Weekly Market Flash

The More Things Stay The Same

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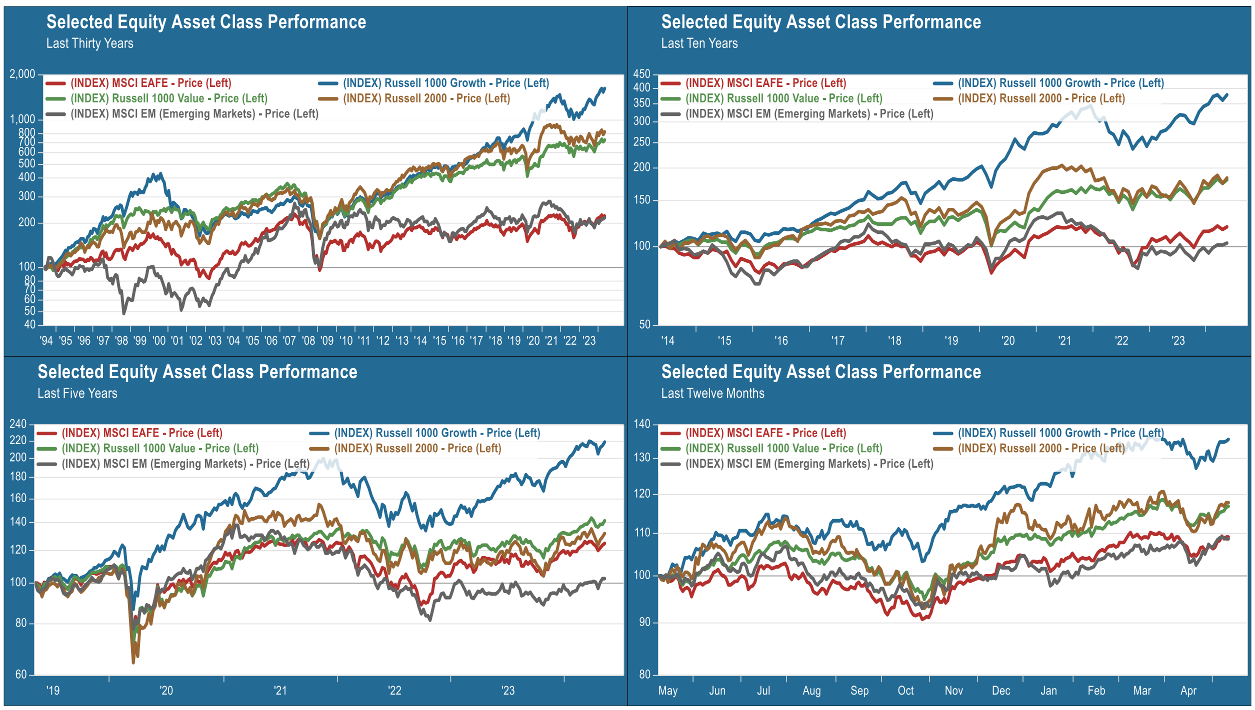
There is a genuinely strange phenomenon that has taken place in the global equity market over what is by now a very long time period. Consider the chart below. It shows the relative performance of five equity asset classes – US large cap growth, US large cap value, US small cap growth, non-US developed and non-US emerging markets – over four different time periods. Thirty years, ten years, five years and one year. Here is the strangeness: the performance ranking in each and every one of these time periods is nearly the same. Growth, value, small cap, international developed and international emerging (with large cap value and small caps being a bit of a toss-up). Different span of time, same order. Each and every time.



Source: MVF Research, FactSet

Diversification, Risk and Return

As investment managers, this situation presents a challenge. We have to look at it from several different perspectives. First of all, there is the principle of diversification. One of the cardinal tenets of investment management is that nothing stays the same forever; mean reversion will at some point bring the high flyers down to earth, and when that happens you want to have other positions in your portfolio that offer some cushion. Diversification offers – or should offer – that kind of protection.

That's all well and good, but there is also something about the performance pattern in the above chart that challenges basic financial theories about diversification, risk and return. Open up any textbook about investment management written any time in the last, say, sixty years, and you will encounter something called the "risk frontier." This is a linear-ish progression of assets from the safest to the riskiest – from cash under the mattress to, say, investing in early-stage venture capital. The line is supposed to be upward sloping, meaning that as the risk properties of an asset increase, the expected return on that asset over a suitably long period of time should also increase. More risk, more return. As an old Ukrainian saying goes, if you don't take the risk, you don't drink the Champagne.

But what is a suitably long period of time? Thirty years? Look at the thirty-year performance chart in the upper left quadrant. The two worst-performing asset classes by far are also the two riskiest (measured by standard deviation) – international developed and (especially) emerging markets. High risk, low return is not something any rational investor would choose. And the very close performance results between US large cap value and US small cap would look very different on a risk-adjusted basis, with large cap value being considerably less risky over time than small cap. Higher risk, same return is also not a great selling point.

The Economic Context

Returns in financial markets, of course, don't happen for no reason at all. The global economy has changed in many ways over the past thirty years. Take US large cap growth, the runaway outperformer over this time. There are really three stories here: the rise of the Internet economy in the mid-late 1990s, followed by the tech stock crash in the early 2000s, and then the rise of Big Tech to a position of economic dominance from the 2010s and particularly in the past decade or so. Tech isn't even really an isolated industry sector any more – the intellectual property of technology leaders infuses everything from carmakers to insurance companies to consumer retailers. Small wonder that these repositories of valuable IP, most of which live in the large cap growth segment of the market, have done so well.

At the same time the US economy overall has outperformed those of other developed countries, while emerging markets has really been the story of an increasingly troubled China, a few bright growth prospects in South Asia and Asia-Pacific, and mostly disappointing growth stories elsewhere. The investment thesis for emerging markets back at the turn of the twenty-first century was the belief that they would contribute an increasing share of global growth and catch up over time to the per-capita income levels of Europe, North America and Japan. That thesis has not stood the test of time very well, at least so far.

Nothing Stays The Same Forever

When you look at the magnitude of the performance gap between US large cap growth and everything else over these different time periods, a certain part of your brain has to be telling you that this is not likely to stay the same indefinitely. Right? Going back to that diversification template, this too will pass – and when it does, you want to be prepared. If you think that the history of the past thirty years is going to repeat itself over the next thirty years, well, you would just park all your long-equity capital into large cap growth and leave it there. But history doesn't repeat, and the economy is likely to change in unpredictable ways as time unfolds. Neither we nor anyone else knows when that will be, or what the impact on different asset classes will be – but the change will come. Be prepared, keep your eyes wide open, and always challenge yourself.

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