Legg Mason
Thought Leadership™

The new core:
DIVERSIFICATION BASED INVESTING

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- Diversification matters, especially in turbulent markets. But not all diversification methods are the same.
- Macro matters: our research shows that equity returns were driven, over the long term, largely by economic sector and country — so it makes sense to diversify across these key drivers.
- Diversification Based Investing diversifies across countries and sectors to capture the potential of easily-overlooked market segments, while limiting exposure to potentially damaging forces.
- We also believe true diversification should account for the shifting dynamics of economic and market trends — like the current cross-border energy dynamic — so we re-examine these relationships periodically.

FEB 2016

The core problem

An investor's core allocation is akin to the foundation of a home; if not laid properly, instability will eventually appear. To build a strong financial foundation, investors often combine stocks, bonds and other alternatives, knowing that no one asset class will always outperform. While this concept is widely understood and employed, investors often neglect diversifying within each type of asset, leaving themselves unknowingly overexposed to other forces in the market.

This is particularly true of equities, where many investors have increasingly turned to passive indices like the S&P 500 or the MSCI EAFE Index. Investors perceive these cap-weighted investments as efficient ways to gain broad market exposure, because they include a large number of stocks across industries — and across geographies if investments are global.

How traditional diversification can disappoint

But in times of market volatility, investors are often disappointed with the results of these efforts. That's because of an unrecognized attribute of this type of investing: the majority of the resulting investment weight is heavily concentrated in a small number of sectors (and for international investors, countries).

With investment dynamics like this, investors would be well served to look for a better way to establish a broad allocation to equities in a diversified portfolio.

Diversification Based Investing: An introduction

QS Investors has developed a different approach to diversification. In 2000, when the collapsing Internet bubble underscored the perils of capitalization-weighted indexes, the weaknesses of the traditional approach to diversification became clear.

QS embarked on research to find big-picture factors affecting returns by investigating the overarching sources of diversification — including global economic or industry trends — in the search for common drivers useful to better manage risk, while preserving the possibility of participation in markets' upward trends.

This matters to investors seeking diversification; like asset classes, the performance of stocks based in different countries or in different economic sectors can vary significantly, depending on the market environment. One example: Figure 1 shows the performance of the Utilities sector, one of ten sectors within the S&P 500 for each of the past five calendar years. That sector was the best performing in two non-consecutive years, but among the worst in the other three. And by geography, Figure 2 shows that European stocks outperformed other regions in one out of the past five years, but were the worst performing in two others.

As long-term followers of the market know, a wide variety of different themes within the market drive performance over time. In some eras, technological breakthroughs drove performance more than valuation; in other times, earnings, dividend growth, or exposure to emerging markets called the tune.

Predicting these market developments is notoriously difficult; getting them wrong risks missing out on emergent sectors and relationships, or being heavily exposed to sudden swings in sentiment or outlook. In our view, preparation beats prediction; rather than placing high-risk directional bets based on forecasts, we've chosen diversification methods intended to capture any emerging trends and minimize exposure to existing vulnerabilities.

That's why QS Investors believes a truly diversified portfolio should have balanced exposure across the themes driving the markets.

Beyond traditional diversification: A different type of core

The QS approach focuses on staying "market-agnostic," diversifying across investment themes to deliver more balanced equity exposure. The approach seeks to capture the upside trends of markets as they develop, rather than focusing on what has worked in the past. At the same time, the method relies on this enhanced diversification to control exposure to the downdrafts that may result from the economic cycle (cyclicals versus staples), swings in style performance (for instance, value versus growth stocks), or episodic issues (for instance, country crises).

An example of the shortcomings of fixed factors: current approaches to investment risk management tend to lean toward defensive investing styles, with the goal of minimizing the effect of market downturns. The consequence is often significant lost opportunities when market leadership shifts toward higher-growth themes.

Adapting to the changing messages of the market

A key advantage of the QS approach is that it's adaptive, taking into account the evolving economic landscape, macro trends and investor sentiments. The adaptive approach allows it to adjust for, and take advantage of, changes in market dynamics over time, minimizing the effects of the common trap of focusing on long-term — but potentially stale — market relationships, while investing for the future.

Surfing the changes: Diversification Based Investing in action

For QS, Diversification Based Investing involves three steps:

- Identifying the drivers of market performance: This analysis of performance patterns of country and sector returns looks for clusters of market correlations, which provide insight into how segments of the market are acting, whether from an economic or behavioral association, providing an alternative view of equity market risks and opportunities.
- Diversifying across correlation clusters: Once these patterns have been uncovered, QS allocates portfolio positions across them in equal proportions — in order to create portfolios that are diversified across these specific patterns. Just like investors combining asset classes with different strengths, QS allocates across different relationships, to unlock the full potential of diversification.
- Adapting to the changing environment: Once each year, the systematic analysis is conducted anew, to pick up changing trends in the market, and the portfolios are recomposed accordingly.

Conclusion: Adaptive diversification for a changing market

Financial markets over the past decade have taught investors one enduring lesson: the dynamics driving markets can change radically — in either direction — over time. So it can make good sense for investors, in continuing the search for future wealth while managing risk, to seek out approaches that diversify within asset classes in a way that adapt to changing market dynamics above and beyond simpler models of broad asset-class diversification.

To take advantage of the changing nature of markets, a diversification-based investment regime should recognize the following:

- Macro matters: Economic sectors and countries are the key drivers of equity market performance
- Preparation beats prediction: Because prediction of these trends is hard, it's better to diversify around those changes rather than to try to anticipate them.
- Cap-weighted indexes aren't diversified: Their very structure forces them to become more concentrated over time, exposing investors at the worst possible times.

The QS solution is diversification based on what matters, rather than what's traditional. Based on managing the exposure to past market relationships — as well as seeking to increase exposure to emergent trends — the approach seeks to limit the impact of market turbulence while taking advantage of growth not yet reflected in cap-weighted index-based investments.

Investment risks

Diversification does not assure a profit or protect against market loss. Active management does not ensure gains or protect against market declines. Outperformance does not imply positive results.

Definitions

The **S&P 500 Index** is an unmanaged index of 500 stocks that is generally representative of the performance of larger companies in the U.S. Indexes are unmanaged, and not available for direct investment. Index returns do not include fees or sales charges. The **Barclays U.S. Aggregate Bond Index** is an unmanaged index of U.S. investment-grade fixed income securities. The **Morgan Stanley Capital International (MSCI) EAFE Index** is an unmanaged index of equity securities from developed countries in Western Europe, the Far East, and Australasia The **MSCI Europe Index** is a free float-adjusted market capitalization index that is designed to measure developed market equity performance in Europe: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland and the United Kingdom. The **MSCI AC Asia Pacific Index** is a market capitalization weighted index that is designed to measure the equity market performance of the developed and emerging markets in the Pacific region. The **MSCI Emerging Markets (EM) Index** is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.

Figure 1: S&P 500 industry sector returns (2010–15)
Top two and bottom two sectors for each year

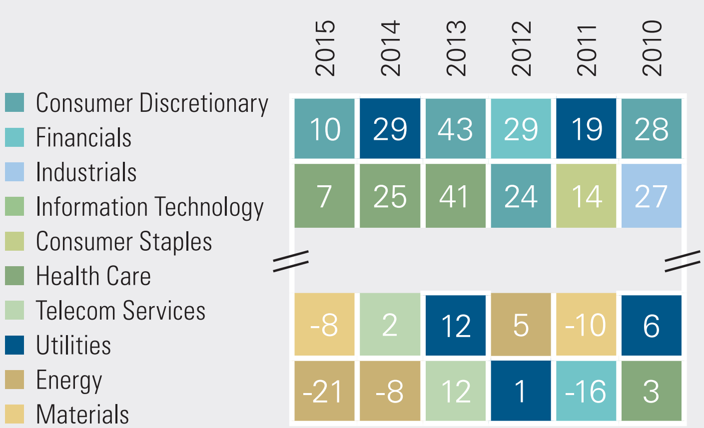
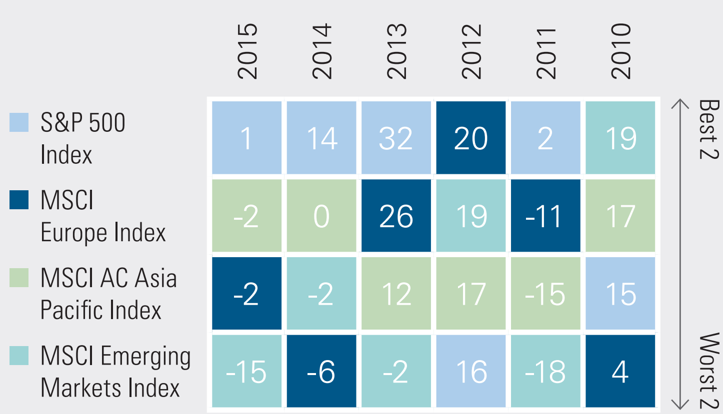


Figure 2: Returns by region (2010–15)
Top two and bottom two regions for each year



Source: Bloomberg, as of December 31, 2015. **Past performance is no guarantee of future results.** Indexes are unmanaged, and not available for direct investment. Index returns do not include fees or sales charges. This information is provided for illustrative purposes only and does not reflect the performance of an actual investment.

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