

Diversification Is a Lonely Business

As US equity markets take a well-earned rest for Thanksgiving, following a rather eventful couple of weeks, we thought it might be an opportune moment to reflect on some of the lessons recent market events have provided.

Much has already been written about the fortunes of Nvidia and whether investors have become a little too enthusiastic about artificial intelligence. Rather than add to that commentary, we thought it might be more interesting to explore one of the most widely accepted, yet often most difficult to adhere to, principles of investing: diversification.

One of the more peculiar aspects of investment management is that some perfectly sensible investment decisions can, for extended periods, look like mistakes. Maintaining exposure to less fashionable markets, holding bonds or resisting the temptation to increase exposure to the best-performing companies can become increasingly difficult to justify when other investments are delivering exceptional returns. Financial advisers will be familiar with these conversations. Clients who were comfortable with the idea of a diversified portfolio when it was first recommended may understandably begin to question the merits of

that approach. The difficulty, of course, is that the longer a particular investment strategy works, the more compelling the argument for abandoning diversification becomes. In doing so, however, investors become increasingly dependent on that strategy continuing to work.

The uncomfortable nature of diversification

A well-diversified portfolio will almost inevitably contain investments that, with the benefit of hindsight, an investor might wish they had not owned. The temptation is to judge each investment in isolation, rather than consider the role it plays within the wider portfolio. Yet an investment that has contributed relatively little to returns during one period may make a valuable contribution during another. The challenge is distinguishing between an investment that is no longer worthy of a place in the portfolio and one that is simply experiencing a period of relative underperformance. The two are not necessarily the same.

The illusion of diversification

A portfolio may contain a dozen different investment funds, each with a different investment manager and investment objective, and yet be considerably less diversified than it appears. It is only when we look beneath the surface of those individual funds that we begin to understand the true nature of the portfolio and the risks to which it is exposed.

One of the less obvious consequences of a prolonged bull market is that it can gradually change the risk characteristics of a portfolio without the investor making a single investment decision. Most of the world's major equity indices are weighted according to the market value of their constituent companies. As individual companies outperform, they can account for an increasingly large proportion of the index. Investors who originally bought broad exposure to an equity market may therefore find themselves increasingly dependent on a relatively small number of companies.

As part of our ongoing investment management process at TAM, we monitor the combined underlying exposures across our model portfolios. Selecting good fund managers and constructing a well-diversified portfolio are two quite different disciplines. Understanding where their investments overlap, where they complement one another and where they are exposed to similar risks is an important part of portfolio construction.

Nvidia provides a topical example. Whilst the company represents over 7% of the S&P 500 and over 5% of the MSCI World Index, its disclosed underlying exposure within our Active High Growth portfolio is closer to 2%.

The seven US mega-cap companies commonly referred to as the Magnificent Seven collectively account for around 33% of the S&P 500 and 24% of the MSCI World Index, compared with around 9% of our portfolio based on available underlying holdings data.

> **Diversification is not simply about how many investments you own, but how dependent your portfolio is on the same things going right.**

This does not reflect a negative view of these companies or the opportunities presented by artificial intelligence. Diversification does not require us to forgo an investment opportunity, but it does require us to consider how much of our clients' capital should be dependent upon it. An investor can be entirely correct about the long-term prospects for artificial intelligence and still find that some of the investments associated with it disappoint. The quality of a business, the price being paid and the amount of capital committed to it are all important considerations.

When diversification earns its keep

For much of the past few years, investors could be forgiven for questioning the merits of diversification. The technology-heavy Nasdaq 100 has delivered some exceptional returns, and maintaining exposure to less fashionable areas of the equity market has often come at the expense of performance.

October, however, provided an interesting reminder of how quickly market leadership can change. Whilst the Nasdaq 100 fell by more than 6%, the Dow Jones Industrial Average gained almost 2%. The contrast between US growth and value stocks was even more pronounced, with the former falling by over 5% and the latter gaining almost 5%. Perhaps more interestingly, whilst the S&P 500 fell by almost 1%, an index investing in the same companies but giving each an equal weighting gained around 5%. The Bloomberg US Aggregate Bond Index, meanwhile, gained approximately 2.4%.

In our previous Investment Note, Paid to Wait, we discussed how the return of meaningful yields to bond markets had changed the investment landscape. Investors no longer needed to rely quite so heavily on equities to generate attractive portfolio returns. Recent market conditions have served as a useful reminder that bonds can contribute to a portfolio through both the income they generate and the diversification they offer.

What appeared from some of the headlines to be a difficult month for investors was, in fact, a rather good one for certain areas of the financial markets.

By maintaining exposure to different companies, investment styles, geographical regions and asset classes, investors are better positioned to participate in opportunities as market leadership changes, whilst reducing their dependence on any single source of returns.

There is, however, another important aspect of managing investment risk that receives considerably less attention: the influence it has on investor behaviour.

By seeking to moderate volatility and, more importantly, the magnitude of losses during difficult market conditions, we can help investors retain the confidence to remain invested. Some of the most damaging investment decisions are made not because an investor has selected the wrong investments, but because they have lost the confidence to remain invested. Unfortunately, this can happen at precisely the point

when the opportunities for recovery are becoming more attractive.

Diversification, alongside considered asset allocation, investment selection and ongoing portfolio management, plays an important role in managing these risks. None of these disciplines can eliminate investment losses, but together they can help make the investment journey more manageable. Our responsibility as investment managers is not simply to construct portfolios capable of delivering attractive long-term returns, but to construct portfolios that our clients have the confidence to remain invested in throughout the investment journey.

Diversification requires conviction

Diversification is sometimes perceived as an absence of conviction on the part of an investment manager. In practice, maintaining a diversified portfolio can require considerable conviction, particularly when markets are rewarding those who have chosen a more concentrated approach. At TAM, diversification does not mean maintaining a static allocation regardless of market conditions. Our portfolios evolve as valuations, economic conditions and investment opportunities change. There will be occasions when we favour a particular market and others when we believe the potential returns no longer adequately compensate investors for the risks involved.

We will not always get these decisions right. Just as a rising market does not make every investment decision a good one, a falling market does not necessarily vindicate a more cautious approach. What matters is that our decisions remain consistent with our clients' investment objectives and that each investment has a considered role within their portfolio.

With the benefit of hindsight, it is always possible to identify a portfolio that would have delivered better returns. But our responsibility is to construct portfolios for a future that remains uncertain, rather than one we already understand. That means maintaining the discipline to look beyond the prevailing investment trends, recognising that today's market leaders may not be tomorrow's and ensuring that our clients are not overly dependent on any particular investment outcome.

There will inevitably be periods when a diversified approach appears less rewarding than a more concentrated one. Maintaining that discipline during such periods can be uncomfortable, but it is precisely then that it matters most.

The merit of diversification lies not in our ability to predict the future, but in recognising the limitations of our ability to do so.

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