TRANSCRIPT

Swinging at the Right Pitches

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Warren Buffett sums up his most important lesson in investing by referencing Ted Williams' book, The Science of Hitting. Williams was of course a Major League Baseball player who ranks as the last batter to hit over .400. He once divulged that his secret was to wait for the right pitch. Buffett has commented, "That's exactly the philosophy I have about investing—wait for the right pitch and wait for the right deal. And it will come. It's the key to investing."

So how can investors apply Buffett's advice and hope to benefit from it? By investing in focused strategies, portfolios that typically hold 50 or fewer stocks and include only managers' highest conviction ideas—their version of the right pitch.

Just as hitters have different views on what determines a good pitch that is worthy of a swing, portfolio managers have varying degrees of conviction about their holdings in larger, diversified strategies. Research supports the idea that managers' highest conviction positions are most likely to outperform. As a result, focused portfolios have greater potential to generate alpha.

This fact is not widely visible across the mutual fund industry, however, which has evolved over the years to effectively offer one-stop shopping. Investors have generally bought broadly diversified portfolios that minimize risk relative to benchmarks, or tracking error, while seeking relative outperformance. However, the industry may have taken risk mitigation too far, as evidenced by the large number of broadly diversified strategies that are unable to outperform their benchmarks. Investors may better handle risk management by using a combination of focused portfolios to achieve asset allocation targets rather than investing with individual managers who hold a large number of positions.

In our view, accepting more volatility or tracking error in individual strategies can be a key solution for investors who want more alpha. Putting multiple focused strategies together in a thoughtful asset allocation plan may make the most of managers' skills and still provide the desired diversification.

Focused strategies therefore offer a remedy to the challenges associated with excessive diversification at the individual strategy level and potentially produce better results. We believe investors who allow portfolio managers to swing only at the best pitches stand a very good chance of winning.

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