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What Ted's Thinking

Concentration vs. Diversification

Earlier this week, I rotated the lion's share of my SPAC portfolio to concentrate in three names from two sponsors – Chamath Palihapitiya (IPOD and IPOF) and Jason Karp (HMCO). I also tightened the selection of warrants to focus only on those most likely to make a bang with a merger announcement.

The evolution of my SPAC portfolio got me thinking about when to concentrate and when to diversify more broadly.

Last fall, SPACs offered one of the best risk-reward I had ever seen. In SPACs: Croupiers and Incentives, I described a 5:1 risk-reward trade that seemed 80% likely to play out. Sponsor selection barely mattered because the expected return across the universe of SPACs was that attractive. I wanted to capture the anomaly, so I built a diversified portfolio. When opportunities are abundant, portfolio construction calls for diversification. The goal is to capture the opportunity (or beta or alternative beta) by being generally right and not specifically wrong.

SPACs sold off a few months ago and the risk-reward changed. The downside disappeared, but so did the easy money. I saw a risky, longer duration opportunity to buy SPAC warrants, described in Follow the SPAC Upside. Sponsor selection mattered, and I honed the number of positions accordingly. When a broad opportunity set is average but the likely dispersion of outcomes is wide, portfolio construction calls for concentration. The goal is to be specifically right and capture the right tail of the distribution.

This thought process for portfolio construction extends to asset classes and manager selection. Take hedge funds for example. When we launched Protégé Partners twenty years ago, we believed strongly in both the prospects for hedge funds and the small manager advantage within hedge fund strategies. We constructed a portfolio diversified across 50 managers as a result, and it worked fantastically. Today, expected returns across hedge funds are much lower, and well-constructed portfolios are highly concentrated in select managers. Public equities in the U.S. call for the same concentration. The index return is not attractive, so most leading allocators pick only a few managers, who in turn often oversee concentrated portfolios of positions.

In contrast, allocators typically have many more venture capital and private equity managers in their portfolios. Venture capital managers manifest a wide dispersion of returns and attractive prospects if you can remove the left tail. The average may not be exciting, but a slight skew to above average is wildly attractive. In private equity and private credit, the average has done the job. Allocator portfolios hold many more private managers than public ones.

Easy games in investing are hard to come by and fleeting. As André Perold from HighVista said, "Alpha is scarce and hard to find. You don't find it on the corner of Fifth Avenue and 47th Street." When you see a pile of alpha, diversify and go all in. More often, when you don't, do your homework and concentrate.