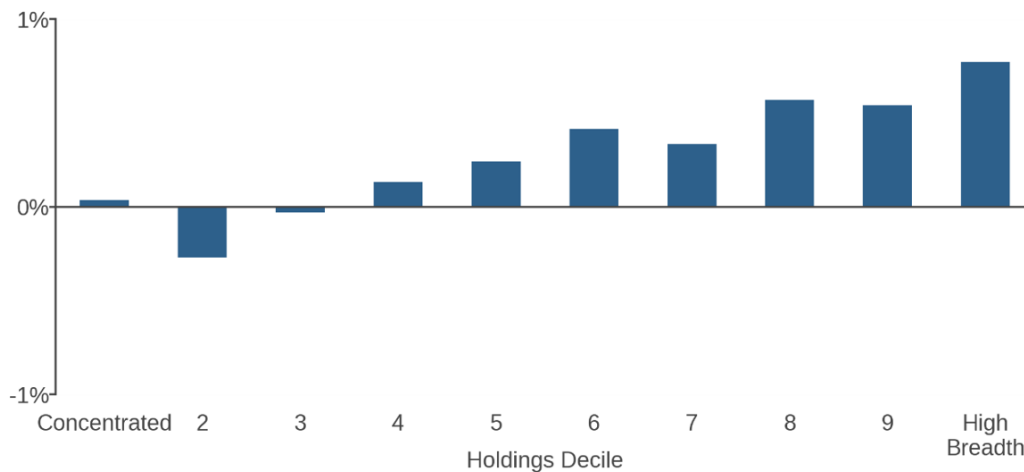
Do concentrated managers actually exhibit greater skill? My colleague, Anshuman Ramachandran and I, studied this question in recent research.² In an analysis of almost 3,000 institutional long-only U.S. equity strategies over the past decade, we found no evidence that highly concentrated strategies, i.e., strategies in the smallest decile by number of stocks held (median of ~25), outperform their benchmarks to a greater degree than better-diversified ones (Figure 1). We also found no evidence that concentrated managers exhibit superior stock-selection ability. These results held up after controlling for investment style, AUM, and other considerations.

¹ Goyal, Amit and Sunil Wahal, “The Selection and Termination of Investment Management Firms by Plan Sponsors.” *The Journal of Finance* 63, issue 4 (August 2008): 1805-1847.

² See [Concentrated Equity: Practice versus Premise](#), Acadian, October 2024.

Figure 1: Average Annualized Active Returns by Holdings Decile

Versus manager's preferred benchmark; based on data from 2013-2023



Active returns are measured relative to the Primary Benchmark recorded in eVestment. The performance information presented here is gross of fees. Strategies are sorted into holdings deciles each month, and excess returns within those holdings deciles are then averaged over time. Dataset includes long-only U.S. strategies that satisfy several conditions related to data completeness and consistency. Details available upon request. Source: Acadian based on data from eVestment. eVestment Alliance, LLC, and its affiliated entities (collectively, eVestment[™]) collect information directly from investment management firms and other sources believed to be reliable, however, eVestment does not guarantee or warrant the accuracy, timeliness, or completeness of the information provided and is not responsible for any errors or omissions. Performance results may be provided with additional disclosures available on eVestment's systems and other important considerations such as fees that may be applicable. Not for general distribution and limited distribution may only be made pursuant to client's agreement terms. All managers in an eVestment category are not necessarily included. Copyright 2012-2024 eVestment Alliance, LLC. All Rights Reserved. Every investment program has an opportunity for loss as well as profit. Past performance is no guarantee of future returns. For illustrative purposes only.

While greater skill wasn't evident, the impact of greater noise was. Concentrated managers exhibited larger active drawdowns and were overrepresented in the poorest performance decile (not just the best).

Many asset owners who invest in concentrated strategies understand that any single such portfolio will generate noisy returns. Instead of holding one concentrated strategy, they hold a portfolio of a few. The value proposition is that the asset owner will be better off assuming the tasks of portfolio construction and management while focusing their active managers exclusively on selecting stocks. The hope is that the portfolio of concentrated strategies will have higher risk-adjusted performance than a single diversified strategy.

But this approach reflects two assumptions: not only that concentrated managers possess and (predictably) manifest greater skill than those that are better diversified, but also that asset owners can identify and craft well-risk-managed portfolios of them. The performance analysis in our study disputes the first assumption. Our research also exposed reasons to doubt the validity of the second.

Specifically, we document that concentrated strategies exhibit noisier risk exposures, greater style drift, and suboptimal tradeoffs in systematic alpha drivers. This is hardly surprising in a class of strategies typified by rudimentary portfolio construction methods. Even well-known risk and alpha factor exposures are likely to go unmeasured and unmanaged. That's simply not the focus of

managers who view their task in terms of becoming the next Warren Buffett—trying to identify promising individual companies.

But this also means that the behavior of concentrated strategies is more difficult for asset managers to predict. *Ex post*, their return streams may stray far from what was expected *ex ante*. Unfortunately, it is the asset owner who assumes the associated challenges in manager selection, risk management, and performance analysis. These tasks are easier said than done, yet they are routinely waved away in literature promoting concentration.

Too Easy to Imitate

The concept of concentration has a seemingly persuasive logic: In the context of an old-school, labor-intensive stock picking approach, a discretionary PM surely would struggle to form opinions about more than a limited set of companies and to manage an expansive portfolio. Holding a diversified portfolio would imply investing in companies that the manager knows little about, perhaps just to soak up AUM.³

So where does the premise go wrong? As discussed, one reason is hindsight bias. In an investing world filled with noise, it is difficult to discern skill. Strategies, investment approaches, and even asset classes that have performed well attract attention and flows. Concentrated portfolios, in effect, exploit the difficulty that investors have in processing that noise.

³ This logic does not apply to systematic investing approaches. See [Concentration, Conviction, and Quant](#), Acadian, 2015.

In this regard, the recent investing climate has been especially conducive to concentration. In an environment where market rallies have been identified with just a few high-profile stocks (think Magnificent 7), and even benchmarks came to be described as highly concentrated (whether accurately or not⁴), the notion of limiting investments to a small and stylistically narrow set of names became natural.

But another problem with concentrated investing, which is inextricably tied into its underlying intuition, is that it's *easy*. Forming a small, low-turnover portfolio of relatively liquid stocks does not have to be any challenge. For all the good that Warren Buffett has done, he has also created a legion of imitators whose primary occupation seems to be penning folksy investor letters that explain the idiosyncratic genius of their winners, why their losers were the product of circumstances beyond their control, and how they fill their time. While plenty of these wannabes are eventually exposed, many draw substantial assets first.

Conclusion

Are there stock pickers with special skill? Yes. But asset owners would be wise to expect that they are harder than ever to find. Concentrated investing is highly susceptible to copycat approaches. As my colleague Owen Lamont has pointed out, to the extent that the number of holdings in a portfolio has become identified with investment conviction, a misguided and harmful conflation, the metric has also lost all value.⁵ Individual PMs and product purveyors can too easily take a flyer on launching a “high conviction” strategy to capitalize on the concentration trend.

In summary, it's time to dismiss the number of holdings as a measure of conviction and to recognize that concentrated equity strategies are a risky and deceptively simple solution for asset owners in pursuit of exceptional skill.

⁴ See [Owenomics: Magnificent Ignorance about the Magnificent Seven](#), June 2024.

⁵ See [Owenomics: Goodhart's Law of Active Management](#), September 2024.

BIOGRAPHY

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Seth is Acadian's Director of Client Advisory, a team that produces original research on topical issues in systematic investing and regularly meets with key clients, consultants, and prospects. Seth also chairs Acadian's Editorial Board, driving the firm's thought leadership. Prior to joining Acadian in 2014, Seth held senior roles in equity derivatives trading, research, and strategy at UBS, Barclays Global Investors, and Deutsche Bank. Seth holds a Ph.D. in economics from Stanford University and a B.A. in economics from the University of Chicago.

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