Position Size and Diversification

A common question asked by beginner investors is how much of their trading capital should they commit to one stock?

There are two aspects to this problem. The best known is the position size rule, which is to risk no more than a certain low percentage: 0.5% to 2% depending on who you read, how they calculate the risk and how big your trading capital is.

However, the other aspect is how much of your capital to commit, assuming you are not risking up to the maximum of your position size rule. I once asked Dr Elder, who is prepared to risk 2% of capital on one trade, whether he would put all of his trading capital into one stock if he could do so without risking more than 2%. His answer was yes! Now, intellectually there is no problem with this - any trade that risks only 2% of capital is an equivalent risk. I think Dr Elder's answer has an implicit assumption that the stock being bought was a very large liquid stock and that it was therefore possible to execute the stop-loss order close to the trigger price for the stop.

However, in a market meltdown like October 1987 or an unforseen disaster for a single company, like Sirtex in 2015, the price could fall way through your stop before you could get out. While this risk might be small, it is there and I think there is room for at least a minimum of diversification to deal with it.

More importantly, there is an aspect other than risk involved here. That aspect is opportunity cost. If you tie all your funds up in one investment, you cannot have any money working for you in other stocks. That a means you had better be sure that you have selected the best opportunity to put your money into. Otherwise, it could sit there going nowhere, while other opportunities go begging. Personally, I cannot often spot the best one, so I try to spread my capital a bit, on the basis that some of them will be winners. I then increase my exposure to the winners and pull money off the losers.

Portfolio theory suggests that after you have 8 uncorrelated positions in your portfolio, further diversification only marginally reduces specific risk (the risk attaching to a specific stock). However, all stocks are to some extent correlated, so a fully invested portfolio needs to have more than 8 stocks, or include other asset classes that are not correlated to stocks.

My rule is not to invest more than 6% of my investment capital in any one stock. This will mean that when I am fully invested, I have at least 17 stocks and probably up to about 25 or 30. However, I never go above 30 - it is much too hard to watch them all and there is a strong psychological risk that I let some little losers run because the bigger positions are making money.

All of this discussion – position size and diversification – is fundamental to managing risk, which here means preservation of capital. Investment returns are a function of how much capital we have to invest. Making sure we stay in the race is critical to our success as investors.

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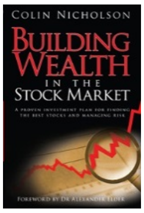

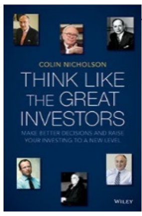

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