











# Divide and Conquer

***"Investing should be more like watching paint dry or watching grass grow. If you want excitement, take \$800 and go to Las Vegas." — Paul Samuelson***

Just like that, we are on the back half of 2024. Prognosticators have put together a host of outcomes on the forward-looking direction of the markets and global economy. We are no longer speculating if inflation is moving towards target. Canada has shown a regression in rates (albeit, at the detriment of the economy losing steam). The BoC has kickstarted its easing cycle in June and with below target inflation readings (with exception to the last update) evidence would suggest a more aggressive path towards lower policy rates. The US is somewhat later to the party on retreating inflation with their resilient economy. However, we are beginning to see signs of reprieve and cracks in the system that would suggest cuts are on the horizon. The next employment and inflation numbers over the summer will dictate their flight to a new neutral interest rate. This exhausted headline on both sides of the border seemed to be the cocktail party fodder amongst financial professionals for the better part of two years. Nevertheless, the capital markets continue to look ahead with their anticipatory nature and stemming new highs.

Theory tells us that as interest rates drop, cyclical sectors will see some significant upside, adding more breadth to market returns. But still, there is a disparity in market performance led largely by a handful of stocks. Today's tech giants are dominating the market composition of the largest, most robust index on the globe, the S&P 500. The 3 largest companies Microsoft, Apple and Nvidia now run with over 10 trillion in market capitalization. For context, that is over 20% of the S&P's just shy of ~50 trillion market cap. Diversification in investing has been known to be the only free lunch in finance. With this concentration and continued appreciation of a few names, I have been navigating the question, "why not just hold a few US stock names that are outperforming the markets and short term cash proxies at high yields?"

Rank	Name	Market Cap	Price	Today	Price (30 days)	Country
1	 Apple AAPL	\$3.572 T	\$232.98	▲ 1.88%		USA
2	 Microsoft MSFT	\$3.465 T	\$466.25	▲ 1.46%		USA
3	 NVIDIA NVDA	\$3.318 T	\$134.91	▲ 2.69%		USA
4	 Alphabet (Google) GOOG	\$2.370 T	\$192.66	▲ 1.17%		USA
5	 Amazon AMZN	\$2.079 T	\$199.79	▲ 0.23%		USA

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The cadence around investors that truly believe mega cap tech companies will continue to reign globally and be the key contributor to US market performance is a valid prognosis from where we are currently standing. On that notion, there are no comparable companies around the world investing in developing cutting edge artificial intelligence and cloud platforms. The 10 largest stocks accounted for 14% of the S&P 500 stock index a decade ago. Today, they carry over 35% of the index weight, primarily due to this advancement in technology. While this does pose a record concentration risk, corporate America's reliable profit engine has been a beacon of light for outperformance since 2009.

#	Company	Symbol	Portfolio%
1	Microsoft Corp	MSFT	7.32%
2	Apple Inc.	AAPL	7.09%
3	Nvidia Corp	NVDA	7.01%
4	Amazon.com Inc	AMZN	3.87%
5	Meta Platforms, Inc. Class A	META	2.48%
6	Alphabet Inc. Class A	GOOGL	2.37%
7	Alphabet Inc. Class C	GOOG	1.99%
8	Broadcom Inc.	AVGO	1.61%
9	Eli Lilly & Co.	LLY	1.58%
10	Berkshire Hathaway Class B	BRK.B	1.58%

2

Recognizing this situation, **I would like to challenge the argument of this myopic fixation around a handful of companies in favour of a broad-based asset allocation for long-term investors. Thus, answering the question “why diversification?”**

### Why Diversification?

Indicators are starting to turn a corner as the slow bite of high interest rates are filtering through in the States. US GDP grew at a lethargic 1.4% annual pace from January to March, the slowest quarterly pace in nearly 2 years<sup>3</sup>. Business activity in the US services sector is starting to retract and job growth is positioned to moderate<sup>4</sup>. This is typically where hypotheticals prop up from fear mongering “experts” to ultimately prompt knee jerk reactions in the market. It is not my place to speculate on which market will show upside surprises versus regression. The futility of predictions by even the most sought-after investment professionals is an empirical known and can contribute to unfiltered noise. Although sustained levels of outperformance will always be welcomed, it is appropriate to reflect on historical evidence to signal the timeless investment principle of diversification.

USD	10-20	00-10	90-00
S&P 500	13.88%	1.41%	19.12%
Canada S&P/TSX Composite	3.16%	11.06%	22.45%
MSCI AC World	9.71%	3.69%	16.18%
MSCI AC World ex USA	5.40%	5.97%	14.78%

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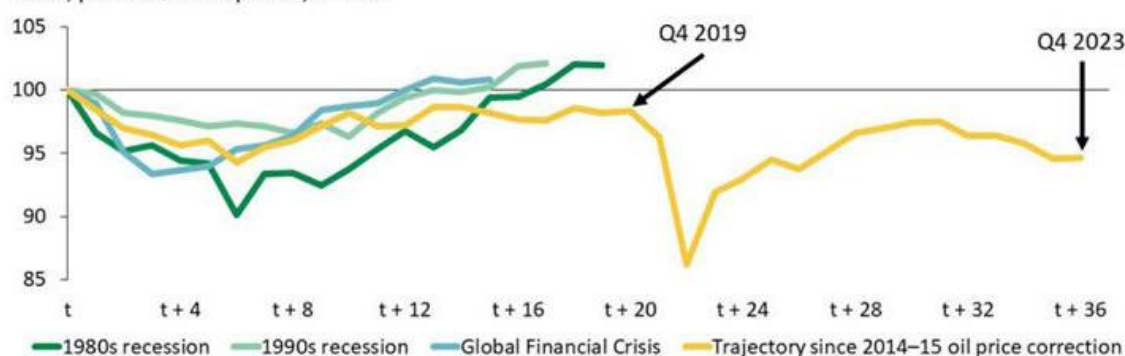
The illustration above highlights in 10-year annualized performance by decade in common currency. Yes, the US has been the darling of growth for the past 15 years. Nevertheless, you can see that during periods of calamity like the tech bubble or great financial crisis, Canada fared significantly better.

It is difficult to reason with the rational mind on why capital should be deployed to other asset classes if you are a long-term investor. Canadian markets have been struggling comparatively speaking; The productivity gap has been widening when stacked against the US. Canada in 2022 was producing just 71% of the value generated in the US economy per hour and the disparity has not alleviated in current terms<sup>6</sup>.

### Outside Central Canada, Output per Person Hasn't Recovered from COVID-19 or the 2014–15 Oil Price Downturn

#### GDP per capita – Canada excluding Quebec and Ontario

Index, pre-downturn quarter, t = 100



Statistics Canada, Institut de la Statistique du Québec, Ontario Ministry of Finance and Desjardins Economic Studies

7

The result? **Canadian stocks are trading at a discount compared to these tech giants.** The commanding financial and energy presence domestically will show upside as central banks get more accommodative, allowing for long-term opportunity. And if not right away, the 10 year rolling returns clearly depict why one should spread their asset composition across established companies in developed markets. This allows for a hedging of certain risks catered to specific markets. As an apt generalization, the US market is considered to possess a more growth-oriented investment market, while Canada maintains its modest value tilt. There is always a home for value as economic cycles transition to a more favourable monetary stance.

#### What this means from a portfolio context

One headwind to how investors think about diversification is that it is relatively easy to look at markets out of a parochial or narrow sighted lens amid the stronger performance we are witnessing in a handful of stocks. It is common for investors to forget what large drawdowns feel like when numbers continue to trend upward by a commanding margin. In the face of global discord, political turbulence and economic reprieve in some pockets, investors can forget that spreading ones investable allocation across equity markets, and further, asset classes, acts as a ballast when there is inevitable periodic turbulence. This not meant to be pessimistic; My unwavering stance is to temper expectations during a state of euphoria. I continue to be a huge advocate for technological advances in this nascent AI

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industry and investors should follow where the capital is flowing. My job, however, is to be a skeptic and ensure the long-term risk is worth the reward.

The trepidations of going 100% in any sector, market, or asset class comes with risks. In most circumstances the United States builds the best case given its international presence regarding revenue generation. Notwithstanding, tech and financials making up over 40% of S&P index weight- exposing positions to interest rate risk, extended valuations, and lofty growth rate expectations. The tailwinds have been favourable, but drawdowns when increasingly concentrated in a few positions or a tilted index can be challenging. **As quoted by BMO's Senior Economist, Robert Kavcic, "while the S&P 500 continues to push record highs, the equal weighted version of the index remains below the early 2022 high and is trailing the cap-weighted S&P 500 by 17 percentage points in the past year"**<sup>8</sup>. This is typically the point in any cycle where investors should revisit the drift in their portfolio and ensure they are not overweight in comparison to their strategic asset allocation.

Consistently revisiting one's portfolio with a professional can ensure that one avoids the adverse sequence of returns that could disrupt near term life events (large purchases, retirement, estate planning, etc.). Misaligned incentives are pervasive. Realigning one's portfolio to coincide with original objectives and subsequent time horizons is paramount. All in all, diversification will more feasibly safeguard the stark ebbs and flows of the capital markets and help investors not to succumb to emotional biases when there is inevitable volatility. The US market will always have a home for equity investors; however, a risk audit is always warranted if returns seem too good to be true. **As said at the start, good investing should be like watching paint dry.**

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