Richard Bernstein Advisors

The Leaders In Pactive® Management

RBA Quick Insights

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The biggest risk to portfolios today

Diversification is a hedge against uncertainty

To start, let's discuss what diversification is and what it is not. Diversification is a hedge against uncertainty. If one knew with 100% certainty what the best performing investment would be, any rational investor would simply put all their money into that one single investment because owning anything else would detract from performance. The less certainty you have, the more diversification you should seek.

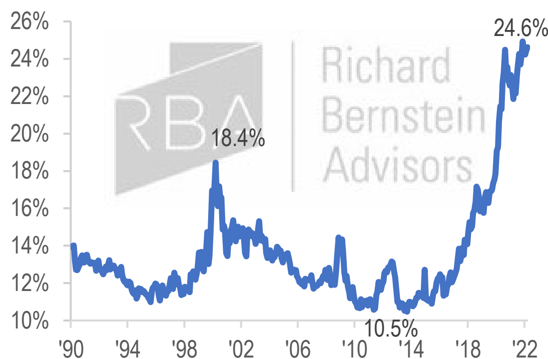
Diversification is a function of concentration and correlations

Diversification is less about increasing portfolio returns, and more about creating a smoother ride. For example, let's say you have two investments that will generate the same return but with very different performance trends. In this scenario, you will end up with the same returns whether you own one investment, the other investment or both. But the day-to-day volatility of those returns should be dampened when you own them together vs. owning them separately. Just how much the volatility is dampened will depend on (1) the concentration of the portfolio in each investment and (2) the correlation between the investments.

The problem in portfolios today is that concentration is high…

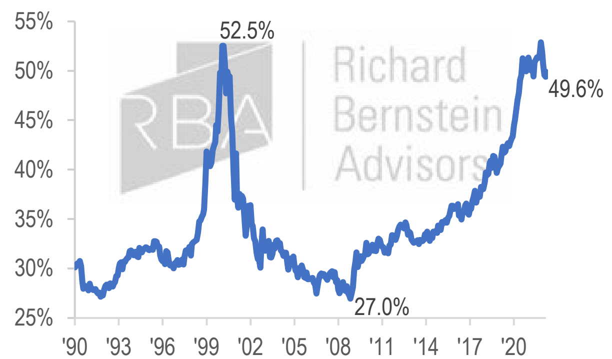
The narrow leadership of the past decade has led to high market concentration in those areas that have worked, namely US over international, large caps over small caps, and growth over value. Whether one focuses on single stocks, sectors, regions or styles, the level of concentration in the stock market is at or near record levels (Charts 1-4).

Chart 1: Top 5 market cap stocks % of S&P 500®
(1/31/1990 - 3/31/2022)



Source: Richard Bernstein Advisors LLC, Bloomberg, S&P
Note: based on total company market cap

Chart 2: Info Tech, Comm Svcs & Discretionary % of S&P 500®
(1/31/1990 - 04/04/2022)



Source: Richard Bernstein Advisors LLC, Bloomberg, S&P
Note: based on index weight

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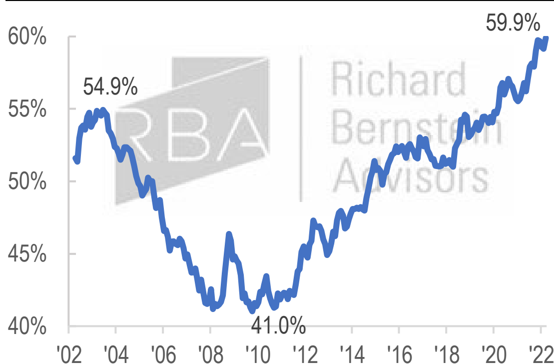
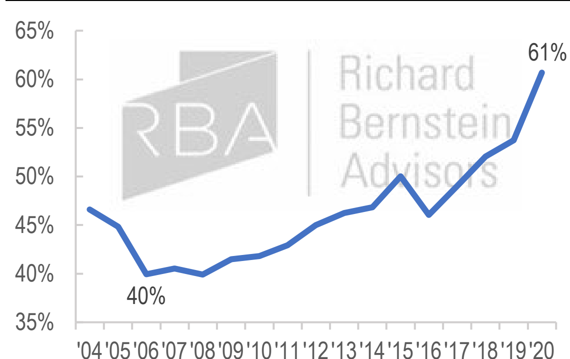
Chart 3: US % of global stock market (MSCI ACWI)
(04/30/2002 - 3/31/2022)



Source: Richard Bernstein Advisors LLC, Bloomberg, MSCI
Note: based on stock ISO countries

Chart 4: Growth % of total large cap growth & value mutual fund AUM
(2004 - 2020)

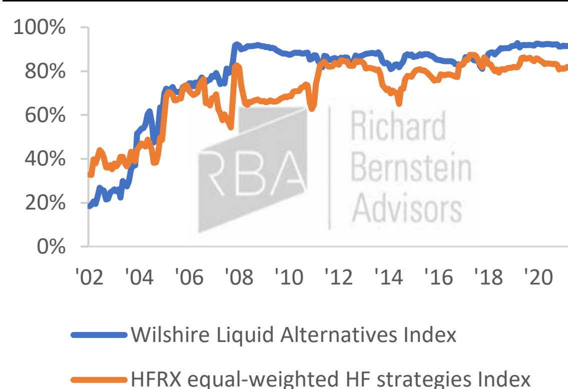


Source: Richard Bernstein Advisors LLC, Bloomberg, ICI

…AND so are correlations

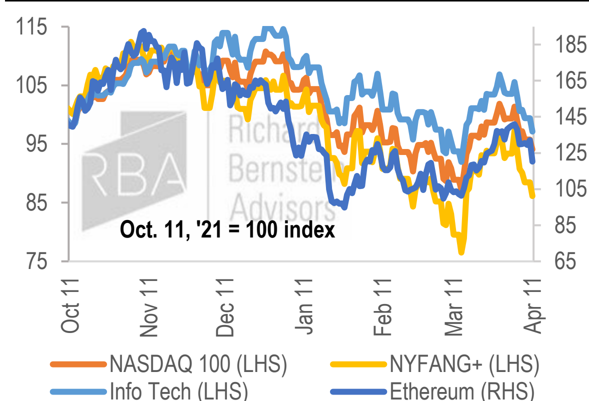
The very assets most sought after as sources of diversification, such as bonds and alternative investments, tend to have high or rapidly increasing correlations with stocks. Consider the Wilshire Liquid Alternatives Index, which is predominately made up of hedge funds. Both liquid alternatives and the broader hedge fund universe have become extremely correlated with stocks (Chart 5). In their limited history, cryptocurrencies have also become increasingly correlated with stocks, particularly with the areas of the market where concentration is the highest (Chart 6).

Chart 5: 3-yr rolling correlation of monthly returns vs. S&P 500®
(12/31/2002 – 03/31/2022)



Source: Richard Bernstein Advisors LLC, Bloomberg, Wilshire, HFRI

Chart 6: Ethereum vs. various "Tech" indices over the last 6 months
(10/11/2021 – 4/11/2022)



Source: Richard Bernstein Advisors LLC, Bloomberg, S&P, NASDAQ

Bonds offer limited diversification in a rising rate paradigm

We believe we are in a new paradigm of rising interest rates, which suggests that bonds are not likely to provide anything like the type of negative correlations with stocks that investors have come to expect over the past 40 years. Case in point, the first quarter of this year was the first quarter since 1980 — the tail end of the last rising rate regime — where stock markets fell and bonds were down more than 5% (Chart 7).

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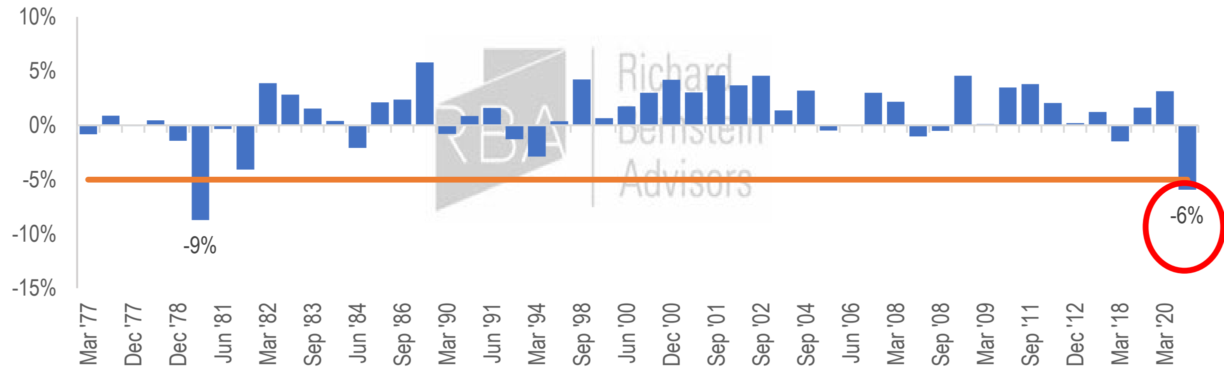
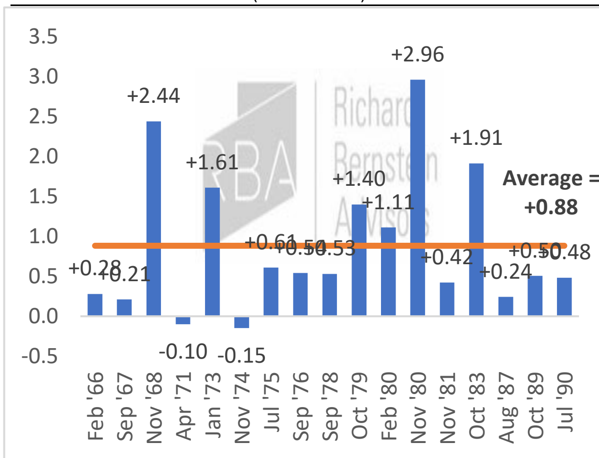
Chart 7: US Bloomberg Aggregate Bond Index returns in quarters where the S&P 500® had negative returns (March 1977 – March 2020)



Source: Richard Bernstein Advisors LLC, S&P, Bloomberg, S&P

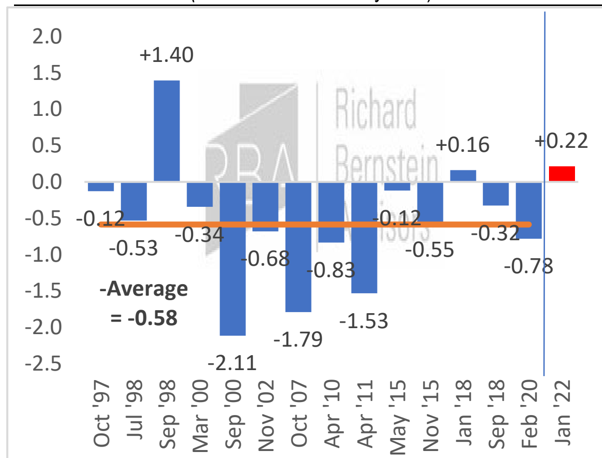
In fact, during the entire 30-year period from 1965 through 1995, there were only two instances where stocks fell by over 10% and the yield on 10-year Treasury bonds also declined — i.e. bond prices rose. All of the other 15 stock market corrections saw Treasury yields rise (bond prices fall) by an average of 88bp (Chart 8). It was only in the past two decades of low and declining interest rates where Treasury yields have tended to fall during stock market corrections, but that period may now be over (Chart 9).

Chart 8: Chg in 10-yr Tsy yield during 10%+ S&P 500® corrections (1965 – 1995)



Source: Richard Bernstein Advisors LLC, Bloomberg, S&P

Chart 9: Chg in 10-yr Tsy yield during 10%+ S&P 500® corrections (October 1997 – January 2022)



Source: Richard Bernstein Advisors LLC, Bloomberg, S&P

Higher interest rates hurt long-duration assets and those reliant on leverage

Other areas that investors often look to for diversification are private equity and real estate. However, if the new paradigm results in higher debt financing costs, the returns and valuations of these investments could come down dramatically due to their reliance on low-cost leverage. Additionally, long-duration investments, for which the bulk of the profits are projected to be far into the future, face significant valuation risk from higher interest rates. While this may pertain to some alternative investments such as venture capital or cryptocurrency, this also comes full circle back to the concentrated areas of the stock market. As highlighted in a report by BofA Research, the investment recovery period — also known as duration — for the US stock market remains near record levels, which makes it extremely vulnerable to higher interest rates (Chart 10).

Chart 10: S&P 500® duration based on BofA US Equity Strategy Dividend Discount Model framework
(2001 – 2021)

Source: BofA US Equity & Quant Strategy

Source: BofA Research

Almost everything is dependent on low interest rates

To summarize, today's stock markets are more concentrated than they have ever been. The increased concentration is in long-duration equities, which has increased the stock market's sensitivity to interest rates. Investors have flocked to alternative investments hoping to add diversification, but most of these investments have high or increasing correlations with stocks and/or may struggle in a period of secularly rising interest rates.

Getting diversification today requires an active approach

The high degree of market concentration combined with elevated correlations across the investment landscape suggests that passive diversification is extremely low. This is not a desirable situation given the increased likelihood of a new paradigm of higher inflation and higher interest rates, and is particularly worrisome against the current fundamental backdrop of slowing corporate profit growth, tightening liquidity and elevated investor sentiment. We think the prudent response to such an environment would be to proactively force diversification into portfolios by reducing concentration and having exposure in areas with lower correlations. In our portfolios, we accomplish this by having less exposure to US stocks associated with innovation, technology and growth, while lessening our portfolios' vulnerability to higher interest rates. Investors that attempt to follow suit should be prepared for tremendous resistance from their risk managers who will argue that the benchmark risk is too big. But that is exactly the point: **prudent investors seeking diversification today should not look anything like their overly concentrated and highly correlated benchmark investments.**

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INDEX DESCRIPTIONS:

The following descriptions, while believed to be accurate, are in some cases abbreviated versions of more detailed or comprehensive definitions available from the sponsors or originators of the respective indices. Anyone interested in such further details is free to consult each such sponsor's or originator's website.

The past performance of an index is not a guarantee of future results.

Each index reflects an unmanaged universe of securities without any deduction for advisory fees or other expenses that would reduce actual returns, as well as the reinvestment of all income and dividends. An actual investment in the securities included in the index would require an investor to incur transaction costs, which would lower the performance results. **Indices are not actively managed and investors cannot invest directly in the indices.**

Wilshire Liquid Alternatives Index: The Wilshire Focused Liquid Alternative Index℠ measures the performance of a focused basket of mutual funds that provides risk adjusted exposure to equity hedge, global macro, relative value, and event driven alternative investment strategies.

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