What's the Right Number of Funds to Own?

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Three? Five? Ten? Twenty? There's no definitive answer as to the optimal number of mutual funds that investors should own in their portfolio. Some individuals are content, and well served, to own just one fund (i.e., a balanced fund), while others feel it's more appropriate to own 7 or 8. If you have a good reason for owning each fund and they don't all fall into the same sandbox (e.g., Canadian equity, small-cap U.S. equity, monthly income, etc.), you shouldn't focus too much on a magic number.

That said, holding more than 10 or so funds is widely accepted as being too many, as it can lead to overdiversification, the dangers of which are clear and well documented. They include:

- Overlap in your stock holdings,
- Increased costs (transaction fees, loads, commissions, etc.),
- Watering down your strategy,
- Difficulty monitoring a large number of funds, and
- Diluting your knowledge of each holding.

The objective, of course, of owning more than one fund is to improve your portfolio's diversification and reduce its risk (defined as volatility in this context). Yet, if you own a handful of funds that all invest in the same space, you haven't achieved much diversification and your returns are likely to be just as bumpy. Indeed, a well-diversified balanced fund can be a much better solution than owning half a dozen large-cap Canadian equity funds.

Over the past decade, the industry's marketing machine has done a good job of pushing investors off track from a sensible approach to portfolio construction. Every time a fad or trend gains popularity, you can be sure that there will be no shortage of new funds trying to capitalize on it. Remember all those Internet and technology funds in the late 90s? Or the explosion of energy and resource funds just a few years back? The next wave could very well be principal protection and income-oriented products, given the recent carnage in the equity markets.

The bloated line-ups of many fund companies also make it difficult for investors to filter through the vast sea of products and choose a few core funds with which to form the backbone of a portfolio. With several of the mammoth fund complexes each overseeing well over 100 funds, the choices can be staggering.

While our opening question need not fall into the realm of rocket science, there have been statistical studies done on the number of funds that investors should hold. Mutual fund research firm Morningstar tackled the question by creating hypothetical portfolios ranging from one to 30 funds, using every possible variation of funds. They then looked at the volatility of each portfolio by calculating its five-year standard deviation. Not surprisingly, portfolios comprised of one fund had the highest volatility (standard deviation). After seven funds, however, Morningstar found that a portfolio's standard deviation more or less stayed the same regardless of how many funds were added (Morningstar.com, Investing Classroom, "Course 109: How Many Investments Should You Have?"). Another study published in the *Journal of Investing* concluded that owning four funds reduced risk (volatility) by 75%, whereas owning more than eight funds did little to further reduce risk (*USA Today Magazine*, "Mutual Funds: How Many Should You Own?" December 1, 1997).

Investors should keep in mind that these studies focus on finding the optimal number of funds to own, based on minimizing a portfolio's risk (volatility). Yet, while reducing risk is certainly important, it should not necessarily be the primary goal of every investor. If you want to beat the market, you have to take on risk and be willing to accept some volatility of returns along the way. So, while adding a seventh or eighth fund to a portfolio may slightly reduce its volatility, it may also bring it closer in line with the market. If market matching returns are your goal, you're better off buying a low-cost index fund(s). If you want to beat the market, you have to look different than that, and a good way of doing this is by owning fewer funds.

There's a compelling case to be made for the "less is more" concept, beyond the risk of looking like the market. Owning, and sticking to, fewer funds not only makes it easier to keep track of your fees and performance, but it helps keep

your portfolio's turnover low (assuming the turnover within the funds you own is also low), which can reduce your tax burden. Importantly, it also encourages you to stick to your investment strategy, rather than adding the latest "fund of the month" to your portfolio and inadvertently changing its direction. Owning a concentrated portfolio of funds also reduces your risk of overdiversification.

Many industry veterans subscribe to this line of thinking. John Bogle, the founder of Vanguard (a prominent U.S. fund company), notes in his book *Common Sense on Mutual Funds*, "I truly believe that it is generally unnecessary to go much beyond four or five equity funds. Too large a number can easily result in overdiversification." (Bogle, John, *Common Sense on Mutual Funds*, John Wiley & Sons, 1999, p.101) Similarly, Louis Lowenstein, a financial author and Professor Emeritus of Finance and Law at Columbia Law School, recommends that mutual fund investors find three, or at most four, stock funds that meet their needs (Lowenstein, Louis, *The Investor's Dilemma*, John Wiley & Sons, 2008, p.181).

As we've seen of late, complexity in the financial world often does more harm than good. You don't need to own a portfolio of 20 funds. It won't reduce your portfolio's volatility and it won't produce higher returns. Indeed, the more funds you add, the more likely it is to look like the index – but at a much higher cost.

For many investors, a portfolio of four to six thoughtfully chosen funds should meet all their needs. Two to four stock funds and one or two income funds can provide plenty of diversification without running the risk of excessive overlap. Advanced investors may want to add a specialty fund to the mix if they have a particular expertise and strong conviction about a specific field (e.g., health sciences, real estate, etc.).

When your fund count approaches the double digits, however, it's a good time to ask a few questions. Do you have an accurate idea of how many stocks you own? Is duplication kept to a minimum? Does each fund represent a meaningful position in your portfolio? Can you easily assess your overall fees? Do you know what your portfolio's aggregate performance is?

If "no" keeps popping up, you're probably overdiversified and it may be time to consolidate. Evidently, two hands aren't always better than one when it comes to the right number of funds to own.

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