Diversification? The Last Free Lunch Is Getting Leaner

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The diversification benefits offered by broad market index investing has long been an enticing and popular option. However, the composition of one of the most broadly-followed indices the S&P 500, has meaningfully changed over recent years. While an investment in the S&P 500 still offers 500 unique stocks allocated across eleven sectors, the name concentration of the index has a significant impact on the source of investor returns.

As of 9/30/21, the seven largest names in the S&P 500 represented nearly 25% of the index. Of note is the fact that these seven names are all primarily driven by the same factors. Specifically, they are heavily exposed to the mega-large cap technology momentum trade. Consequently, the recent driver of returns for the index is the result of concentrated factor bets.

Factor analysis identifies performance catalysts for a given security. This allows an investor to accurately isolate contributors of return for each position, a key distinction when creating a truly diversified portfolio. Due to the market cap concentration of the S&P 500, the index's risk factor diversification has reduced over time (Chart 1).

While Vaughan Nelson's Select strategy typically holds 30 names or less, the portfolio has always maintained exposure to a broad number of factors. This factor diversification is evidenced in 2021 by the fact that the portfolio's performance has been greatly aided by stock selection in health care, financials, consumer and industrials, and not largely dependent on large cap technology (Chart 2).

In short, given the concentration and similarities amongst the largest S&P 500 names, the S&P 500's factor diversification has declined while Vaughan Nelson's Select has remained relatively constant. The net result is that, at present, the 29-name Select strategy has a greater level of factor diversification as compared to the 500-name index.

At Vaughan Nelson, we invest with the mindset of offsetting our clients' future liabilities. We do so in a fundamental, bottom up, research driven, high active share, concentrated, factor diversified manner. This process has resulted in the ability to generate performance through stock selection while maintaining broad factor diversification.

Chart 1

S&P 500 Factor Diversification Has Declined

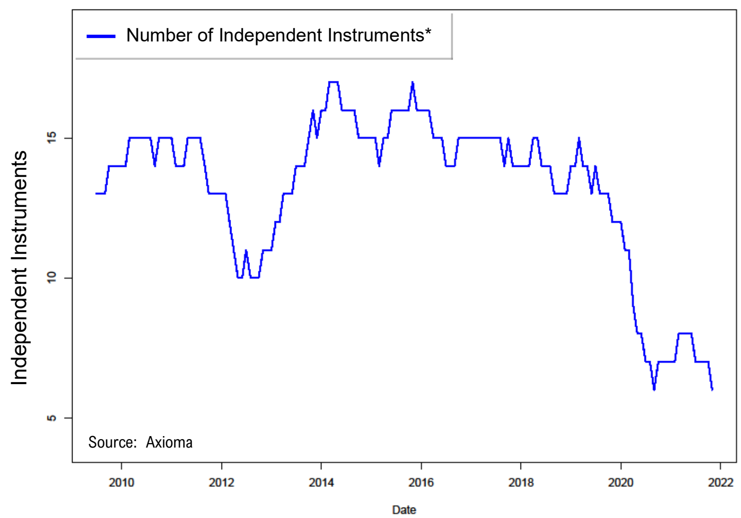
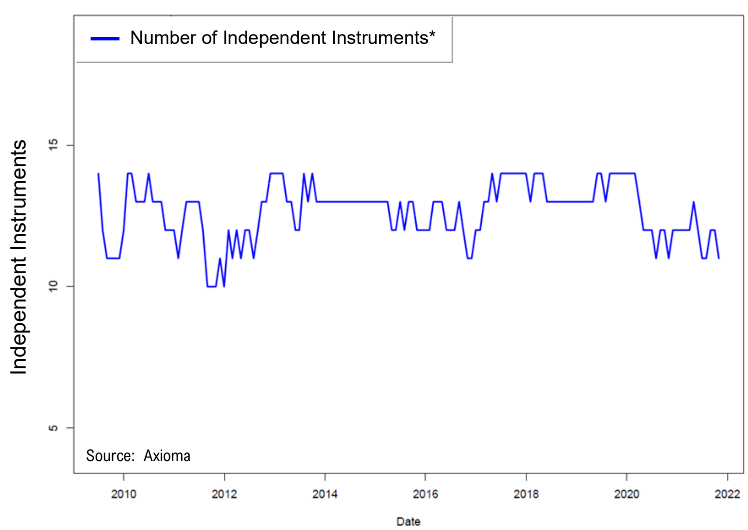


Chart 2

Vaughan Nelson Factor Diversification Has Been Stable



* Independent instruments are groups of companies that share highly correlated factors. Factor exposures between independent instruments are uncorrelated. A larger number of independent instruments implies greater factor diversification of the benchmark/portfolio.

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