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Diversification Should Transcend Asset Classes and Geographies

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Snapshot

- Truly diversified portfolios have struggled versus U.S. equity indexes in recent years, in large part because such indexes have become more concentrated than ever in just a few stocks.
- With increased concentration risk in these indexes, it may now be more important than ever to properly diversify your portfolio.
- Spreading investments across asset classes is widely considered the most effective way to diversify a portfolio. But even within equities it's possible to achieve meaningful diversification benefits by investing globally, across market capitalizations and sectors.

Equity markets have been dominated over the last few years by U.S.-based, mega-cap, technology-oriented stocks. In such an environment, investors who have held any reasonably well-diversified portfolio have not kept pace with these few names or the indexes that they dominate, such as the NASDAQ 100 and the S&P 500. This comes as no surprise; a truly diversified portfolio will never be the top-performing investment over any short time horizon. This is not a shortcoming of diversification. Clearly, identifying the high-flyers with perfect foresight is essentially impossible, and for investors without a crystal ball, diversification can reduce potential risk without sacrificing expected return. From this perspective, 2020 shouldn't really be any different. Perhaps the momentum of the technology stocks continues, or perhaps an entirely different trend will emerge—maybe value stocks will have their long overdue day. The point is, as always, there is plenty of uncertainty involved with investing, and that means there is never a bad time to be diversified. We have always supported, and continue to support, diversification at all times for all clients.

Diversification is as Crucial as Ever

We believe that the current environment might be one in which diversification is especially crucial. The reason for this is fairly straightforward—the U.S. stock market is more concentrated in just a few stocks than it has ever been. While the S&P 500 index contains a diverse-sounding 500 stocks, the reality is that few of those stocks are materially represented in the index. As seen in Exhibit 1, over 20% of the index is comprised of just 5 stocks.

Exhibit 1: Weight of Top 5 Companies in the S&P 500 Index

Source: SEI, FactSet as of June 30, 2020.

Microsoft and Apple combine to total more than 11% of the index. The information technology sector constitutes more than 26% of the index, and this doesn't even include Facebook, Alphabet or Amazon. These technology-related stocks are categorized in communications services (Facebook and Alphabet) and consumer discretionary (Amazon)—sectors which constitute another 11% and 10.5%, respectively. It is clear that an investment in the S&P 500 has become increasingly concentrated and the higher the concentration and more correlated these stocks are, the higher the probability that they will all decline simultaneously. This is the essence of risk, and while risk cannot be eliminated from capital markets investing, it can certainly be managed.

Diversification is Not a Panacea…

We can't guarantee that these few sectors and stocks won't continue to outperform the rest of the market. While we (and our managers) believe that these exposures appear relatively unattractive at the moment, we are humble enough to recognize that we could be wrong about that. The fact that we (and all investors) could be wrong, though, is precisely why diversification is important. If we don't know which securities will perform best over any particular horizon, we can better manage our risk by investing across a wide range of assets and geographies. With the S&P 500 less diversified than ever, we believe it is an opportune time for investors to reassess the concentration within their portfolios and to seek ways by which to improve diversification.

…But it can Reduce Correlations and Risk

Multiple avenues exist for enhancing the diversification of a portfolio currently invested only in U.S. equities. First, and likely most importantly, investors can construct portfolios that are genuinely multi-asset, incorporating asset classes like nominal and inflation-linked government bonds, commodities, and credit into their holdings. In most cases, high quality bonds will offer the most diversification potential, as their performance has generally be less linked (and, in some cases, inversely linked) to the economic cycles to which equities are highly correlated. Inflation protection through assets like inflation-linked bonds can also prove valuable in the event that inflation surprises create a drag on economic growth and equity performance. Even lower quality high-yield and emerging-

market bonds offer the potential for some diversification, though they are no doubt more correlated to many of the same risk factors as equities. In our view, the most crucial step in diversifying beyond a few U.S. technology stocks is to invest in entirely distinct, genuinely diversifying asset classes.

A more modest, but still meaningful, diversification benefit can be achieved by investing the equity portion of the portfolio more globally. Concentrating one's equity holdings within a single country or region exposes the portfolio to a single set of political, regulatory, trade, and cyclical factors, making it more likely that the majority of the portfolio's holdings will rise and fall at the same time. Arguably, recent trends away from globalization and toward localization of trade, supply chains, etc. have exacerbated this issue – single country equity indexes may be less globally diversified than they have been in the past. By spreading equity exposures out across the globe, investors may increase the chance that some of their holdings move in a less correlated manner; this is the crux of portfolio diversification. It's worth noting that even a fully market-cap-weighted global equity index like the MSCI ACWI Index holds over 58% of its weight in the United States. Hence, globally diversifying is far from underweighting the U.S.; it's simply not investing only in the U.S.

Finally, and perhaps most basically, it's possible to achieve some level of diversification even within U.S. equities. Given the concentration of the S&P 500 in such few names and sectors, allocating to small and mid-cap stocks may be more important than ever in diversifying one's portfolio. Some investors even pursue alternative weighting schemes, such as equal-weighting or fundamentally-weighting (weighting by corporate financial metrics like earnings or revenue), as opposed to pure market-capitalization-weighting. Value-oriented investors would argue that the S&P 500's dominance by a few names and sectors makes it unduly exposed to expensive growth stocks. By explicitly pursuing diversification via active management within one's U.S. equity portfolio, this type of concentrated risk can be mitigated.

It's not always easy to do the right thing

We always believe in diversification – it is a mathematically demonstrable fact that diversified portfolios can offer better expected risk-adjusted returns at any level of return or risk than concentrated portfolios. Nevertheless, there are even more compelling arguments to be made that now is an especially crucial time for investors to emphasize diversification. By (1) allocating to assets with low correlations to equities, (2) investing more globally in one's equity portfolio, and (3) diversifying across capitalizations, sectors, and risk exposures, it is possible to reduce the concentrations currently present in the S&P 500. We can't guarantee that the largest technology stocks will lag going forward because we can't predict the future. But that's exactly the point of diversification.

Important Information

The **NASDAQ 100 Index** includes 100 of the largest U.S. and non-U.S. non-financial companies listed on the NASDAQ Stock Market based on market capitalization.

The **S&P 500 Index** is an unmanaged, market-weighted index that consists of 500 of the largest publicly-traded U.S. companies and is considered representative of the broad U.S. stock market.

Indexes are unmanaged and one cannot invest directly in an index.

Important Information

This material represents an assessment of the market environment at a specific point in time and is not intended to be a forecast of future events, or a guarantee of future results. This information should not be relied upon by the reader as research or investment advice.

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