Mutual Fund Stock Overlap: A Common Problem for Investors Holding Multiple Mutual Funds Inside Their Portfolios

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What is Mutual Fund Stock Overlap?

As a portfolio manager, we strive to remain keenly analytical of the investment industry. Frequently investors come to us with a large portfolio of mutual funds recommended (or sold) to them by their financial advisors. Their mutual fund portfolios reveal a concerning level of stock 'overlap', as well as an overweighting of individual securities and market sectors within their funds. Overlap commonly occurs when multiple mutual funds in an investor's *mutual funds* portfolio are each buying the same stocks, again and again, which can significantly increase overall portfolio risk.

For example, most mutual fund shareholders are not aware that their funds are considerably overweight in technology and social media shares due to the popularity of these sectors and their respective stocks. Quite often, due to both mutual fund structure and methodology (inclusive of index funds), as these stocks increase in value, so does their portfolio weighting within the fund. Notably, of the 500 companies in the S&P 500 index, the *top 30 stocks represent 40% of the index's weighting*! As such, when investors own a 'menu' of mutual funds the result may be too many highly correlated funds, with greater risk and poorer diversification than anticipated when they were building their investment portfolio.

What Does Mutual Fund Stock Overlap Look Like in a Portfolio?

Let's take a closer look. Assume an investor holds 10 mutual funds, which is not uncommon. In aggregate, 10 funds will often represent total holdings of shares in over 2000 individual companies. That's a considerable amount, but it doesn't mean the portfolio is diversified in such a way to provide an investor with less risk than the overall market. Due to stock overlap, despite having 2000 stocks, the 10 mutual fund portfolio might have 25% of all their total holdings in just 25 stocks, exposing the portfolio to considerable shock during periods of market weakness.

To this point, consider the shares in 3 of the most popular and widely owned stocks, Apple, Microsoft and Amazon. If an investor only owns one mutual fund everything might be okay. However, with 10 mutual funds, it's likely that several funds hold a 3-4% weighting respectively in Apple, Microsoft and Amazon. An investor may find that though the advice he received was (and his funds appear) to have different investment strategies (e.g. a *value* fund, a *growth* fund, a *global* fund, etc.): collectively he has a higher concentration in just these three stocks that could exceed 10-12% of his total investments, significantly increasing stock risk, sector risk, market risk and portfolio volatility.

All might seem well when markets are rising, however investors with similarly composed mutual funds in their portfolios are particularly vulnerable during stock market declines. This is both unwelcome and avoidable and too often occurs when advisors and investors have an incomplete understanding of their mutual funds' holdings and the necessary elements for effective and *constructive* diversification.

Why Are Mutual Funds Buying The Same Stocks?

There are two primary reasons. First, we observe that portfolio managers within a mutual fund company (which manage numerous funds with a wide array of investment strategies) invest 'by committee', share research and may together conclude, for example, that Apple fits several of their individual fund 'mandates' and strategies.

The second problem is closely correlated with the first. Mutual fund managers are intensely focused on *their* mutual fund peer group and industry 'benchmark' metrics. As a requirement to successful distribution and marketing of their fund to investors: managers often 'hug' their fund's respective benchmark (index) to ensure it is in alignment *with* their peer group's specific fund metrics, such as all *U.S. large cap growth funds.*

Said another way, many mutual funds hold well over 200 stocks because their benchmarks own them as well. That's why so many funds buy Apple, Microsoft and Amazon and why managers also buy stocks they might not otherwise wish to own if they weren't compelled to closely adhere to their benchmark. The unfortunate irony is that mutual fund managers often increase portfolio risk by holding higher weightings in 'popular' stocks while adding lower quality stocks to round out their holdings to fit peer group metrics. The problem is: if a fund looks like its benchmark, it will perform like its benchmark—and, after subtracting the mutual fund's costs, most mutual funds will indeed underperform. It's simple math.

Conclusion: Portfolio Structure Matters

How an investment portfolio is structured is fundamental to investment performance, market risk and portfolio volatility. *Mutual funds are designed for the masses* with operational, structural and performance constraints consistent with that objective. Consider that a mutual fund investor with $3 million receives essentially the same investment management and service for their portfolio as does an investor with only $300 in the mutual fund. Clearly, a significant investor should expect more.

The Blue Granite Capital Core Strategy Account is structured as a Separately Managed Account (SMA). The SMA portfolio structure is quite different than a mutual fund, and considerably more advantageous to investors. *More on the benefits of an SMA structure for high net worth investors in our next paper.*