The Case for Diversification

2015 has proven to be another challenging year for asset allocators who, like us, believe that diversification provides a net benefit to an investor's long term, risk-adjusted returns. For the second straight year (and three out of the last five years), the S&P 500 Index has outperformed all other major equity indices, rendering any diversification away from the largest U.S. companies as only detractive from results. While we know intuitively that market leadership moves in cycles, in this edition of MAInsights, we will offer some historical perspective on equity market returns and examine the main factors that we believe are suppressing the value of diversification this time around.

Does diversification work?

Although the last few years have made it seem futile to be invested anywhere but in the largest U.S. stocks, history has shown that diversification by market cap and geography is still a good idea. If you refer to Exhibit A, you will find "The Callan Periodic Table of Investment Returns" which ranks key indices in order of annual performance over the last twenty years. Looking at the four primary equity indices, the S&P 500, Russell 2000, MSCI EAFE, and MSCI Emerging Markets Index, we found that the S&P 500 was actually the worst performing of these markets more often (7 years) than it was the best (6 years). In addition, four out of the six years that it claimed the top prize occurred between 1995 and 1998 during the U.S. technology bubble, a period of time that most investors look back on as a market anomaly. Of course, a similar case could be made that the tech bubble also set up the S&P 500's long stretch of *under*performance between 2002 and 2006; but nonetheless, it is clear from historical data that 1) market leadership is highly unpredictable from year-to-year and 2) the longer that one market leads, the more likely it is to lag in subsequent years. The point of application for investors, in our view, is that the inclination we all feel to invest solely in what has been working has historically led to the wrong moves at the wrong time. It is in this light that we are sticking with our equity diversification despite its underperformance in recent years, with the expectation that patience will be rewarded in time.

Why isn't it working now?

We view two factors as the main sources of frustration for asset allocators in the current market environment: the strong dollar and the incredibly "narrow" market. As of 11/30/15, the U.S. dollar had risen 18% against a basket of global currencies over the previous twelve months. For investors in companies domiciled outside the United States, the currency translation impact of this move in the U.S. dollar has been a material headwind for international allocations. As illustrated in the table below, there has been a wide performance gap between local currency and U.S. dollar returns for most international markets in both 2014 and 2015, which has been bad news for U.S. investors with globally diversified portfolios.

	YTD		2014	
Country / Region	Local	USD	Local	USD
Regions / Broad Indexes				
All Country World	3.9	-0.1	9.9	4.7
U.S. (S&P 500)	-	3.0	-	13.7
EAFE	8.7	0.9	6.4	-4.5
Europe ex-U.K.	14.4	2.1	7.4	-5.8
Pacific ex-Japan	-2.8	-10.3	5.8	-0.3
Emerging Markets	-4.4	-12.7	5.6	-1.8

The second headwind for diversified investors this year has been the concentration of market returns in the largest companies in the market. Since the beginning of 2015, the top 10 companies by market cap in the S&P 500 have gained 13% on average through 11/30/15.

Ticker	Company
AAPL	Apple
AMZN	Amazon
BRK/B	Berkshire
FB	Facebook
GE	General Electric
GOOGL	Google
JNJ	Johnson and Johnson
MSFT	Microsoft
WFC	Wells Fargo
XOM	Exxon

The other 490 companies are *down* over 5% on average! As shown in the table below, the performance disparity between the top 10 companies and the rest of the market hasn't been this wide since the late 1990's. It is actually more typical that the top 10 companies *underperform* the rest of the market, supporting the thesis that diversifying into smaller cap names enhances the return potential of a portfolio. Not so much in 2015.

Year	Top 10 by Market Cap	Rest of Market Performance	Spread	S&P 500 Performance	S&P 500 Perf. Next Year
'91	40.90%	32.00%	8.90%	26.30%	4.50%
'92	-4.30%	12.60%	-16.90%	4.50%	7.10%
'93	-1.40%	12.90%	-14.30%	7.10%	-1.50%
'94	-0.70%	-1.80%	1.10%	-1.50%	34.10%
'95	37.00%	27.70%	9.30%	34.10%	20.30%
'96	27.40%	16.40%	11.00%	20.30%	31.00%
'97	33.00%	25.80%	7.20%	31.00%	26.70%
'98	37.90%	11.60%	26.30%	26.70%	19.50%
'99	34.30%	10.00%	24.30%	19.50%	-10.10%
'00	-27.50%	7.90%	-35.40%	-10.10%	-13.00%
'01	-8.40%	-1.70%	-6.70%	-13.00%	-23.40%
'02	-28.60%	-19.30%	-9.20%	-23.40%	26.40%
'03	12.60%	40.20%	-27.60%	26.40%	9.00%
'04	-2.60%	15.20%	-17.90%	9.00%	3.00%
'05	-4.00%	6.80%	-10.90%	3.00%	13.60%
'06	13.90%	14.00%	-0.10%	13.60%	3.50%
'07	-2.70%	0.80%	-3.50%	3.50%	-38.50%
'08	-35.70%	-41.10%	5.40%	-38.50%	23.50%
'09	7.40%	42.70%	-35.30%	23.50%	12.80%
'10	11.20%	19.00%	-7.80%	12.80%	0.00%
'11	6.50%	-1.70%	8.20%	0.00%	13.40%
'12	9.50%	14.50%	-5.00%	13.40%	29.60%
'13	22.30%	34.50%	-12.20%	29.60%	11.40%
'14	8.20%	11.80%	-3.60%	11.40%	1.04%
'15 YTD	13.33%	-5.46%	18.79%	1.04%	??

When will diversification work again?

We believe the strong dollar and "narrowness" of the current market are both temporary factors that will diminish in their influence going forward. The surge in the U.S. dollar over the past year has been largely due to the divergence of U.S. monetary policy from the rest of the world as the Fed anticipates "lift off" from zero interest rates in December. While we would expect other world central banks (i.e. European Central Bank and Bank of Japan) to remain much "easier" than the Fed for some time, this seems largely priced into the currency

market already. As for the concentration of return in the largest market cap stocks, we wonder how much of this phenomenon is attributable to investors shirking active management for the passive index approach of ETFs. Considering that the top 10 S&P 500 companies represent nearly 20% of the total market cap, this subset of companies does attract a disproportionate amount of every dollar invested into S&P 500 ETFs. Since we do not expect this trend towards passive indexing to dissipate anytime soon, other factors like company-specific performance and shifting market momentum are more likely to disrupt the concentration of performance in the largest names.

The challenge for diversified investors is to stay the course in the periods of time when diversification is not working and not popular. At MAI, we try to stay focused on the risk and return benefits of owning portfolios diversified by market cap and geography for the long run with the expectation that these portfolios will outperform on a risk-adjusted basis over time. If history is any guide, we would expect this philosophy to pay off for investors in the coming years.

Please send your questions, comments and feedback to: info@mai.capital. Any statistics mentioned have been obtained from sources we believed to be reliable, but the accuracy and completeness of the information cannot be guaranteed. Any statement non-factual in nature constitutes only current opinion of this author which is subject to change without notice. Neither the information nor any views expressed should be considered as investment advice or constitute as a recommendation to buy or sell any security, strategy or product nor should it be considered as a forecast of future events or a guarantee of future results.

THIS IS NOT A RECOMMENDATION TO BUY OR SELL ANY SECURITY.

Asset Allocation Philosophy & Process:

The importance of diversification

Annual Returns for Major Indices (1992-2014) Ranked in Order of Performance

The below table presents the broad asset classes of stocks vs. bonds and further details stocks by capitalization (large vs. small), styles (growth vs. value) and geographic region. It is noteworthy that no asset class consistently captures the top rank on a relative or absolute basis.

1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
R2000 Value 29.14%	MSCI EM 74.84%	MSCI EAFE 7.78%	S&P/Citi 500 Growth 38.13%	S&P/Citi 500 Growth 23.97%	S&P/Citi 500 Growth 36.53%	S&P/Citi 500 Growth 42.16%	MSCI EM 66.41%	R2000 Value 22.83%	R2000 Value 14.02%	Barclays Agg 10.25%	MSCI EM 56.28%	MSCI EM 25.95%	MSCI EM 34.54%	MSCI EM 32.55%	MSCI EM 39.82%	Barclays Agg 5.24%	MSCI EM 79.02%	R2000 Growth 29.09%	Barclays Agg 7.84%	MSCI EM 18.63%	R2000 Growth 43.30%	S&P 500 Growth 14.89%
R2000 18.41%	MSCI EAFE 32.56%	S&P/Citi 500 Growth 3.13%	S&P 500 37.58%	S&P 500 22.96%	S&P 500 33.36%	S&P 500 28.58%	R2000 Growth 43.09%	Barclays Agg 11.63%	Barclays Agg 8.44%	MSCI EM -6.00%	R2000 Growth 48.54%	R2000 Value 22.25%	MSCI EAFE 13.54%	MSCI EAFE 26.34%	MSCI EAFE 11.17%	R2000 Value -28.92%	R2000 Growth 34.47%	R2000 26.85%	S&P 500 Growth 4.65%	R2000 Value 18.05%	R2000 38.82%	S&P 500 13.69
MSCI EM 11.40%	R2000 Value 23.77%	S&P 500 1.32%	S&P/Citi 500 Value 36.99%	S&P/Citi 500 Value 21.99%	R2000 Value 31.78%	MSCI EAFE 20.00%	S&P/Citi 500 Growth 28.25%	S&P/Citi 500 Value 6.08%	R2000 2.49%	R2000 Value -11.43%	R2000 47.25%	MSCI EAFE 20.25%	S&P/Citi 500 Value 5.82%	R2000 Value 23.48%	S&P/Citi 500 Growth 9.13%	R2000 -33.79%	MSCI EAFE 31.78%	R2000 Value 24.50%	S&P 500 2.11%	S&P 500 Value 17.68%	R2000 Value 34.52%	S&P 500 Value 12.36%
S&P/Citi 500 Value 10.52%	R2000 18.88%	S&P/Citi 500 Value -0.63%	R2000 Growth 31.04%	R2000 Value 21.37%	S&P/Citi 500 Value 29.98%	S&P/Citi 500 Value 14.67%	MSCI EAFE 26.96%	R2000 -3.02%	MSCI EM -2.37%	MSCI EAFE -15.94%	R2000 Value 46.03%	R2000 18.33%	S&P 500 4.91%	S&P/Citi 500 Value 20.80%	R2000 Growth 7.05%	S&P/Citi 500 Growth -34.92%	S&P/Citi 500 Growth 31.57%	MSCI EM 19.20%	S&P 500 Value -0.48%	MSCI EAFE 17.32%	S&P 500 Growth 32.75%	Barclays Agg 5.97%
R2000 Growth 7.77%	S&P/Citi 500 Value 18.59%	R2000 Value -1.54%	R2000 28.45%	R2000 16.49%	R2000 22.36%	Barclays Agg 8.69%	R2000 21.26%	S&P 500 -9.10%	R2000 Growth -9.23%	R2000 -20.48%	MSCI EAFE 38.59%	S&P/Citi 500 Value 15.71%	R2000 Value 4.71%	R2000 18.37%	Barclays Agg 6.97%	S&P 500 -37.00%	R2000 27.17%	S&P/Citi 500 Value 15.10%	R2000 Growth -2.91%	R2000 16.35%	S&P 500 32.39%	R2000 Growth 5.60%
S&P 500 7.62%	R2000 Growth 13.37%	R2000 -1.82%	R2000 Value 25.75%	R2000 Growth 11.26%	R2000 Growth 12.95%	R2000 Growth 1.23%	S&P 500 21.04%	MSCI EAFE -14.17%	S&P/Citi 500 Value -11.71%	S&P/Citi 500 Value -20.85%	S&P/Citi 500 Value 31.79%	R2000 Growth 14.31%	R2000 4.55%	S&P 500 15.79%	S&P 500 5.49%	R2000 Growth -38.54%	S&P 500 26.46%	S&P 500 15.06%	R2000 -4.18%	S&P 500 16.00%	S&P 500 Value 31.99%	R2000 4.89%
Barclays Agg 7.40%	S&P 500 10.08%	R2000 Growth -2.43%	Barclays Agg 18.47%	MSCI EAFE 6.05%	Barclays Agg 9.65%	R2000 -2.55%	S&P/Citi 500 Value 12.72%	S&P/Citi 500 Growth -22.08%	S&P 500 -11.89%	S&P 500 -22.10%	S&P 500 28.68%	S&P 500 10.88%	R2000 Growth 4.15%	R2000 Growth 13.35%	S&P/Citi 500 Value 1.99%	S&P/Citi 500 Value -39.22%	S&P/Citi 500 Value 21.18%	S&P/Citi 500 Growth 15.05%	R2000 Value -5.50%	S&P 500 Growth 14.61%	MSCI EAFE 22.78%	R2000 Value 4.22%
S&P/Citi 500 Growth 5.06%	Barclays Agg 9.75%	Barclays Agg -2.92%	MSCI EAFE 11.21%	MSCI EM 6.03%	MSCI EAFE 1.78%	R2000 Value -6.45%	Barclays Agg -0.82%	R2000 Growth -22.43%	S&P/Citi 500 Growth -12.73%	S&P/Citi 500 Growth -23.59%	S&P/Citi 500 Growth 25.66%	S&P/Citi 500 Growth 6.13%	S&P/Citi 500 Growth 4.00%	S&P/Citi 500 Growth 11.01%	R2000 -1.57%	MSCI EAFE -43.38%	R2000 Value 20.58%	MSCI EAFE 7.75%	MSCI EAFE -12.14%	R2000 Growth 14.59%	Barclays Agg -2.02%	MSCI EM --1.82%
MSCI EAFE -12.17%	S&P/Citi 500 Growth 1.68%	MSCI EM -7.32%	MSCI EM -5.21%	Barclays Agg 3.63%	MSCI EM -11.59%	MSCI EM -25.34%	R2000 Value -1.49%	MSCI EM -30.61%	MSCI EAFE -21.44%	R2000 Growth -30.26%	Barclays Agg 4.10%	Barclays Agg 4.34%	Barclays Agg 2.43%	Barclays Agg 4.33%	R2000 Value -9.78%	MSCI EM -53.18%	Barclays Agg 5.93%	Barclays Agg 6.54%	MSCI EM -18.17%	Barclays Agg 4.21%	MSCI EM- 2.27%	MSCI EAFE -4.90%

Source: FactSet & Zephyr. A summary description of each index can be found on the following page.

Index Descriptions

Barclays Aggregate Bond Index, known as the Lehman Brothers Aggregate Bond Index prior to 2008, includes U.S. government, corporate, and mortgage-backed securities with maturities of at least one year.

MSCI EAFE is a Morgan Stanley Capital International Index that is designed to measure the performance of the developed stock markets of Europe, Australasia, and the Far East. Returns are presented net of foreign withholding taxes and unhedged in US Dollars.

MSCI Emerging Markets is a Morgan Stanley Capital International Index that is designed to measure the performance of equity markets in 21 emerging countries around the world. Returns are presented gross of foreign withholding taxes and unhedged in US Dollars. Annual net data is not available prior to 2001.

Russell 2000 measures the performance of small capitalization U.S. stocks. The Russell 2000 is a market-value-weighted index of the 2,000 smallest stocks in the broad-market Russell 3000 Index. These securities are traded on the NYSE, AMEX, and NASDAQ.

Russell 2000 Value and Russell 2000 Growth measure the performance of the growth and value styles of investing in small cap U.S. stocks. The indices are constructed by dividing the market capitalization of the Russell 2000 Index into Growth and Value indices, using style “factors” to make the assignment. The Value Index contains those Russell 2000 securities with a greater-than-average value orientation, while the Growth Index contains those securities with a greater-than-average growth orientation. Securities in the Value Index generally have lower price-to-book and price-earnings ratios than those in the Growth Index. The indices are market-capitalization weighted. The constituent securities are not mutually exclusive.

S&P 500 measures the performance of large capitalization U.S. stocks. The S&P 500 is a market-value-weighted index of 500 stocks that are traded on the NYSE, AMEX, and NASDAQ. The weightings make each company’s influence on the Index performance directly proportional to that company’s market value.

S&P 500 Growth and S&P 500 Value measure the performance of the growth and value styles of investing in large cap U.S. stocks. The indices are constructed by dividing the market capitalization of the S&P 500 Index into Growth and Value indices, using style “factors” to make the assignment. The Value Index contains those S&P 500 securities with a greater-than-average value orientation, while the Growth Index contains those securities with a greater-than-average growth orientation. The indices are market-capitalization weighted. The constituent securities are not mutually exclusive. These were formerly known as the S&P/ Citi Indexes.

One cannot invest directly in an index. Data is presented for information only and is derived from sources MAI believes to be reliable; MAI does not guarantee their accuracy.