Hymans Robertson Investment Services (HRIS)

Dealing with current market conditions: the importance of portfolio style diversification

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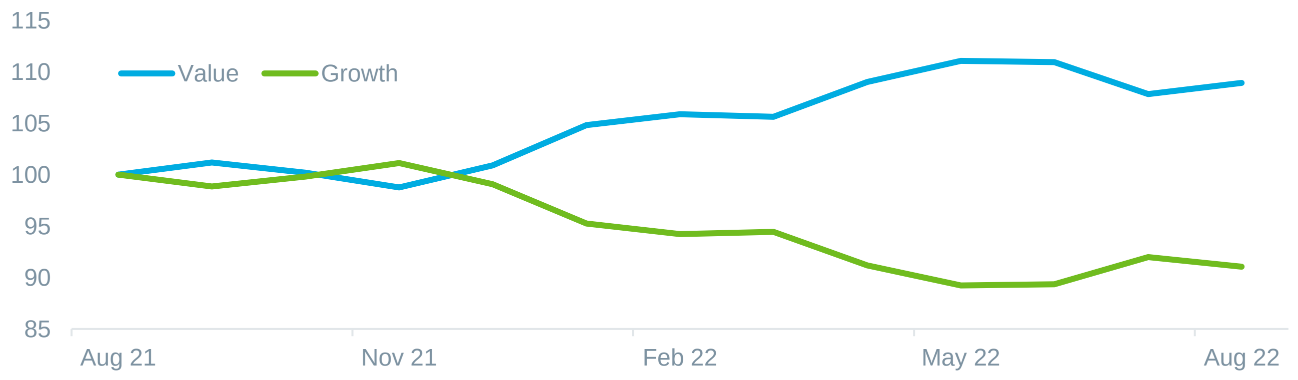
Recent market events have reminded investors again of the importance of diversification. In particular, “Growth” investing has faced a torrid time in 2022, after enjoying strong performance in prior years. In contrast, “Value” investing has enjoyed a strong recovery, after its own “annus horribilis” in 2020. In this note, we discuss investment style in more detail and, as we look ahead, highlight three ways in which Advisers can achieve portfolio style diversification.

Equity style performance over the past year

Equity markets have recently experienced high levels of volatility. However, this just tells part of the story. There has also been considerable volatility within equities, most notably between different investment styles. As a reminder, equity styles represent the different approaches that many investors take when selecting stocks. For example, a “Growth” style describes an approach which focuses on stocks (perhaps innovative, or immature companies) that investors believe will grow quicker than the market, whereas a “Value” style involves a focus on stocks that look cheaper than the market (often represented by relatively mature, well established firms). If implemented consistently, both styles of investing have been shown to add value in the long-term – but, as we have seen recently, both come in and out of favour in the short-term.

Chart 1 shows this dispersion in more detail, with “Value” stocks significantly outperforming “Growth” over the past 12 months. This has been driven by rising interest rate environment, in combination with concerns over global growth rates. Higher interest rates tend to damage the valuations of “Growth” stocks as their future stream of earnings are discounted at a higher level.

Chart 1: Equity style performance relative to the MSCI world over 12 months (source: Datastream)



The underperformance of the "Growth" style has been felt by a number of investors – in particular those holding active equity funds that use a growth style (often holding a meaningful portion of portfolios in technology stocks), as well as a number of ESG and Sustainable equity funds, which often invest in more immature companies, whilst also restricting investments in more mature, "Value" sectors such as energy infrastructure, or Tobacco.

Looking forward

Many investors are currently asking:

- "When will "Growth" come back into favour?" and;
- "Should I sell my recently underperforming "Growth" funds".

The short answer to the first question is, "it will, but it might take quite a bit of time, and the timing will be unpredictable" and the answer to the second is "maybe". We provide more context (and hopefully helpful responses) below:

When will growth style come back into favour?

Chart 2 below shows how a number of investment styles have performed for each of the past 18 years. A shown, style performance changes considerably, from one year to the next.

This is one of the reasons we are strong advocates of maintaining ongoing style diversification within our investment portfolios, and why assessing manager and portfolio style exposure is a key element of our strategic decisions and ongoing investment monitoring.

Chart 2: Calendar year Equity style performance relative to the MSCI world since 2004 (source: Datastream)

2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Small Cap (20.5%)	Momentum (30.9%)	Value (21.7%)	Momentum (18.7%)	Min Vol. (-24.9%)	Small Cap (46.2%)	Small Cap (14.3%)	Min Vol. (6%)	Small Cap (18.7%)	Small Cap (32.5%)	Min Vol. (16%)	Min Vol. (5.7%)	Value (14.9%)	Momentum (29.6%)	Min Vol. (-0.3%)	Quality (35.4%)	Growth (31.7%)	Quality (24.0%)
Min Vol. (17.7%)	Small Cap (21.7%)	Min Vol. (20.9%)	Quality (16.6%)	Quality (-30.7%)	Growth (32.5%)	Momentum (31.3%)	Quality (3.3%)	Momentum (17.5%)	Momentum (30.3%)	Quality (11.8%)	Growth (5.6%)	Small Cap (13.3%)	Growth (26.1%)	Momentum (-3.8%)	Growth (32.9%)	Momentum (31.3%)	Value (22.7%)
Momentum (17%)	Value (17.7%)	Momentum (18.2%)	Growth (12.3%)	Value (-38.2%)	Quality (30.6%)	Growth (31.7%)	Momentum (2.2%)	Growth (17%)	Growth (26.4%)	Growth (11%)	Quality (4.6%)	ACWI (9.7%)	Quality (25.7%)	Quality (-5.4%)	Momentum (27.2%)	Quality (23.2%)	ACWI (21.4%)
Value (16%)	ACWI (17.4%)	Small Cap (17.6%)	ACWI (7.7%)	ACWI (-39.2%)	ACWI (30%)	Min Vol. (1.3%)	Value (-5.8%)	ACWI (16.5%)	ACWI (26.2%)	ACWI (9.9%)	Momentum (4.1%)	Min Vol. (8.1%)	ACWI (20.4%)	Growth (-6.1%)	ACWI (26.9%)	ACWI (14.8%)	Growth (19.7%)
ACWI (12%)	Growth (17.2%)	ACWI (17%)	Min Vol. (3.7%)	Growth (-40.2%)	Value (27.5%)	ACWI (14.8%)	ACWI (-6%)	Value (16.1%)	Value (25.9%)	Momentum (9.5%)	Small Cap (2.6%)	Quality (7.4%)	Small Cap (19.9%)	ACWI (-7.2%)	Small Cap (24.8%)	Small Cap (14.3%)	Small Cap (19.5%)
Quality (10.8%)	Min Vol. (15.6%)	Quality (13.9%)	Small Cap (3.2%)	Small Cap (-41.5%)	Momentum (15.8%)	Quality (23.2%)	Growth (-6.2%)	Quality (14.7%)	Quality (25.3%)	Value (8.7%)	ACWI (1.8%)	Momentum (4.9%)	Min Vol. (16.2%)	Value (-8.3%)	Value (21.1%)	Min Vol. (1.3%)	Min Vol (16.8%)
Growth (8.1%)	Quality (12.2%)	Growth (12.5%)	Value (3.1%)	Momentum (-43.3%)	Min Vol. (15.4%)	Value (-1.4%)	Small Cap (-10.2%)	Min Vol. (11.6%)	Min Vol. (21.7%)	Small Cap (6.7%)	Value (-2%)	Growth (4.6%)	Value (15%)	Small Cap (-12.3%)	Min Vol. (21%)	Value (-1.4%)	Momentum (10.4%)

In terms of the "Growth" style, it has benefited over the past decade from an environment of low interest rates, as this has led to high present values being given to future potential earnings. Whether we are now in fundamentally changed market environment, or the past 12 months have been a temporary headwind and "Growth" will again start to get a tailwind, all remains to be seen. **Because of this we are strong advocates of building investment portfolios that are not overly-reliant on a single specific set of future economic scenarios.**

Should I sack my underperforming "Growth" manager?

This is a tricker question, and in reality it will vary on a case by case basis.

Key questions to consider include;

- How has the manager performed relative to their growth peers?
- Am I comfortable accepting a sustained period of underperformance from growth?
- Has the manager stuck to their conviction, or have they actually traded a number of their holdings, thereby crystallising a number of the losses that have taken place in the portfolio, removing any recovery potential?
- Is your portfolio well enough diversified by style, fund and/or manager?

If your answer is "No" to any of these questions then it may indicate that it is time to make changes to your fund roster.

Three ways of achieving diversification

History tells us that styles can remain out of favour for prolonged periods of time. Whilst growth has been one of the stronger performing styles since the global financial crisis, it is worth noting that it had underperformed four of the five years prior to this.

We believe it is not possible to reliably 'time' exposure to styles (for example, looking to focus on a particular approach at the expense of others). As a result, we always look to maintain a diverse range of approaches when designing our Model portfolios for clients.

This includes the following three elements:

1. **Seek an appropriate mix of styles within equities**. It's very easy to jump on the bandwagon when a particular style is rallying, however we look to avoid this. Instead, our focus is on ensuring the portfolios are balanced across a range of styles helping to bring greater stability throughout different economic cycles.
2. **Consider diversification at an overall portfolio level.** It's easy to look at equities in isolation when thinking about investment styles. However, we always look holistically at the portfolios, recognising that correlations exist within other asset classes. For example, recent falls in gilts have been highly correlated with the falls in growth stocks. A well-diversified portfolio would have helped manage that risk.
3. **Fund and Manager diversification.** Don't be reliant on a single manager and fund – particularly if those funds hold a relatively concentrated set of investments in their own right. Given this we appoint a range of our managers and funds, each of which have been well researched, and which are monitored on an ongoing basis, including daily performance monitoring and quarterly interactions with the managers.

If you wish to have further details on HRIS' Model Portfolios, please let us know.

Email **enquiries@hymans.co.uk** or call **020 7082 6000.**

By William Marshall, HRIS Chief Investment Officer

Risk warning

The value of your investments and the income from them may go down as well as up and neither is guaranteed. Investors could get back less than they invested. Past performance is not a reliable indicator of future results. Changes in exchange rates may have an adverse effect on the value of an investment. Changes in interest rates may also impact the value of fixed income investments. The value of your investment may be impacted if the issuers of underlying fixed income holdings default, or market perceptions of their credit risk change. There are additional risks associated with investments in emerging or developing markets. The information in this document does not constitute advice, nor a recommendation, and investment decisions should not be made on the basis of it. The material provided should not be released or otherwise disclosed to any third party without prior consent from HRIS.

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