

Smart Thinking

A Skill Versus Luck Essay Series by Michael A. Ervolini // September 2025 | Issue 03

Broadening Diversification To Include Skill

Few investors, if there are any, doubt the benefits of diversification. Deciding precisely how to achieve it, however, remains a thorny challenge.

SEEKING DIVERSIFICATION

The practice of diversification (AKA risk management) gained considerable analytic rigor with the 1952 paper "Portfolio Selection" by Harry Markowitz.¹ In his paper Markowitz informs us that a portfolio's riskiness is not simply the average risk of the assets or funds it owns. Instead, portfolio level risk is based upon the degree to which the prices of the various assets and funds move together. Said differently, do portfolio assets and funds provide offsetting or compounding riskiness? Assets and funds with positively correlated price movements tend to exacerbate risk while those whose price movements are uncorrelated or negatively correlated ameliorate it. One of Markowitz's enduring contributions is showing that many sources of risk can be analytically identified, quantified and, therefore, managed.

Diversification and risk analytics have been greatly expanded since the 1950s. Within equities alone this includes the analysis of asset price movements in relationship to company location (country, global region) and relative to a host of factor exposures, such as market value (size), financial dynamics (growth vs. value), price momentum, balance sheet quality (debt levels), and earnings growth. These and similar characteristics are commonly integrated into portfolio construction processes. The intended result is a portfolio whose assets are sufficiently diverse such that the net effect provides an attractive trade-off between quantifiable risks and hoped for returns.

The diversification benefits from many traditional factors are in decline according to numerous studies.² This may be due to the effects of globalization and/or other market forces. What's clear is that more positive correlations are now being observed among a number of traditional diversification characteristics. This dynamic, in good part, motivates the continued search for newer and alternative sources of incremental diversification.

THE HUMAN FACTOR

One idea that is gaining traction involves expanding the sources of diversification to include fund manager skill. While this may seem obvious implementing it has become possible only recently due to newer analytics. Traditional efforts to capture elements of manager skill have relied upon conventional analytics such as relative return, multi-factor alpha, attribution, upside/downside capture, information ratio, and active share. These metrics are very helpful in describing how an equity fund has performed. They say little about manager skill, however. Their shortcoming with regard to describing skill is inherent in the data they use. These data consist of two forms of outcome, namely fund returns and/or daily holdings. The outcome-driven results they produce can only hint at the presence or absence of skill. These analytics cannot identify nor quantify skill directly.

Fortunately, newer analytics for computing skill now exist. These newer analytics use as inputs the decisions made by the fund manager. These newer methods are referred to as decision-based analytics. These newer analytics relate the decisions made by the manager with the returns they generate. They connect cause and effect. This is precisely how skill is computed in other demanding endeavors like sports, auto racing, jet piloting, and surgery. These newer analytics provide capital owners and allocators enhanced insights into manager skills, decision consistency, and heretofore undetectable sources of risk.³ Examples of how these newer analytics are helping asset owners and allocators are discussed next.

BETTER INSIGHTS, BETTER DECISIONS

Incremental diversification can be captured through the use of manager skills. Importantly, it is accessible even from funds whose managers are pursuing the same style and strategy. This opportunity exists when the stocks they purchase reflect different alpha time horizons or alpha generating profiles.⁴ One manager might buy stocks that typically take off soon after initial purchase and continue to generate excess returns for 9 to 18

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months (relatively fast and short time horizon). A second manager with the same mandate might be purchasing stocks that are slow to show any price movement but once they get going can generate alpha for two and three years or more (slow starters with extended time horizon. These two managers are fishing in essentially the same pond for the same species. Yet the fish they land are quantifiably different.

Alpha time horizon and other manager skills are now being used by JANA Investment Advisers, a manager search and OCIO consultancy. According to Justin Tay, JANA's Head Of Global Equity Research: "Knowledge of a manager's alpha time horizon can support allocations to multiple top managers even in the same style –while avoiding overlapping decision processes. It's a subtle but important form of diversification."⁵ This type of diversification can improve the odds of capturing the full potential from each style/strategy blend by finding managers whose buy processes yield stocks that outperform over different time horizons.

Another aspect of skill involves the management of significant losers, defined as positions down by 20% or more. Some managers are skilled at culling out significant losers unlikely to recover and/or retaining those that eventually do rebound. The opposite also is observed where managers are too quick to sell depressed stocks which soon rebound and/or have trouble letting go of weak positions that never recover. Knowing how effectively managers (even great ones) deal with significant losers provides additional insights into how risky a fund may become in a market downturn.

Then there is the question of position sizing. Deploying meaningful capital into stocks before or as soon as they begin to take off enables funds to capture the full benefit of strong buys. In contrast, habitually under sizing or chasing strong buys undermines the potential available from purchases that outperform. Knowing how effectively a manager builds up their best buys (winners) can shed light on the likelihood of capturing excess returns going forward.

These and other newer analytic results are enabling asset owners and allocators to better assess equity managers and strengthen their allocation processes.

IT'S CATCHING ON

Increasingly investors are integrating the newer analytics into their equity allocation processes. Pension funds and sovereign wealth funds are using the newer analytics to both assess external allocations and to obtain clearer insight into how effectively internal teams are managing their equity funds. Endowments, Family offices, and large asset management companies are using the newer analytics to better understand the strengths and shortcomings of their third-party equity managers. The results include a deeper understanding of which skills are driving results and which skill deficits may represent previously unknown risks. The insights obtained also support more productive discussions between investors and fund managers – during due diligence, at regular update meetings, and especially when fund results are disappointing.

CONCLUSION

Portfolio diversification is a common objective. Globalization and other market forces are increasing the correlation among various diversification characteristics (e.g., funds, asset types, factors). Stronger positive correlations make diversification ever more difficult.

In response asset owners and allocators are expanding how they view and implement their approaches to diversification. One transformative effort underway is the integration of manager skills as an additional alpha and risk characteristic. Doing this requires use of newer decision-based analytics. These newer analytics provide superior measures of manager skill by relating decisions taken by a manager to the impact such decisions have on fund results.

It's time. Time to improve the industry's knowledge about manager skill. Time to capture more effectively the potential available from actively managed equities. Time to make better equity allocation decisions.

Endnotes:

¹ Harry Markowitz, "Portfolio Selection," *The Journal of Finance*, Vol. 7, No. 1. (Mar. 1952), pp. 77–91. <http://links.jstor.org/sici?sici=0022-1082%28195203%297%3A1%3C77%3APS%3E20.CO%3B2-1>

² "For example, see: Richard Yasenachak, "Correlation Conundrum: How Will You Fix Portfolio Diversification?," Intech Investment, Inc., March 8, 2023. <https://www.intechinvestments.com/>

³ Michael A. Ervolini, "Skill Versus Luck – Taking The Guesswork Out Of Equity Fund Selection," MIT Press, February 3, 2026. Available for pre-order on Amazon.

⁴ A fund's alpha generating profile or information advantage indicates, on average: when new stock purchases begin to outperform, how much excess return they generate, and when outperformance tends to be depleted.

⁵ Interview by the author with Justin Tay, Head Of Global Equity Research, JANA Investment Advisers, Inc., June 2025.