How Many Stocks Should You Hold in Your Portfolio?

By *Charles Fournier* on Sure Dividend
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Charles retired in his mid 50s in May 2016 from a career in Canadian banking. He relies exclusively on income from rental properties and a dividend income stream from a portfolio he amassed over several years.

The subject of how many stocks should be held in a portfolio has been a subject of debate for years. Typically, an investor will want to hold a basket of stocks so as to be properly diversified. Not every investor, however, has this objective in mind. In some cases, the desire is to have a fractional ownership in many wonderful companies because there are just so many wonderful companies out there!

In this post I discuss how I evolved from the 'Shotgun' approach to the 'Rifle' approach. I also touch upon how I whittled down the universe of potential investments from which I would conduct my analysis. Had I not started doing this years ago, I would still be running around like a chicken with my head cut off analyzing countless companies that are not even worth touching with a 10 foot pole.

The Shotgun Approach

A few years ago I was reading another blog in which the blogger disclosed the composition of his/her portfolio. I found it interesting to read that when this individual had started his/her blog a few years prior, the thought was to own a portfolio of 20-30 stocks.

Once the portfolio had evolved to the stage where it consisted of 20 – 30 holdings, however, the blogger decided there was still a number of high-quality companies in which he/she had still not invested. As a result, this threshold was eliminated and the number of holdings crept up. By the time I stumbled on the site, the portfolio had over 50 holdings.

Now, a few years later, the number of companies in which this person had invested has grown to over 100 yet the total portfolio value is less than $400,000.

This got me thinking…"what is a reasonable number of stocks to hold in a portfolio?"

I am certainly not here to criticize this individual's approach to investing. In fact, when you learn about the individual's background you can't help but to be awestruck by what this person has accomplished.

This individual found a strategy that suited his/her personality. It appears to have worked and this person appears to be extremely happy with the outcome of his/her decisions. All the more power to this individual!

My Early Days of Self-Directed Investing

I will confess that when I first started self –directed investing in the mid 1990s I was enamored with the thought of holding shares in multiple companies. There were just so many companies out there in which I wanted a piece of the action that I would buy 100 – 200 shares and then move on to the next company.

After a couple of years of doing this, my thought process evolved. I was regularly receiving drips and drabs of dividend payments. I would let the cash accumulate in my account until such time as I had sufficient funds to acquire another 100 – 200 shares in another company. As you may suspect, this just ended up increasing the level of dividend drips and drabs that was hitting our various

investment accounts. This resulted in an increase in the number of investment decisions I had to make!
After reading countless books about Warren Buffett, Charlie Munger, Peter Lynch, etc., the light bulb went off in my head. Reading quotes such as the following certainly helped put things in perspective!

Note: You can read more quotes from great investors at the following links – Charlie Munger quotes, Warren Buffett quotes, Peter Lynch quotes.

"Our investment style has been given a name – focus investing – which implies 10 holdings, not 100 or 400. Focus investing is growing somewhat, but what's really growing is the unlimited use of consultants to advise on asset allocation, to analyze other consultants, etc. "
– Charlie Munger

"Diversification is protection against ignorance."
– Warren Buffett

"Students learn corporate finance at business schools. They are taught that the whole secret is diversification. But the exact rule is the opposite. The 'know-nothing' investor should practice diversification, but it is crazy if you are an expert. The goal of investment is to find situations where it is safe not to diversify. If you only put 20% into the opportunity of a life-time, you are not being rational. Very seldom do we get to buy as much of any good idea as we would like to."
– Charlie Munger

"The worst thing you can do is invest in companies you know nothing about. Unfortunately, buying stocks on ignorance is still a popular American pastime.'"
– Peter Lynch

I must admit I was somewhat befuddled when I read Buffett's and Munger's pearls of wisdom. Here they were, stressing that you

should focus your investments as opposed to 'throwing mud at the wall' yet when you delve into Berkshire Hathaway, you realize they own dozens of 100 companies outright; I draw your attention to page 118 of 124 in the 2016 Berkshire Hathaway Annual Report.

The difference between Berkshire Hathaway and me, however, is that it has so much money and it continuously generates so much money. What else can you do except to acquire companies outright!? I think, therefore, that we should exclude all these wholly owned companies and look at what investments Berkshire Hathaway is making in publicly traded companies. Looking at the most recent 13-F on the United States Securities and Exchange Commission website we see that Berkshire Hathaway is extremely focused when it comes to investments in publicly traded companies.

The Rifle Approach

I started to narrow my focus and selected a handful of great companies. I slowly began to acquire shares in each company so that the automatic reinvestment of the dividends would purchase at least one share.

While I became more focused I knew Buffett and Munger were in a totally different league from me. Firstly, I did not own multiple companies outright. Secondly, I did not have the same level of positive cashflow as they did. Thirdly, I knew there are so many variables that can change over time (eg. company's future dividend policy or future earnings multiples) which could turn a 'great company' into a 'not so great company'.

Given the above, I just could not envision myself investing in only 10 companies. Could you imagine if I owned a couple of Kodak or General Electric (GE) type companies in a portfolio of 10 stocks? I also looked at what could happen to a company on the future earnings multiples front. I previously used the examples of Cisco (CSCO) and Intel (INTC) in my Should You Invest When the Market Appears to be Overvalued? article. These were great companies but they were valued in the stratosphere. If I had included these two

‘darlings’ in my group of 10 companies I would have been in a heap of trouble.

My Investment Criteria

While I decided to become more focused with my investing style, I viewed 10 companies as being too few for my liking. At the same time, ~75 or more seemed unreasonable to me. As a result, I arbitrarily chose 45 – 55 different companies as an optimum number of companies in which to invest. Trust me…there really was nothing scientific about how I arrived at this range.

In addition, I decided that I would hold companies within the 5 main economic sectors:

- Manufacturing & Industry
- Resources & Commodities
- Consumer
- Finance
- Utilities

Being heavily weighted in one or two economic sectors did not meet my definition of diversification. I wanted to spread my money over these 5 economic sectors but that did not mean I would have equal weighting in each.

I also decided that there were certain industries and types of investments that simply just did not meet my level of risk tolerance.

Based on my observations from years in cash management at a major Canadian financial institution, I saw that Corporate bankers would occasionally switch industry coverage. I can’t recollect, however, a Corporate banker transferring to or from Mining industry coverage or Real Estate coverage. It just seemed like lending to companies in those spaces required a different mindset; the members of those coverage teams spent years developing the expertise required to properly assess companies within these two

industries; I also viewed these industries as being cyclical and volatile. I wanted to avoid this.
Some readers might suggest that if I wanted to avoid cyclicality and volatility I should have also eliminated investments in the oil and gas sector. I, however, decided that companies like Exxon (XOM and Chevron (CVX) [both of which are Dividend Aristocrats] should not be excluded from my investment universe so I made an exception when it came to the world's oil and gas behemoths.

I also excluded micro and small cap stocks from my universe of potential investments. While some investors reap outsized gains by investing in such companies, my risk tolerance level is such that I will lose sleep at night if I invest in this space.

Back in the 1990s, when I narrowed down the universe of companies in which I would conduct research, I had no idea what were Master Limited Partnerships, Business Development Corporations, Closed End Funds, REITs, and Equity REITs. Over the course of time, as I learned more about these types of investments, I also eliminated them from the universe of companies in which I would invest.

I have no interest in investing in entities in which a significant portion of cash flow is paid out to unit holders. I wanted to invest in companies which generate copious amounts of free cash flow (FCF) that can be used to grow the business (organic or acquisition), to repurchase shares, to repay debt, or to increase the dividend at rates well in excess of the rate of inflation.

In addition, I wanted to invest in great companies which are priced fairly. I had no interest in investing in mediocre companies which are priced well.

It also dawned on me that if Buffett or Munger, two of the brightest investors, rarely touch Master Limited Partnerships, Business Development Corporations, Closed End Funds, REITs, and Equity REITs… why would I?

Most recently I have also added marijuana and crypto currency companies to the universe of companies which have absolutely no appeal to me.

I was ready to build my portfolio once I had:

- Eliminated certain types of corporate structures
- Identified the industries which hold the greatest appeal to me from a risk/reward perspective
- Determined the appropriate size of companies (market cap) for me
- Satisfied myself that sufficient shares are traded on a typical trading day (I avoid thinly traded stocks)
- Determined the key metrics I would analyze prior to making any investment (eg. credit ratings, free cash flow, dividend growth, dividend payout ratio, valuation metrics such as EPS, adjusted EPS, price/earnings)

Current Portfolio

While I disclose the FFJ Portfolio holdings on my site, the vast majority of my holdings are kept confidential.

On January 31, 2018, my wife and I held shares in 52 companies. The top 10 companies comprised 52.753% of the market value of our holdings.

COMPANY	% HOLDING
VISA INC.	9.041%
BANK OF NOVA SCOTIA	6.829%
3M COMPANY	6.713%
ROYAL BANK OF CANADA	4.997%
CHURCH & DWIGHT	4.177%
JOHNSON & JOHNSON	4.126%
CHEVRON CORPORATION	4.091%
WALMART INC.	3.859%
CANADIAN NATIONAL RAILWAY	3.118%
CANADIAN IMPERIAL BANK OF COMMERCE	2.901%
BECTON DICKINSON	2.901%
TOTAL TOP 10	**52.753%**

The next top 10 holdings comprised 21.216% of our portfolio. I strongly suspect that if I disclosed the names, you would be familiar with most, if not all, the companies.

There you have it. Twenty companies make up ~74% of our entire holdings.

The remaining ~26% is also made up of well known names although some readers may not recognize names such as Broadridge (BR), CDK Global (CDK), or Intact Financial (IFC). I am certain, however, everyone is familiar with Nike (NKE), United Technologies (UTX), FedEx (FDX), McDonald's (MCD), and Microsoft (MSFT).

Volatility

The reason we selected our current holdings is not just because they have competitive advantages or because they generate strong free cash flow. It is because in days similar to those experienced in early February 2018 we really don't care if the stock prices drop precipitously.

Just because 3M (MMM) and Johnson & Johnson (JNJ), for example, fell more than 5% in value on February 5, 2018 does it mean these companies are in jeopardy of going under. If anything, I WANT share prices to drop because they become more attractively priced!

I have been waiting for a correction. In fact, in several of my recent posts [eg. United Technologies (UTX), Stanley Black & Decker (SWK), Honeywell (HON), Bank of New York Mellon (BK), etc.], I came to the conclusion these companies were overvalued.

In my opinion, investors are better off to just 'stand at the plate and to let the pitches go by'. Now, I think the pitcher is getting tired and the pitches are starting to come up in the strike zone… the sweet spot.

Final Thoughts

After catching a 7 AM train to work and a 6 PM train home, day after day, month after month, year after year…I don't do that anymore! I think this is partially attributed to the fact that years ago I adopted the 'Rifle Approach' to investing.

By no means am I suggesting this approach is the 'Holy Grail'. I just know that if I had 'thrown mud against the wall' and had invested in companies that fell outside my investment criteria I might have one day found myself in the predicament of having to confess to my better 50% that I did an investment "Ooops!". I don't need to mess up with our investments to create "Ooops!". I have lots of other ways of creating them.

I wish you all the best on your journey to financial freedom.

Thanks for reading this article. Please send any feedback, corrections, or questions to support@suredividend.com.