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The Value of Owning a Diversified Portfolio

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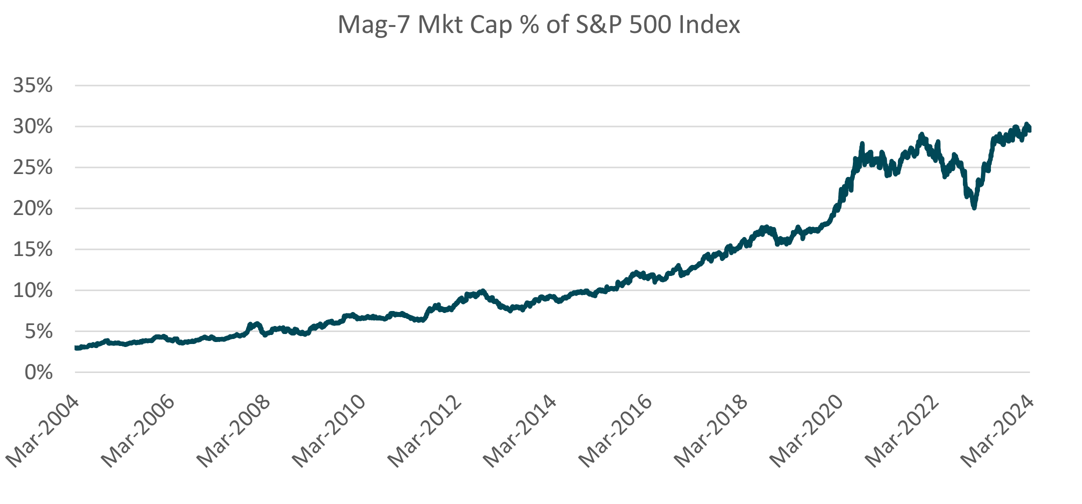
In recent years, a common question often arises amongst our clients – why don't we just invest all of their assets in U.S. stocks for the long run given their outperformance over the last couple of decades? Our answer revolves around the material reduction in portfolio risk that comes from owning a diversified portfolio of securities.

Our brief commentary below will explain why we believe taking a diversified, global and active approach to security selection and asset allocation is in the best interest of our clients.

Overconcentration of U.S. Equity Markets

The market value of the well-discussed "Magnificent 7" (Amazon, Alphabet, Meta, Apple, Microsoft, Nvidia and Tesla) now accounts for 30% of the value of the entire S&P 500 Index, yet contributes nearly 75% of S&P 500 returns.[1] Effectively, this means that ~99% of stocks in the index (the other ~493) contributed only one-quarter of its return.

Longer term, the risk of investing in a single overconcentrated equity market is substantial. As concentration builds, the valuations of the largest companies expand. Illustrating this point, in 2000, Nortel Networks had a market capitalization of $380 billion, accounting for nearly 35% of the S&P/TSX Composite Index, and was viewed as a company you couldn't avoid owning. Just a year later, the company had already lost ~90% of its market value, eventually filing for bankruptcy in 2009. Just because it's big, doesn't make it a great company.



Source: Bloomberg, Odlum Brown Limited. Mag-7 stocks include AAPL, GOOG, AMZN, META, MSFT, NVDA, TSLA.

Hindsight is 20/20

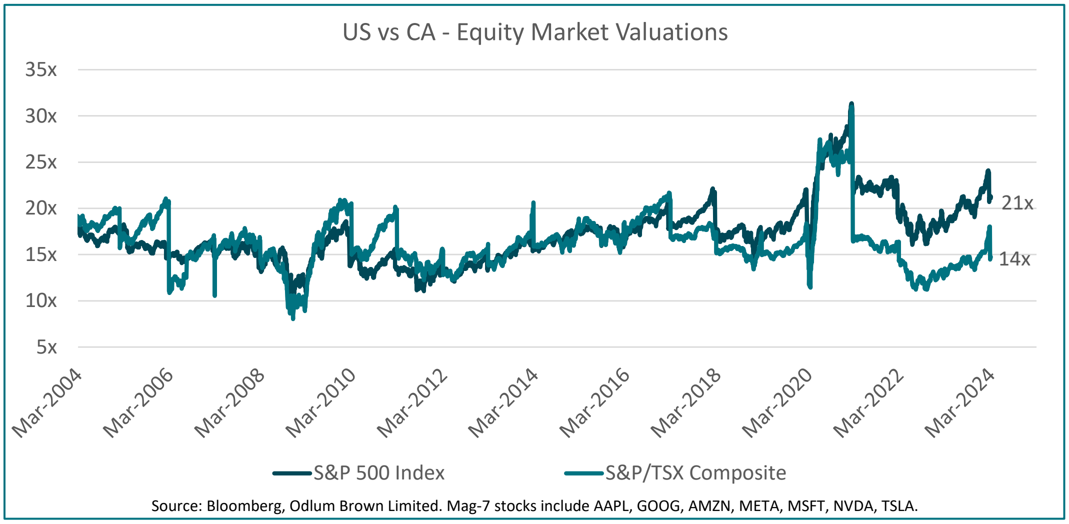
The U.S. market has benefitted from major structural themes over the past few decades which have led to its outperformance relative to other markets.

[1]According to Goldman Sachs; year-to-date period from 2023-01-01, to 2023-11-01.

A rather important question then becomes, when has a U.S.-equity-centric investment strategy worked? Effectively, investing solely in the U.S. market has been successful when interest rates were declining and/or already low and broad global equity performance was strong. In periods of capitulation, heightened risk and volatility (like the macro environment we currently find ourselves in), investing across asset classes and geographic regions has provided investors with the ability to pivot dynamically, reduce risk and capitalize on extremes in investor sentiment as it relates to an individual security, industry, asset class or region. Importantly, not all markets follow the same cycle at the same time. Some countries may be entering a recession while others may be exiting one, providing an opportunity for enterprising investors. Similarly, some industries are more susceptible to changes in the business cycle (cyclicals) while others fare well across all cycles (defensives/non-cyclicals).

Mean reversion as it relates to investing is the concept that values (stock prices, valuations, margins, etc.) return to their long-run average or trend. When investing solely in one region or market, one cannot benefit from disconnects in valuations between different geographic regions. By owning securities across more than one market, investors are able to shift their geographic asset allocation over time to benefit from differences in valuations between regions. This reduces the volatility one sees in their portfolio, as they are able to reduce the impact of regional slowdowns on their total portfolio return.

In the chart below, we've outlined historical valuations[2] for Canadian (S&P/TSX Composite Index) and U.S. (S&P 500 Index) equity markets. As you may have noticed, valuations in Canada and the U.S. have not always moved in lockstep. These periods provided opportunities to capture valuation disconnects in a diversified portfolio. Further, there have been times when valuations "didn't matter" to markets – for example, over the decade from 2010 to 2020, when performance had been strong despite rising valuation multiples. Currently, Canadian equity markets are sitting at approximately a six-turn discount relative to U.S. markets. Importantly, this is one of the largest valuation discounts we've seen in over 20 years, suggesting that there could be value in Canadian equities if valuations mean revert over time.



Source: Bloomberg, Odlum Brown Limited. Mag-7 stocks include AAPL, GOOG, AMZN, META, MSFT, NVDA, TSLA.

In the short run, being diversified may detract modestly from returns, but in the long run owning a well-balanced portfolio should produce strong returns while limiting the ups and downs experienced by owning one asset class in one market. For example, take last year, when two traditionally defensive sectors (REITs and Utilities) underperformed

[2] Valuation metric used is the Price-to-Forward Earnings ratio, which looks at the index price relative to the earnings per share (EPS) expected over the next 12-month period.

markets materially. Has the diversification benefit of owning quality businesses within these segments of the market eroded? Or does this prove to be an opportunity to add to existing investments in reputable and profitable companies?

With the information we've provided above, it is evident that valuations matter, just as the price you pay for your clothes or your home matters. To that effect, after almost a decade of rising multiples and investor speculation, higher rates are forcing investors to pay more attention to the price that they pay for assets.

We leave you with a quote from one of our favourite investors, which captures our preference towards owning diversified portfolios:

"When picking a list of growth stocks for long-term investment, broad diversification of the risk is the first and most important principle to follow. No one can look ahead five or ten years and say what is the most promising industry or the best stock to own." – T. Rowe Price

For more information on how our team at Odlum Brown can help you achieve your financial goals, we welcome you to contact:

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