



Domestic Equity Style Diversification:

IS IT STILL IMPORTANT IN TODAY'S ENVIRONMENT?

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U.S. equities, as a whole, have performed exceptionally well over the past decade. More recently, the large cap category of the domestic equity market, led by large Information Technology names, has by far outperformed all other U.S. equity classes. As with any success story, investors do not have to look very hard to find articles supporting the notion that this current phenomenon will continue for the foreseeable future. That has led some investors to question whether owning a diversified domestic portfolio continues to add value in today's environment. At Hancock Whitney Asset Management we believe that it does for many types of investors.

Making Sense of Capitalization and Style

Before we delve into our discussion, it would be beneficial to lay some groundwork and give an overall review of the various equity styles. These are general definitions for both domestic and international equities, although this article will solely focus on U.S. stocks. Most have heard the terms “large cap,” “mid cap” and “small cap” used when discussing the stock market, but you may not have given much thought to exactly what those terms mean. These are the three primary categories that stocks are grouped into and refer to the market capitalization (or market cap) of a publically traded company's common stock. Market cap is defined as the total outstanding shares of company multiplied by the current market price. The total value of a company's outstanding shares is the determining factor for which category the company falls into. While the definition of each category is open for debate, for our discussion we will use the following general definitions:

CATEGORY	MARKET CAP	PRIMARY INDICES
LARGE CAP:	Greater than \$10 billion	S&P 500 and Russell 1000
MID CAP:	Between \$2 billion and \$10 billion	S&P 400
SMALL CAP:	Between \$300 million and \$2 billion	S&P 600 and Russell 2000

Furthermore, equities can be broken down into two broad styles, growth or value. Much like the definition of the three market cap categories, the definition of the terms “growth” and “value” are also open for interpretation. However, we will use the following, very general, definitions:

Growth stocks are companies that are expected to grow faster (as measured by earnings, revenues, cash flow, or by some other matrix) than the rest of the market. These companies tend to limit dividends and instead use the cash generated from their operations to reinvest in their business in an effort to continue expanding.

Value stocks, on the other hand, tend to be companies that trade at a discount to various analytical measures (Price-to-Earnings, Price-to-Book, etc.). These companies tend to pay and grow dividends and may be in cyclical or mature industries.

Companies tend to evolve over time and as they become more established can move between size and style categories. Yesterday's mid cap growth company could become tomorrow's large cap value company and so on.

Below is the “style box” that is used throughout the financial industry, and popularized by Morningstar, Inc., to group equities based upon these two style characteristics.

	Value	Core	Growth
Large	Large Cap Value	Large Cap Core	Large Cap Growth
Mid	Mid Cap Value	Mid Cap Core	Mid Cap Growth
Small	Small Cap Value	Small Cap Core	Small Cap Growth

Academia, along with the vast majority of financial professionals, have long advised investors that the most prudent way to invest in U.S. equities is to diversify portfolios across domestic equity styles and market capitalizations. In fact “diversification” is one of life's big lessons that we have all been taught over the years via the tried-and-true axiom, “Don't put all of your eggs in one basket.” However, when we look at the performance of the U.S. equity landscape over the past few years, it is evident that the clear winner has been Large Cap Growth stocks. That should really come as no surprise since this equity style is dominated by “mega cap” technology names such as Apple, Microsoft, Amazon, Alphabet (Google) and Facebook, most of which have been the darlings of the market in recent years. Technology-related companies have been the primary driver of this equity style. That statement is amplified by the fact that the Information Technology and Communication Services sectors comprise an astounding 53% of the S&P 500 Growth Index. Given that information as a backdrop, along with the fact that the world is becoming more dependent on technology every day, many have started to ask, “Does diversification still matter when it comes to investing in U.S. equities?” We argue that it most certainly does matter now, as much as it ever has.

Picking Yesterday's Winner Isn't Necessarily the Best Strategy

Like most things in today's society, many individuals take a short-term view and tend to judge investing through a simple lens of "win or lose." This is a classic trap to fall into and one that is easy to quantify by simply comparing the performance of a well-diversified domestic equity portfolio to the best-performing index of the moment. That, in turn, leads investors to start questioning why they should bother owning anything other than the most recent winner. This thought process is understandable, even more so in today's world of FOMO (Fear Of Missing Out) especially when you have the luxury of hindsight. Unfortunately, always trying to ensure that you own today's shining star is a futile exercise, usually unobtainable, and also gives no credence to managing risk in an equity portfolio.

The primary goal of diversifying a domestic equity portfolio across multiple styles is to manage the overall risk, or potential volatility. The common misconception is that diversification is meant to boost performance. In reality, the true reason for investing in different styles is to provide the opportunity for an investor to improve returns over multiple economic and market cycles by investing in equity classes that are not correlated. In short, that means what is working well today in one area of the equity market, may not perform well when the winds of change begin to howl. An example of this would be in times where global economic expansion exceeds that of our domestic economy. During periods like this, larger, multinational U.S. companies may benefit more than smaller companies that derive most of their revenues from inside of our borders. Conversely, the opposite may be true when the U.S. economy is performing better than the rest of the world. There are other instances that may cause growth stocks to outperform value names, or vice versa. One thing is certain: The domestic and international economies are in constant motion as are equity market conditions. Sometimes the changes in one or both are fairly evident, but many times the environments morph slowly over time. In either case broad changes are difficult to predict, which makes it difficult to reallocate in order to take advantage of the new dynamic, before it is too late. This is why owning a diversified portfolio is a wise choice for many investors.

Below is a chart depicting the annual performance rank of the nine domestic equity style boxes over the last three decades. For each year, the chart lists the domestic equity styles by performance with the best performer on the top row and the worst on the bottom row. The chart is a great visual to show how fluid performance has been across different styles of domestic equities and how quickly things can change. One year's top-performing style can easily fall out of favor in the following years (or months). It is certainly true that picking one or two styles can potentially lead to some short-term superior performance (or possibly underperformance), but over long periods of time, trying to decide which area of the equity market to move into and out of can be very detrimental to overall long-term performance. This tactic is akin to one of the great risks of investing, market timing.

1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
LCG	SCG	SCV	SCV	LCG	LCV	LCG	LCV	LCG	MCG
LCC	MCG	MCV	SCC	LCC	LCC	LCC	MCV	LCC	SCG
MCG	SCC	SCC	LCV	SCV	LCG	LCV	LCC	MCG	LCG
LCV	SCV	MCC	MCV	SCC	MCV	SCV	SCV	LCV	SCC
MCC	MCC	LCV	MCC	LCV	MCC	MCV	LCG	MCC	LCC
MCV	LCG	LCC	SCG	MCC	MCG	MCC	MCC	MCV	MCC
SCG	MCV	MCG	MCG	MCV	SCG	MCG	MCG	SCG	LCV
SCC	LCC	SCG	LCC	MCG	SCC	SCC	SCC	SCC	MCV
SCV	LCV	LCG	LCG	SCG	SCV	SCG	SCG	SCV	SCV

2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
SCV	SCV	MCV	SCG	MCV	MCC	SCV	LCG	SCV	MCG
MCV	SCC	SCV	SCC	SCV	MCV	LCV	MCG	SCC	MCC
MCC	MCV	LCV	SCV	MCC	MCG	MCV	SCG	LCV	LCG
LCV	LCV	MCC	MCG	SCC	LCV	SCC	LCC	LCC	SCG
SCC	MCC	SCC	MCC	LCV	LCC	LCC	MCC	LCG	MCV
LCC	SCG	LCC	MCV	MCG	LCG	MCC	LCV	MCV	LCC
MCG	LCC	MCG	LCV	SCG	SCV	SCG	MCV	SCG	SCC
LCG	MCG	LCG	LCC	LCC	SCC	MCG	SCC	MCC	SCV
SCG	LCG	SCG	LCG	LCG	SCG	LCG	SCV	MCG	LCV

2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
SCG	LCG	MCV	SCG	MCV	LCG	SCV	LCG	LCG	LCG
SCC	LCC	SCV	SCC	LCV	LCC	SCC	MCG	MCG	MCG
MCG	LCV	LCV	MCG	LCC	MCG	MCV	SCG	LCC	LCC
MCC	MCV	MCC	MCC	MCC	SCG	LCV	LCC	LCV	MCC
MCV	MCC	LCC	SCV	LCG	MCC	MCC	MCC	MCC	SCG
SCV	MCG	SCC	LCG	MCG	LCV	LCC	SCC	SCG	MCV
LCG	SCG	MCG	MCV	SCG	SCC	SCG	LCV	SCC	LCV
LCC	SCC	LCG	LCC	SCC	MCV	MCG	MCV	MCV	SCC
LCV	SCV	SCG	LCV	SCV	SCV	LCG	SCV	SCV	SCV

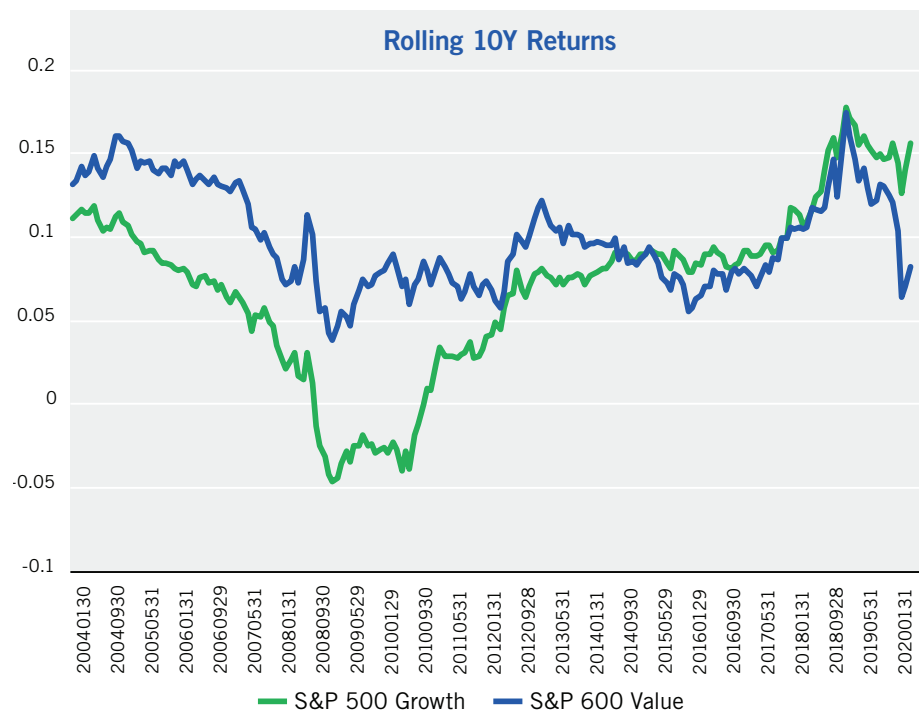
- Large Cap Core (S&P 500)
- Large Cap Growth (S&P 500 Growth)
- Large Cap Value (S&P 500 Value)
- Mid Cap Core (S&P 400)
- Mid Cap Growth (S&P 400 Growth)
- Mid Cap Value (S&P 400 Value)
- Small Cap Core (S&P 600)
- Small Cap Growth (S&P 600 Growth)
- Small Cap Value (S&P 600 Value)

Data Source: FactSet

Diversification Still Matters

Just as in life itself, there are no crystal balls in the world of investing that will tell us when a certain style will fall out of favor and the rotation to another style will occur. The only certainty that we have is, at some point in the future, a rotation will occur. One only need to look back to the late 1990s through 2000 when Technology names and growth stocks, in general, ruled the market. The NASDAQ index, which has a very heavy weighting to the Technology sector, hit an all-time high in early 2000 on the wave of the “dot.com” boom. At that point you were hard pressed to find many investors, either professional or individuals, who would argue that Technology would not keep moving forward. Their ideology was based on the fact that the world would become more dependent on technology, which was very true. However, almost overnight, the technology sector, along with growth stocks as a whole, lost their luster. When Technology stocks became out of favor, it took the NASDAQ index over 14 years to reach the level that it did in early 2000. That is not to say that history will repeat itself, as times are certainly different in the technology sector than they were in the heady days of the late 90s. Instead, the example was meant to point out that just because a certain segment or style of the market is hot today, even if it is based on good logic, the tide can change quickly. There are countless prognosticators (“futurists” they call themselves) that will try to predict what is on the horizon or what will be the catalyst for a change. However, more often than not, the driving force behind a shift is something completely unexpected or something totally unpredictable.

The Rolling 10 Year Returns chart below further exemplifies the point above. Following the great run of Large Cap Growth in the late 1990s through 2000, that style had fallen out of favor, and Small Cap Value was the new “game in town.” However, Large Cap Growth’s reemergence over the past three years has propelled its rolling 10 year returns above that of Small Cap Value. Could another change be on the horizon? There is no way to predict that, but this provides a good bit of support for why a diversified portfolio helps to avoid rollercoaster-like returns caused by only focusing on a very concentrated segment of the equity markets.



Data Source: FactSet

The true value of these charts shows that in the long run, broad diversification across the various domestic equity styles remains important and valuable when considering investment strategies. Not all domestic equity styles will prosper at the same time, so by spreading your investments among different styles of the equity market, you can manage the overall risk or volatility of your portfolio. Although a well-diversified portfolio may not hit a home run year-in and year-out over an intermediate or long-time horizon, an equity portfolio allocated to various styles may provide a risk profile that is appropriate for many long-term investors.

So the question then becomes, “how do you allocate a portfolio among the various domestic equity styles?” This exact question is something that Hancock Whitney Asset Management constantly analyzes and addresses. We continuously research and analyze macroeconomic conditions and what forces might possibly impact various segments of the domestic equity markets. Hancock Whitney Asset Management has gone to great lengths to craft the overall risk parameters for each of the three market cap categories. We make periodic adjustments based upon current economic and market conditions in order to allocate among the various styles. Therefore, rather than simply utilizing a shotgun approach, a great deal of research has gone into how to effectively allocate portfolios that seek to achieve superior long term, risk-adjusted returns for our clients’ portfolios.

A Long-Term Plan

It may be quite difficult to avoid the temptation of following the herd and focusing on one or two specific areas of the equity market that have been performing exceptionally well as of late. However, investors may be served well by taking market cap and style categories into consideration because companies within different segments of the domestic equity markets have distinct risk/return characteristics and tend to perform differently depending on market conditions. In the long run, while nothing is guaranteed, we believe the best way to reduce the overall volatility and manage risk is to construct a diversified strategy that allocates positions to multiple domestic equity categories. By remaining invested in areas of the domestic equity market that are not perfectly or even highly correlated (the degree that investment securities/classes move in relation to one another), investors may allow themselves the opportunity to participate in the current “star” while managing their risk when the market surprises and moves in a completely different direction without warning. Ultimately, this methodology should help to smooth equity returns and temper the dreaded whiplash of volatility.

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