

Why Diversification Results In Mediocrity

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"Diversification is a protection against ignorance. It makes very little sense for those who know what they are doing." -Warren Buffet

When in doubt, diversify. That's the underlying logic behind diversifying everything from your [stock portfolio](#) to the number and types of businesses in your company, and often implicitly drives product development organizations. The argument behind diversification is that there is too much randomness in the world to have an edge based on skill.

While there is unquestionably some truth to the idea that the world is often too random to literally make just one bet, the widely held assumption that diversification is a free lunch is just plain wrong. Just as there is benefit to be derived from diversification with respect to risk, there is a cost, too — that of losing whatever edge you might have been able to gain from skill. Diversification is a strategy to regress to the mean — that is, to be average. For those pursuing excellence, focus is a far better strategy.

Regression towards mediocrity

The [notion of regression](#) comes from [Sir Francis Galton's](#) "Regression Towards Mediocrity in Hereditary Structure." Over time, regression towards mediocrity came to be known as regression to the mean. I prefer Galton's description: Diversification usually leads to mediocrity.

Figure 1 shows the tension between the "edge" gained by focus (y axis) and the gains from making numerous "bets" (x axis). Conventional wisdom has it that any particular bet you make may earn returns greater than or less than the mean — as the number of bets approaches 100 percent of possible bets, you end up with the mean by definition. Many investment strategies explicitly seek to be average; index funds do so by algorithmically approximating entire indices. If you lack the knowledge or time to do the work yourself, and your goal is simply wealth preservation, such a strategy may in fact make sense.

Figure 1: Investment Edge vs. Number of Bets: Regression to the Mean

However, if you're trying to earn excess returns or build a great product, diversification is the enemy. In Figure 2 I have offered an alternative visual of how a knowledgeable investor might perform. I believe an investor can leverage knowledge he has about a particular industry or company to beat the average on a risk-adjusted basis. There is still uncontrollable risk, so I'm not arguing that an investor should invest in just one stock. On the other hand, there is a cost that comes with the security of diversification; you pay for that insurance. Too much, in fact.

Please note that my belief, even though it squares with that of Warren Buffett's, flies in the face of [conventional economic wisdom](#). And that I am not a professional investment adviser.

Figure 2: Investment Edge vs. Number of Bets: Excess Returns Through Focus

If you seek extraordinary performance, focus on what you know very well, do your homework, have conviction and take a stand. It's the right way to build a product, to build a company — and to be an exceptional investor. Clearly even focused investors make a few bets; you can make a few very well-researched bets per year. But can you really make 30 bets per year, per person, and keep coming out a winner? Great entrepreneurs iterate, but my experience with great entrepreneurs is that there's usually an ethos and sense of clarity behind what they're trying to accomplish. It's not about [tossing spaghetti at the wall](#).

Focus increases your ability to understand what matters

The problem with diversification is that the effort required to master something is so great that every spare neuron spent on something else gives the person with focus an upper hand. Diversification is attractive because it's safe and requires little effort.

Warren Buffet and many of the best investors I know favor making a few very well-informed bets rather than opting for significant diversification. Diversification strategies like funds of funds are responsible for allowing [Bernie Madoff](#) to exist. Good [limited partners](#) (LPs) do a great deal of work to pick a relatively small number of investment vehicles, which involves significant research before and oversight after an investment (both of which can quickly uncover Madoff-type scams). Good LPs put their money behind investors who do the same, and good VCs put their money behind entrepreneurs who have a point of view, domain expertise and conviction to realize the impossible.

Focus is not inconsistent with intellectual honesty. It does not mean ignoring feedback. It simply means that your bets are well selected and that your conviction to find a way to make something work is high enough to overcome the inevitable hurdles of building a company, product or investment portfolio.

Focus forces brutal prioritization

Making few bets forces you to make hard decisions. It's extremely hard to measure the value of something against some abstract and absolute notion of value.

Proponents of diversification argue that it takes the edge off of making a mistake. That would be a good argument if people acted the same way independent of their ownership in an outcome, but human beings do alter their behavior based on how much skin they have in the game. When costs and benefits are divided amongst too many people, accountability is lost. Excessive diversification makes participants passive, dependent on the actions of others who are dependent on the actions of others, and so on. It turns them into, at best, [free riders](#), and at worst, suckers.

Focus brings clarity

While everyone else is chasing diversification, those who make a few well-placed bets learn at a faster pace. They have clarity as to what matters in an investment, company or product. This clarity attracts others and makes things clear for them, too.

When Steve Jobs took over Apple (s aapl) again in the late 1990s, he first pruned the organizational ranks. He then pruned Apple's product line down to just four. He communicated Apple's culture to employees, partners and customers with the [Think Different](#) campaign. From that clarity came the iPod and the iPhone.

Making fewer bets requires conviction. It requires the courage to stay the course. And it requires the support and resources to take the long view. If you do these things, odds are that you'll do something worthwhile.

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