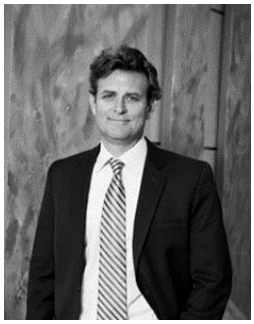
# The Download

2Q 2023



## ANTI-DIVERSIFICATION

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*In the spirit of getting the whole story without reading the article, I have two books on my desk. "Extraordinary Popular Delusions and the Madness of Crowds," and "Skating to Where the Puck Was."*

Nine months ago, the investment industry was drowning in pessimism. This statement is not a supposition. By almost every quantitative measure of sentiment, investors were about as pessimistic at any time since the financial crisis of 2008.

Recession, recession, recession, was all we heard. The national media, articles, strategists, headlines, and so on, all beat the same drum. The Fed was going to destroy the economy, the stock market, and the housing market.

Fast forward nine months, all is good, and the seas are calm. In fact, the economy and capital markets' performance has been so good that investors are once again scrambling to keep up.

The good news here is that a recession did not occur, and one doesn't look likely anytime soon. Further, capital markets responded positively to this about-face in sentiment and economic reality. This renewed optimism and the positive economic outcome was beneficial to Frontier clients. Over the last quarter, year-to-date, and since the depths of despair of 2022, strategy performance has been solid.

While the economy and capital markets dodged the worst outcome, and once again, reality turned out to be not as bad as some had imagined, there is a capital markets nuance, or nuisance for that matter, that needs to be addressed.

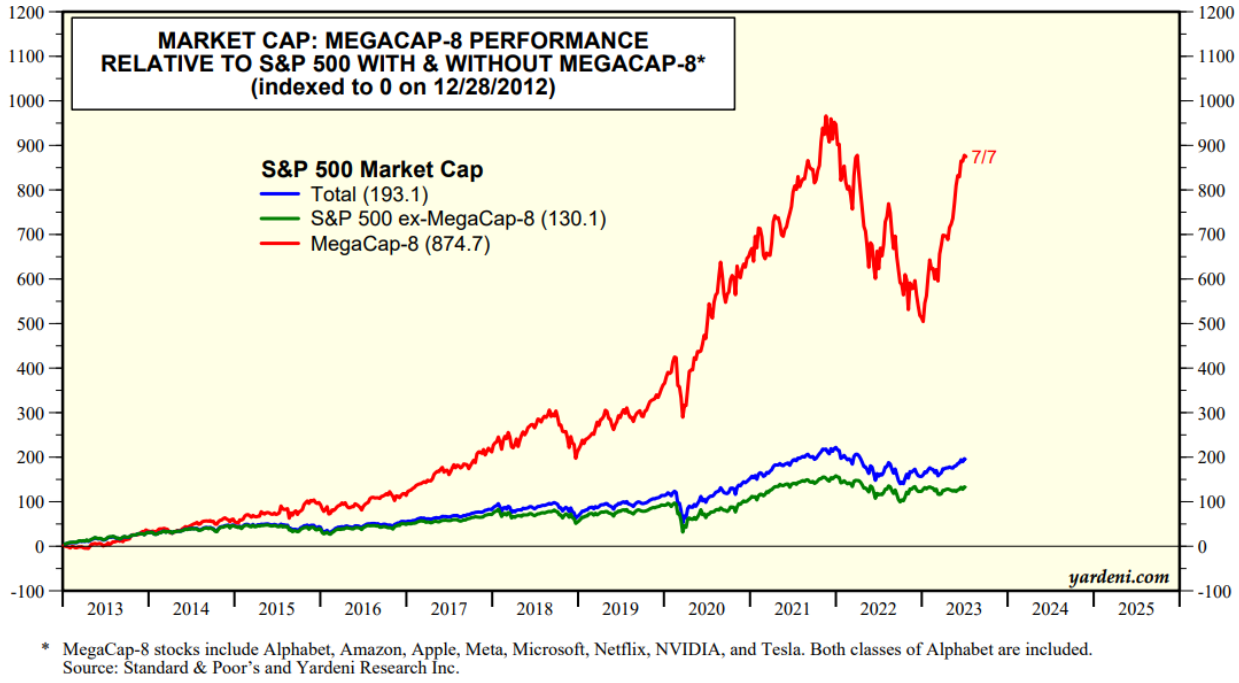
Over the last two decades of managing strategies, we have come to rely on the benefits of diversification and, more specifically, the use of asset allocation as a disciplined methodology to achieve specific return for risk outcomes. However, in the post-COVID environment, many of the long-term benefits of diversification have not been rewarded to their fullest. What has been rewarded has been quite the opposite.

### Anti-diversification and the madness of crowds

As most of you know, the S&P 500® Index is made up of equity ownership in the 500 largest publicly traded U.S. companies. This year, the economic reality turned out to be better than the dire predictions that investors had

imagined, and thus the S&P 500 Index is experiencing strong returns. Simple story, right? Not so fast. Just eight stocks effectively provided almost all the return of the S&P 500 Index this year, while the remaining 492 stocks, on average, have gained close to zero.[1] The performance of just eight stocks is what investors are scrambling to keep up with.

Investors must have short memories. The Mega Cap eight stocks lost approximately 40% of their value in 2022. But, when the bull stampede came roaring back in 2023, investors simply mashed the same old button that had worked so well for them in the decade prior. So much for diversification, for now.




* MegaCap-8 stocks include Alphabet, Amazon, Apple, Meta, Microsoft, Netflix, NVIDIA, and Tesla. Both classes of Alphabet are included.
Source: Standard & Poor's and Yardeni Research Inc.

Source: https://www.yardeni.com/pub/mag8.pdf

## Potential broadening out of the marketplace?

Is this hyper-focused leadership of just eight stocks unsustainable? Or is this the one tree that actually grows to the sky? Alternatively, history might imply that this could be a turning point.

Extreme narrow market leadership has happened before. In 1999, at the tail-end of the Dot Com craze, about eight stocks drove the performance of some indexes ever higher, while much of the broader opportunity set was simply left behind.

We all know the aftermath of the Dot-Com Craze was the Dot-Com Bust, and the NASDAQ Composite Index consequently declined about 70% from peak to trough. However, due to the focus of investors all owning the same few stocks, the losses that occurred to the internet leaders of the day were not universal to the broader investment opportunity set. During the severe unraveling, select value stocks, small-cap stocks, and international stocks actually made money. Quite simply, capital markets broadened out.

We are certainly not expecting anything like the Dot-Com bust to occur, far from it. The moral here is that when investors all pile into the same few investments, most other investments can get left behind. The longer and more

extreme the investor focus becomes, the greater the future broadening out should be. The beneficiaries of this type of change are diversified investors with a keen focus on market valuations. Frontier's greatest period of outperformance was in the years following the Dot-Com bust.

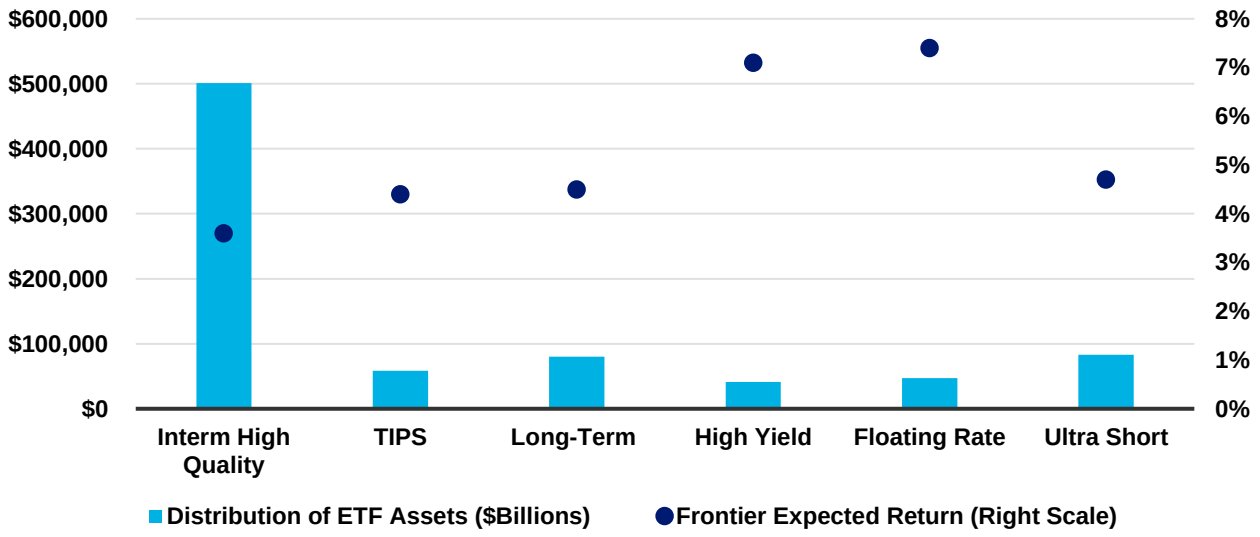
## The return of income – I am not a mathematician, but last time I checked, 7% was still greater than 4%.

Just as the world's stock markets have become focused, so too has the bond market. In short, during the 40 years of falling interest rates, longer-dated and high-quality investment bonds performed well because, after all, interest rates were falling. This era of falling interest rates lasted for so long that the idea of dogmatically owning large positions of intermediate high-quality bonds (core bonds, aggregate bonds) has become institutionalized.

What's the bond position of a 60/40 strategy expected to be? Embedded in the theory of asset allocation is the notion that most of a portfolio's bond holdings are expected to be invested in high-quality intermediate bonds. This is the default, strategic, or benchmark approach.

## Where are most people invested?

**DISTRIBUTION OF ASSETS ($BILLIONS) IN TOP 100 BOND ETFS RELATIVE TO FRONTIER'S EXPECTED RETURNS**




Source: https://etfdb.com/etfs/assetclass/bond/#etfs&sort_name=assets_under_management&sort_order=desc&page=4 and Frontier

But what if high-quality intermediate bonds are yielding 4%, money markets are yielding 5%, and high-yield bonds are yielding 8%, while core inflation is 5%? What do you do then?

When I was just starting out in this business, I was fortunate enough to find myself at a dinner table with the CEO of a major national bank. I was eager to ask him my best question, "Where do you see interest rates going from here?" His response was, "Do you know how you can spot the amateur in the room? They are still trying to predict interest rates." Obviously, a memorable response.

Investors focused on holding high-quality intermediate bonds, in effect, are paying 3% (forgoing higher yields) for the bet that a recession might happen or that interest rates might fall.

Frontier certainly still holds reduced exposures to high-quality intermediate bonds for risk management purposes; however, we are also seeking to capitalize on the higher yields now offered in other sectors of the bond market. This positioning can help provide a tailwind of return from the bond portion of our strategies going forward. Further, Frontier offers a series of Multi-Asset Income strategies that seek to capitalize on these higher yields that are now available in the marketplace.

## Skating to where the puck was

At any point in time, the lure of past performance is strong. We all want to invest in what has performed best in the past, with the naïve hope that this performance will continue. This linear extrapolation is a human feature. But experienced investors know that the past is over, and we all must look forward. More deeply, history has shown that at certain points in time, when everyone appears to be chasing the same few stocks or bonds, the turning points have been greatly beneficial to diversified investors. For it is at those times when undervalued, under-owned, or generally ignored investments can experience their greatest gains.

## Takeaways

1) The performance of the S&P 500 Index has been driven by very few stocks.
2) Many investors are also focusing on high-quality intermediate bonds and, in effect, choosing to forgo the higher yields that are now available in the marketplace.
3) A broader market environment should be beneficial for Frontier investors.
4) The lure of past performance is strong, but at certain times there are turning points, and when this happens, the future can look dramatically different than the past.

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In reviewing the performance information presented here, we recommend that you consider both the returns generated and the level of risk that was assumed in generating those results. We believe that performance information cannot be properly assessed without understanding the amount of risk that was taken in delivering that performance.

Frontier provides model strategies to various investment advisory firms and does not manage those models on a discretionary basis. The performance and holdings of model strategies may vary from strategies managed by Frontier.

Inflation is the decline of purchasing power of a given currency over time. A quantitative estimate of the rate at which the decline in purchasing power occurs can be reflected in the increase of an average price level of a basket of selected goods and services in an economy over some period of time. The rise in the general level of prices often expressed as a percentage, means that a unit of currency effectively buys less than it did in prior periods.

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[1] https://www.yardeniquicktakes.com/megacap-8-stocks-had-a-bad year/#:~:text=The%20combined%20market%20capitalization%20of,to%20%247.1%20trillion%20(chart).

| ASSET CLASS | INDEX | INDEX DESCRIPTION |
|---|---|---|
| U.S. Large Cap Equity | S&P 500 / Nasdaq Composite Index | Represents US large company stocks. |

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