FUNDAMENTUM
INVESTMENT MANAGEMENT

Diversification…. Doesn't Seem Like Such a "Free Lunch" in 2018 So Far

Key Points

- In any given year or short time periods, globally diversified portfolios can underperform a more narrowly defined benchmark, like the S&P 500 Index.
- Fundamentum portfolios are measured against a globally diversified benchmark, using both U.S. and non-U.S. stocks and bonds.
- In 2018 thus far, outside of U.S. Large-Cap Growth and U.S. Small-Cap equities, positive performance has been difficult to achieve.
- The performance of Fundamentum portfolios in 2018 has largely lagged the return of the U.S. focused S&P 500 Index, impacted by the allocations to international equities and fixed income asset classes.
- In our Tactical strategies, we were overweight international equities in 2017, reduced that closer to neutral relative to our global benchmark in May 2018, and recently reduced to an underweight position.

Investors have been conditioned to accept certain principles along the journey to building and sustaining wealth. One is the age-old concept that diversification is a good thing. Whether it involves investing or merely one of those life lessons we pick up over the years, we've been warned "not to put all of your eggs into one basket" for as long as we can remember, an idiom that apparently dates to the novel Don Quixote, written by Miguel Cervantes in the early 1600s. For U.S. investors, 2018 also reminds us of the lyrics of Edwin Starr's' classic song "War"[2], that begins with "War, what is it good for...Absolutely nothing," as diversification has done virtually nothing to help the U.S. investor navigate 2018. Below is a chart summarizing various asset class performance sorted by year-to-date numbers through 8/21/18 market close:

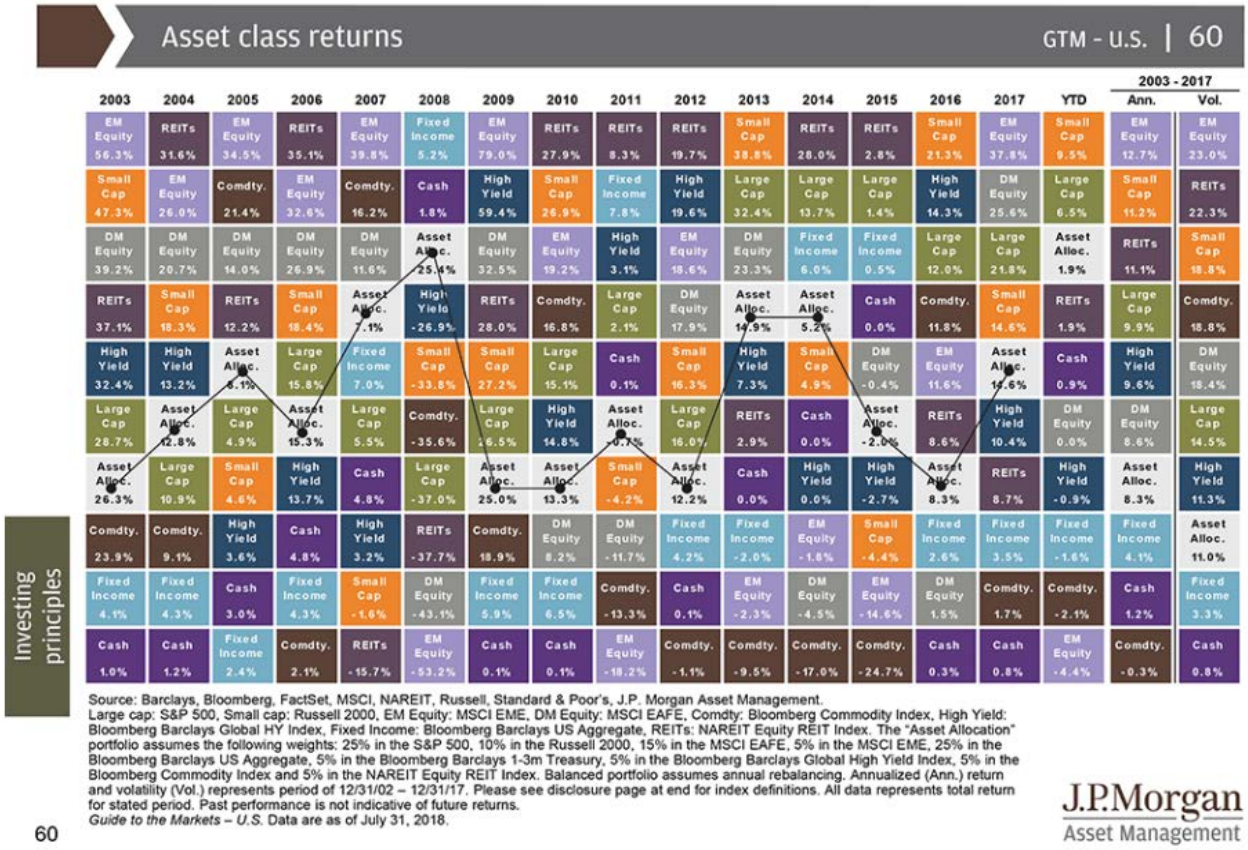
Index Name	Asset Class	% Total Return YTD USD (SORTED)	% Annual Return 2017 USD
Russell 1000 Growth TR USD	US Large Cap Growth Stocks	13.35	30.21
Russell 2000 TR USD	US Small Cap Stocks	12.73	14.65
S&P 500 TR USD	US Large Cap Stocks	8.41	21.83
Nominal Broad US Dollar	US Dollar Relative to Braod Currency Basket	5.72	-6.99
Russell 1000 Value TR USD	US Large Cap Value Stocks	3.53	13.66
MSCI ACWI IMI NR USD	Global Equities-represents the global stock market (about 52% US equities/48% International Equites)	2.30	23.95
ICE BofAML US High Yield TR USD	US High Yield Bonds	1.68	7.48
BBgBarc US Agg Bond TR USD	US Investment Grade Bonds	-0.92	3.54
BBgBarc US Treasury 10+ Yr TR USD	US Treasury Bonds-Longer Term	-2.78	8.18
MSCI EAFE NR USD	Develoed International Stocks	-3.06	25.03
Bloomberg Commodity TR USD	Broad Commodities Basket	-4.26	1.70
MSCI EM NR USD	Emerging Market Stocks	-8.26	37.28
JPM GBI-EM Global Core TR USD	Emerging Markets Bonds	-9.67	14.67

Source: Morningstar Direct-Returns as of 8/21/18 Market Close

With negative returns so far this year in most developed non-U.S. and emerging markets stocks and negative returns in most fixed income asset classes, it may feel like a U.S. investor would have been better off keeping all his/her eggs in the US-only equity basket. The performance story for 2018 thus far has been how U.S. equities have generated a respectable return, but even there, how gains have primarily been limited to small-cap stocks and to large-cap growth stocks.

Still, as the table above shows and is often the case, this year's losers were last year's winners. While the S&P 500 enjoyed strong returns in 2017, non-U.S. equities, including Emerging Markets, did even better, boosting the returns of Fundamentum portfolios last year. Over time, we know it's likely that a diversified portfolio will reduce portfolio volatility and risks, hallmarks of any credible investment management plan. Most investors long ago accepted the notion that "efficient portfolios" are portfolios that are global and balanced (stocks and bonds) in nature. While this doesn't help us feel any better in those years (like 2018 thus far) when being diversified hurts, it should help us stay the course and understand the benefits that diversified portfolios bring to any long-term investment plan.

Looking at the JP Morgan "quilt" of longer-term annual returns, it is quite apparent that the performance of any specific asset class varies quite a lot from year to year. What the flavor of the day is in one year may be very different the next. US Small Cap (Orange) and US Large Cap (Green) have been at or near the top for several years recently. Note the "Asset Allocation" (or diversification) numbers overtime and especially YTD.



There will be years, like 2018, that a diversified asset allocation approach will detract from performance. In others, like 2017, diversified portfolios boosted domestic investor returns. In fact, as the table below from Strategas Securities, LLC[3] shows, there may be DECADES where United States equities (defined here as the S&P 500 Index) will provide NEGATIVE returns, as they did in the decade of 2000's, when the Large-Cap Equity benchmark (the S&P 500 Index) returned -0.9% per year.

	1930s	1940s	1950s	1960s	1970s	1980s	1990s	2000s	2008-17
United States	--	--	--	--	5.9	17.6	18.2	-0.9	8.5
World	--	--	--	--	7.0	19.9	12.0	0.2	5.6
Canada	--	--	--	--	11.0	11.7	9.9	9.2	2.1
Pacific	--	--	--	--	14.8	26.4	0.5	-0.3	3.6
EAFE	--	--	--	--	10.1	22.8	7.3	1.6	2.4
Europe	--	--	--	--	8.6	18.5	14.5	2.4	2.0

Diversified equity portfolios surely helped investors in that decade as well as the 70's and 80's as shown in the chart, just as they would have hurt investors in the 1990s', when owning only U.S. stocks would have provided the highest returns.

In terms of our Tactical international equity positioning, we were overweight international equities in 2017, reduced that closer to neutral relative to our global benchmark in May 2018, and recently reduced to an underweight position. We are broadly in-line with our U.S. equity allocations in relation to the global stock market presently. Within fixed income, we are presently underweight duration and focused primarily on higher-quality bonds.

As we look out into the LONG-term, we believe Fundamentum portfolios will benefit from employing diversified portfolios. U.S. equities sit close to all-time highs, are more expensive than normal on most valuation metrics, are supported by nearly record-high profit margins for U.S. companies, and are boosted by the short-term benefits of the recent fiscal stimulus. These conditions won't last forever, so while diversification has hurt portfolio performance in 2033, we remain confident that this approach will help us achieve longer-term investment objectives.

We appreciate your business and confidence in our process and team. Please don't hesitate to contact us with questions.

The Fundamentum Investment Committee

1. https://www.goodenglish.org.sg/resources/idioms/dont-put-all-your-eggs-in-one-basket
2. https://genius.com/Edwin-starr-war-lyrics
3. Strategas Investment Strategy Report Mon. Aug. 20, 2018