

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 3/31/22, seven of the eight largest weighted companies in the S&P 500, representing 27% of the index, are all primarily driven by the same risk 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 27 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

Mega-Cap Tech Companies Reduce S&P 500 Factor Diversification

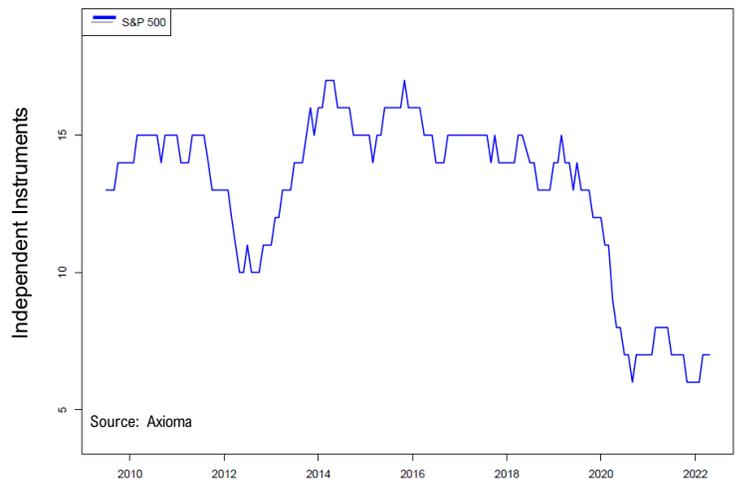
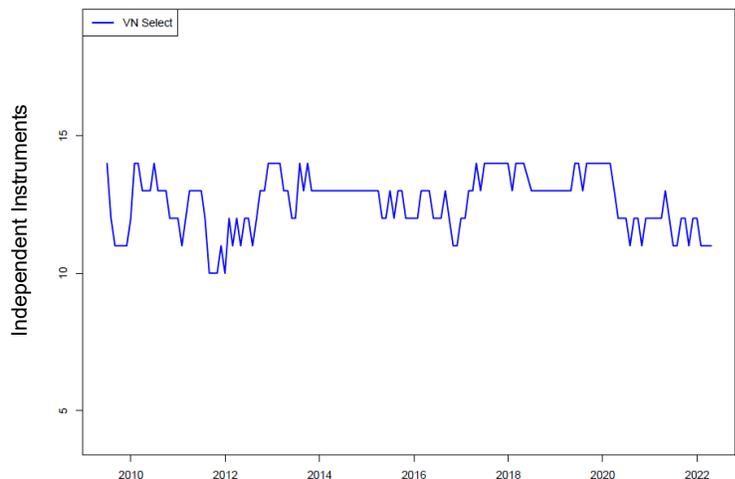


Chart 2

Vaughan Nelson Has Consistent Factor Diversification



* 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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Equity Securities Risk: Equity securities are volatile and can decline significantly in response to broad market and economic conditions. **Non-Diversified Risk:** Non-diversified funds invest a greater portion of assets in fewer securities and therefore may be more vulnerable to adverse changes in the market. **Options Risk:** Options may be used for hedging purposes, but also entail risks related to liquidity, market conditions and credit that may increase volatility. The value of the fund's positions in options may fluctuate in response to changes in the value of the underlying asset. Selling call options may limit returns in a rising market. **Value Investing Risk:** Value investing carries the risk that a security can continue to be undervalued by the market for long periods of time.

High active share is not a guarantee of outperformance or positive performance.

Diversification does not guarantee a profit or protect against a loss.

S&P 500[®] Index is a widely recognized measure of U.S. stock market performance. It is an unmanaged index of 500 common stocks chosen for market size, liquidity, and industry group representation, among other factors. It also measures the performance of the large cap segment of the US equities market.

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