Clark Capital Management Group

NavigatorInsights

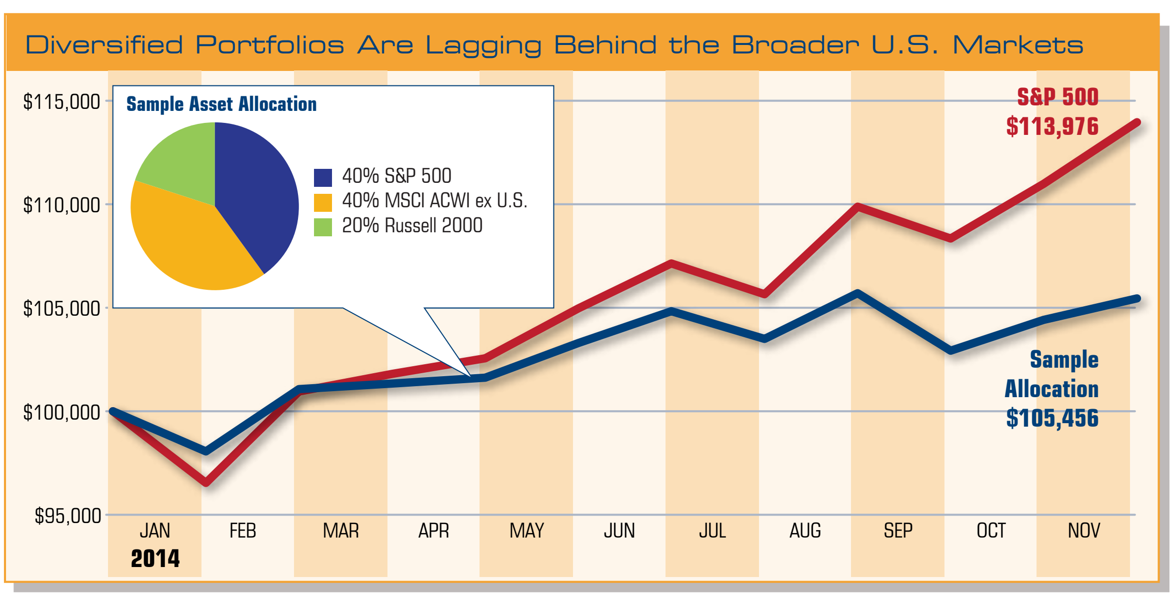
Has Diversification Lost Its LUSTER?

One of the most basic tenets of investing has been the importance of diversification. Individual investors can quickly understand the concept of "not putting all your eggs in one basket." However, the recent market environment has been punishing the prudent, diversified investor. We've written frequently on what we believe to be the benefits of embracing both active and passive investment styles in an effort to deliver diversification of investment methodologies. And while the headlines might reference active vs. passive, ironically, we believe the real culprit holding back investors is diversification.

Diversification is achieved by combining uncorrelated asset classes, "asset classes" that do not move in the same direction at the same time. It usually becomes more difficult to achieve a diversified portfolio in a bear market, because, as we saw in 2002 and again in 2008, when the market encounters a severe setback, correlations among asset classes spike and all asset classes move together in the same direction: down. Diversification is widely regarded as the key to long-term investment success; however, there will be periods of time when a portfolio diversified globally, across asset classes, and among methodologies will underperform.

Leadership has been exceptionally thin in the equity markets. The S&P has been running the charge up the hill pretty much by itself by outperforming small caps, foreign equities and emerging market equities. As Jason Zweig wrote in *The Wall Street Journal* on November 28th, "So far this year, the Russell 2000 index of small stocks is up 3.1%, including dividends, while the S&P 500 is up 13.9%—the widest gap in favor of large stocks since 1998."* The global equity markets have been led by U.S. equities and, within the U.S., large caps have dominated. As I write this article, the S&P 500 is up +13.98% while the Russell 2000 is up only +1.99% and the MSCI All Country World Index (ACWI) excluding the U.S. is down -0.27%.

While investment professionals know that comparing the S&P 500 to a diversified portfolio is not an apples to apples comparison, a large segment of the individual investor population sees the S&P 500 as the benchmark for the stock market.



Portfolio shown is hypothetical and does not reflect an actual portfolio.

As of 11/30/2014. Source: Clark Capital Research; All returns include the reinvestment of dividends

The portfolio shown is made of up 40% S&P 500, 40% MSCI ACWI ex US and 20% Russell 2000. Index returns do not include transaction fees, management fees or any other costs. It is not possible to invest directly in these indices.

The chart above compares a hypothetical asset allocation to the S&P 500 from 12/31/2013 to 11/30/2014.

The large divergence in equity performance gives the false impression that a diversified equity portfolio is underperforming if an investor gauges performance by the S&P 500. For example, a sample portfolio of 40% S&P 500, 20% Russell 2000 and 40% MSCI ACWI ex U.S. would be up 5.88% year to date. Right now, the illusion of underperformance of a diversified portfolio against the S&P 500 is set against the backdrop of a six-year bull market in equities. Naturally, investors are questioning the ability of active managers and stock pickers to outperform.

It may be very tempting for investors to want to add more large cap U.S. equity exposure in light of the strong performance; however, in our opinion adding more large cap exposure decreases diversification and inevitably increases risk in the portfolio. We believe any counter-move downward in large cap U.S. stocks would hit investors who add heavy exposure the hardest, delivering a double whammy of underperformance. For investors who are heavily concentrated in U.S. stock exposure, now may be the right time to take some risk off the table and diversify exposure.

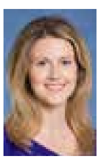
While diversification seems to be out of favor, we believe it is still a key investment principle that should not be hastily discarded. Keeping your clients focused on their goals generally requires continued education on the benefits of meaningful diversification, especially during time periods when the performance of one asset class outshines the others.

Instead of comparing one's investment portfolio to a benchmark, investors should stay focused on their own needs and required rate of return, asking the questions:

- Is risk management important to me now? Would it be more important to me in a bear market?
- Am I seeking to achieve returns in line with a specific benchmark, or am I seeking to achieve personal objectives such as funding my retirement?
- What relevance does the S&P 500's performance this year have to my personal financial needs?

At Clark Capital, we believe that several tools such as an Investment Policy Statement, personal benchmark capabilities, and a well-diversified portfolio can help clients reach their goals.

*As Indexes Soar, Active Stock Pickers Can't Get Off the Ground, *The Wall Street Journal,* 11/28/14



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The S&P 500 measures the performance of the 500 leading companies in leading industries of the U.S. economy, capturing 75% of U.S. equities. The MSCI World Index ex. U.S. is a freefloat-adjusted market capitalization index that is designed to measure global developed market equity performance excluding the U.S. The Russell 2000® Index measures the performance of the 2,000 smallest companies in the Russell 3000 Index. The data shown is provided for illustrative purposes only and should not be considered investment advice.

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