Does a diversification strategy fit with a planner's fiduciary duty?

Tony Vidler | Strictly Business | 02 December 2014

I admit that I have always been a little uncomfortable with some aspects of MPT, and have long held the view that broad portfolio diversification is often a safe path to average performance. A superb piece of research on "The Case For Long Termism" has made me ask the question "diversification is a safe path for who?"

In exploring the issue of long-term thinking and clarity of investment strategy, the author (Ambachtsheer) delivered an excellent analogy for financial planners. It also raises the question in my mind as to whether concentration of investment, or high conviction investing, is the natural path for those with genuine long-term views and strategic clarity.

There is no doubt that long-term thinking and investment in the future reaps its rewards. The analogy woven through Ambachtsheer's research is that of the shift from subsistence societies where virtually all decisions are short-term focused: subsistence societies exist in survival mode, and the concept of putting aside resources or food stocks for another day is, perhaps, a luxury. The move to do so however is what triggered the birth of "investing". Deferring consumption today in order to accumulate future resources that require less personal effort or risk is the essence of wealth accumulation as we know it.

However, humans, being the fickle creatures they tend to be, will often make short-term decisions for immediate personal gain which are at odds with the long-term objective. Over time, businesses evolved and then created governance structures to minimise the ability for a single errant human to compromise the long-term strategy.

Adding in the issue of information asymmetry in investment markets together with the desire to negate short-termism saw the rise of intermediaries - which brings me to the question of whether a diversification strategy fits the client's objectives or the planner's.

I know, I know... heresy. Nobel Prize winners have been lauded for their work in this area, and I have no academic right to question them. But here's the thing - I know a lot of wealthy people, and pretty much all of them made their wealth by concentrating on a very few things. For many, it was concentrated on a single thing, such as a business idea or one single investment strategy. I don't know anyone who got seriously rich from saving fortnightly in managed funds. Certainly there is a place for that, and many sound arguments for their use, particularly in the early accumulation phase for individual investors.

But these empirical observations of what actually works in creating wealth, together with the performance evidence of long-term concentrated (high conviction) investors such as Warren Buffett and John Maynard Keynes do leave me questioning diversification as a strategy for long-term wealth creation. That, in turn, has me wondering about the role of a fiduciary. As Ambachtsheer put it: "Increasingly, fiduciary behaviour and decisions will be judged not by a cookie-cutter off-the-shelf "prudent person" standard (but) by a much broader "reasonable expectations" standard."

The increasing focus on best practice governance standards and mandate management by investment houses is a distinct shift towards higher fiduciary standards for the industry as a whole, with implicit recognition of the need to manage for a wider group of stakeholders than any individual client. Is it unreasonable to expect that this approach, and mood to manage for the long-term good of all stakeholders, will eventually permeate down to individual planner level? Does the planner have a fiduciary responsibility to those other stakeholders in the client's life, such as other family members who are not fee-paying clients themselves?

Additionally, if the evidence suggests that high conviction investing for the long-term produces better than market average returns, does it follow that a planner's role might be to encourage clients to focus resources and efforts, and then stay on course? In other words, to not diversify?

At present, much of the fiduciary standards debate as it concerns financial planners is centered on remuneration models, with the paramount view appearing to be that "fee for time or expertise" is the appropriate fiduciary model. Little of the discussion or debate has evolved to considering the wider implications of the fiduciary's long-term role in the client engagement or, indeed, who the financial planner carries fiduciary responsibilities to in addition to the fee-paying client.

It is not beyond the realms of possibility though that the existing "prudent person" approach to playing it as safe as possible in portfolio construction might actually undergo a significant shift.

Read "The Case for Long-Termism"

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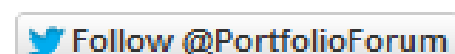

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