Daily Macro Insights: A case for diversification

24/06/2021

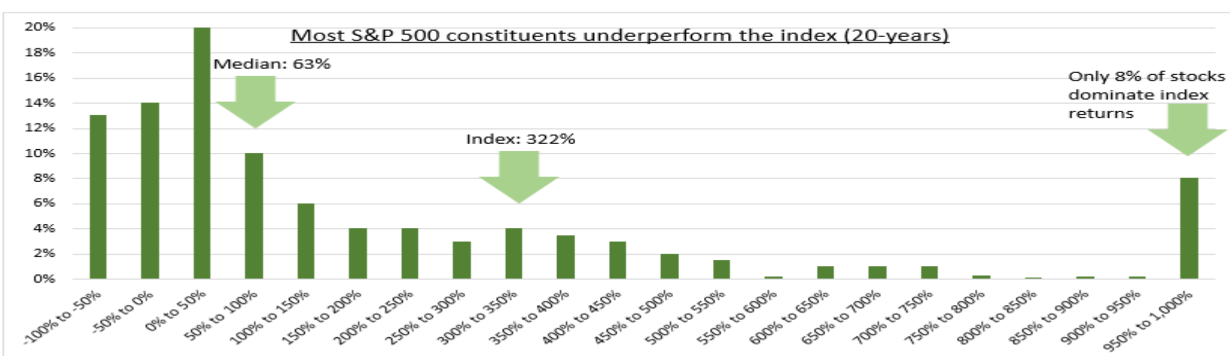
MOST STOCKS UNDERPERFORM: It is a fact that most stocks in a broad index, such as S&P 500, underperform, stacking odds against stockpickers. Investors either need to be consistently good at picking the very small number of dramatic stock winners (or at least avoid the worst performers), or to be well-diversified to guarantee owning the stand-out stocks. This is a case for investing in ETFs, or those few with strong stock picking records (such as BRK.B or SMT.L).

EXPLAINING 'SKEW': Markets are 'positively skewed', with a small number of huge performers having a disproportionate impact. This is caused as a stock can only lose 100%, but upside is infinite. Looking at S&P 500 members the last 20 years (Chart), the median stock is only +63% whilst S&P is +322%. Under a quarter outperform, and 8% make up most of the return. As an example: Amazon (AMZN) is +3,500% but Exxon (XOM) only +62%. But most top stocks were not tech, but from UnitedHealthcare (UNH) to Sherwin-Williams (SHW) and to Autozone (AZO).

ETFs vs ACTIVE: This is one argument in favour of exchange traded funds (ETF's) rather than traditional actively managed funds. ETFs own the whole index, at very low cost, in a tax-efficient way, and by definition do not underperform. The broad case for active management is largely 1) risk management, as can for example boost cash ahead of a crash (if know is coming!), and 2) specialization, as their performance is less bad for niche strategies like small cap or sectors.

INSTRUMENTS: There are over 8,000 ETFs today, managing US$9 trillion, so options are huge. From an ETF on the FTSE 100 index of largest UK stocks (ISF.L) through to one investing in every major global equity market (ACWI), for maximum diversification. Others may want a small allocation to specific sectors, such as real estate (IYR), or to themes, like solar (TAN).

TODAY: BoE ahead of global pack in bond purchase cuts. More tightening signs to help Sterling but temper booming housing (prices +11% yoy). UK equities cheap, under-owned and cyclical.



Source: S&P Dow Jones Indices, Facstet, eToro. 2000-2020

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