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## Staying the Course: Allocating Portfolios for the Long-term

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### Key Takeaways

- The bulk of our investor questions have tended to focus on short-term factors – election outcomes, geopolitical risks – and whether the stock market is too high for a particular moment in time. What so often gets neglected is the structural balance in a portfolio. A misaligned portfolio for the long run can potentially accumulate either excessive idiosyncratic risk or lost opportunities akin to enduring a bear market, albeit hidden beneath the surface over time.
- The US has led global equity returns for an unusually long streak of roughly 15 years. It's been concentrated in a small number of US tech-related shares. There's no good reason to doubt the immediate fundamental strength of potential innovations such as AI. We also can't tell how far the bull market in these shares has already progressed. History shows the S&P 500's top ten constituents by capitalization each year underperformed the broader market in subsequent years (data from 1991-2023).
- Rather than calling for a wholesale shift from US equities to cheaper markets, our approach calls for considering appropriately sized exposure to both. The relative sizes of our long-term allocations will reflect the divergence in valuations, allocating somewhat less to expensive markets and somewhat more to cheaper ones.

### Potential Portfolio Implications

With many investors holding disproportionately large positions in a single equity market – often their home market – broadening equity exposure to a globally diversified portfolio, including fixed income, is likely a prudent first step to consider.

For investors over-allocated to the world's winning equity market (US large caps), the deep underperformance of emerging markets in the past decade makes a broadening core allocation more appealing for suitable investors, not less.

# Staying the Course: Allocating Portfolios for the Long-term

US large-cap equities have been on quite the winning streak. From the depths of the Global Financial Crisis at the end of 2008 to the end of 2023, this sub-asset class – as represented by the S&P 500 Index – has registered an annualized total return of 14.3%.

By contrast, non-US developed market and emerging markets equities – represented by MSCI World ex-USA and Emerging Markets indices – over the same period returned 7.3% and 6.7%, respectively. And over the last five quarters, much of US large cap equities' dominance has come from a handful of leading technology firms, the so-called “Magnificent Seven<sup>1</sup>.”

This performance has prompted some investors to ask a searching question: has portfolio diversification had its day? After all, anyone who put their entire equity allocation or even their entire investment wealth in US large cap equities would have enjoyed strong returns. The US's unique combination of global economic and technological leadership, strong institutions, and its status as the largest and most liquid market may continue to make US large cap equities an enticing investment.

However attractive it may sound, an equity allocation to just one geography – or a handful of large, top performing stocks from that geography – is significantly risky. Citi Global Wealth's investment philosophy is rooted in global diversification across asset classes. This is not based merely on theory but also on our decades of experience building portfolios. Here is why.

## Magnificence may not endure

The “Magnificent Seven”<sup>1</sup> US tech giants have captured investors' imagination. In 2023, for example, this group beat the rest of the S&P 500 index universe by 63%. The S&P's ten largest constituents – which included the “Magnificent Seven” – thus accounted for 32% of its market capitalization at the end of the first quarter of 2024. This was the highest share in decades and up from 17% ten years earlier. After previous spikes in concentration in recent decades, market leadership has tended to become more evenly spread once more.

However, some investors may still feel tempted to hold only the “Magnificent Seven” given recent outperformance, but we believe such a concentrated bet would be unwise. Put simply, today's leaders may not prove to be those of tomorrow. Between 1991 and 2023, the S&P 500's top ten constituents by capitalization each year underperformed the broader market in subsequent years, observed over multiple time horizons (see **FIGURE 1**).

While we acknowledge the attractions of tech leaders broadly, we would not make such holdings a substitute for diversified US equity exposure.

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<sup>1</sup> The Magnificent 7 stocks: Amazon.com (AMZN), Apple (AAPL), Google parent Alphabet (GOOGL), Meta Platforms (META), Microsoft (MSFT), Nvidia (NVDA), and Tesla (TSLA).

**FIGURE 1: Magnificence is impermanent**



Source: OCIS (Office of the Chief Investment Strategist) Strategic Asset Allocation and Quantitative Research, and FactSet. Analysis from December 1990 to December 2023. Chart shows the cumulative total returns of the top ten S&P 500 firms by market capitalization at the end of each year over the following 12 months alongside the cumulative total return of the S&P 500. Each point on the chart shows the cumulative return between that point and one year later. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees, or sales charges, which would lower performance. See Glossary for definitions. **Past performance is no guarantee of future results. Real results may vary.**

## Leading markets today can lag tomorrow

Similar considerations apply when it comes to whole equity markets.

Thanks to their strong collective performance, US large cap equities now represent 62% of the MSCI ACWI IMI Index, a broad global benchmark spanning developed and emerging markets. However, history cautions against extrapolating today's dominance into the long-term.

The outperformance of certain markets tends to wax and wane over time. Between 1990 and 2000, for example, US equities also beat other leading equity markets across the world. From 2000 to 2010, however, the situation was reversed, with emerging market equities outperforming (see **FIGURE 2**). Likewise, Japanese outperformance in the 1980s took its stock market to a 30% share of global capitalization. A multi-year bear market ensued, and even today, Japan accounts for only 6% of world equities.

**FIGURE 2: Leadership each decade has tended to vary**

1980s	1990s	2000s	2010s	2020s
JAPAN 19.31%	SWITZERLAND 19.73%	AUSTRALIA 14.22%	US 14.12%	US 10.04%
EUROPE EX-UK 19.01%	US 17.67%	SINGAPORE 10.19%	SWITZERLAND 9.46%	UK 9.06%
UK 16.58%	HONG KONG 17.54%	CANADA 9.58%	JAPAN 7.72%	CANADA 7.62%
US 13.85%	EUROPE EX-UK 14.35%	HONG KONG 8.30%	HONG KONG 6.48%	EUROPE EX-UK 5.88%
SWITZERLAND 13.22%	UK 12.21%	SWITZERLAND 6.05%	EUROPE EX-UK 6.11%	AUSTRALIA 3.71%
HONG KONG 7.95%	CANADA 11.61%	EUROPE EX-UK 3.48%	AUSTRALIA 4.06%	JAPAN 2.85%
CANADA 7.80%	AUSTRALIA 9.21%	UK 3.41%	UK 2.94%	SWITZERLAND 2.71%
SINGAPORE 6.24%	SINGAPORE 6.98%	JAPAN 1.85%	CANADA 2.58%	SINGAPORE 0.52%
AUSTRALIA 6.20%	JAPAN 0.45%	US 1.49%	SINGAPORE 1.60%	HONG KONG -9.26%

Source: Bloomberg and Haver, as of May 8, 2024. The table shows in descending order the total return performance by decade (1980 through May 8, 2024) of the ten largest developed major equity market groupings, represented by MSCI national and regional benchmarks. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees, or sales charges, which would lower performance. **Past performance is no guarantee of future results. Real results may vary.**

To be clear, this is not to say the US is doomed to poor performance over the next decade. However, valuations for the US – as measured by the cyclical-adjusted price to earnings ratio or "CAPE" – are currently high. Over time, high CAPE readings for equity markets have historically given way to low returns over the subsequent decade. At the same time, some markets elsewhere – and particularly in emerging countries – have lower valuations, which suggests the potential for higher returns over the next ten years.

Rather than calling for a wholesale shift from US equities to cheaper markets, our approach calls for considering appropriately sized exposure to both. The relative sizes of our long-term allocations will reflect the divergence in valuations, allocating somewhat less to expensive markets and somewhat more to cheaper ones.

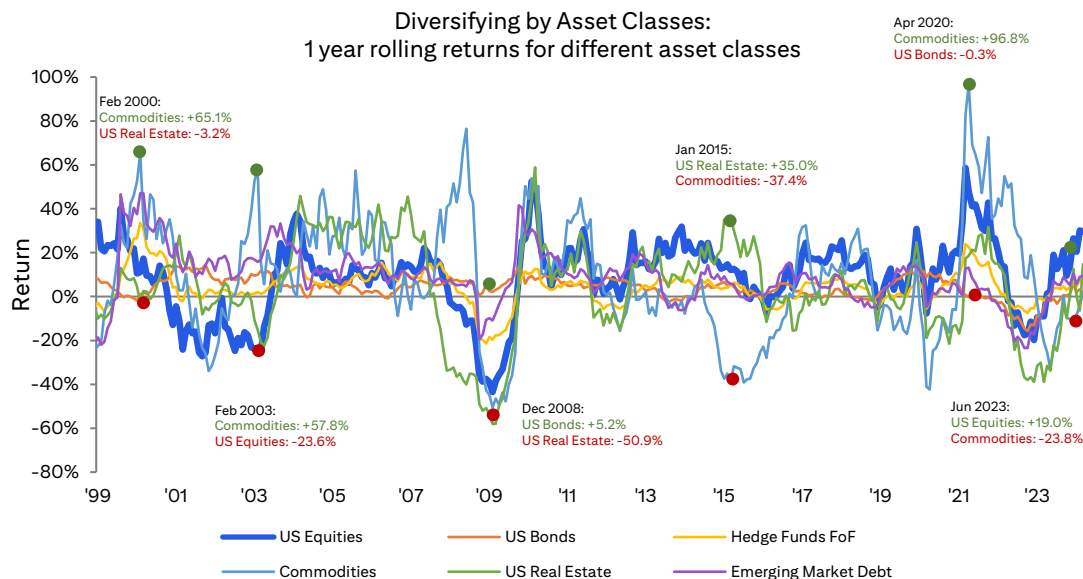
## Broadening allocations may enable stronger risk-adjusted returns

With many investors holding disproportionately large positions in a single equity market – often their home market – broadening equity exposure to a globally diversified portfolio is a prudent first step to consider, while also depending upon their investment objectives and risk tolerance. However, we believe it is not sufficient. Equity markets around the world have tended to be correlated. This is especially true during periods when diversification is most needed, mainly equity downturns. We therefore look beyond equities for further potential diversification.

**FIGURE 3** shows 1-year rolling returns for US equities and other asset and sub-asset classes such as high-quality US bonds, hedge funds, US real estate, commodities and emerging market debt. Year-on-year returns of these asset classes have varied, with some doing well and others poorly at different times.

During various bouts of market stress over the past quarter century, some asset classes have delivered positive returns even as equity markets have fallen. In February 2003, for example, while US equities were down 23.6% year-on-year, commodities were up 57.8%. And in December 2008, when US real estate was down by just over half, US bonds were up 5.2% over the previous year. We believe such dispersion in asset class performance makes a case for allocating across many geographies and asset classes rather than trying to pick winners among them.

**FIGURE 3: Some asset classes have shown low correlation to equities when most needed**



Source: Citi Investment Management, Bloomberg. Analysis as of May 2, 2024. The dates show large divergences between asset classes and how some outperform when others underperform. The indexes shown refer to the MSCI USA Net Total Returns USD for US Equities, the Bloomberg Barclays US Aggregate Bond Index for US Bonds, the HFRI Fund of Funds Composite Index for Hedge Funds, the S&P GSCI Commodity Index for Commodities and the FTSE EPRA Nareit Developed Europe Index for US Real Estate. The Emerging Market Debt total return is composed of Bloomberg Barclays indices measuring performance of fixed and floating-rate US dollar-denominated emerging markets sovereign debt for the Latin America, EMEA (Europe, Middle East, and Africa) and Asian region. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees, or sales charges, which would lower performance. See Glossary for definitions. **Past performance is no guarantee of future results. Real results may vary.**

## Time in the market, not timing the market

Many investors are fixated with timing markets, typically shifting between cash and equities. Their aspiration is to ride the uptrends while sidestepping downtrends. While avoiding market drawdowns has obvious appeal, both financially and psychologically, experience shows it is very hard to accomplish. Typically, market timers end up missing out on valuable stretches of equity gains and earning much lower returns on cash instead (please see our May 18<sup>th</sup> [CIO Bulletin](#) for more).

Staying fully invested and broadly diversified, by contrast, enables investors to seek compound returns over time. High quality bonds may help offset some of the effects of holding equities during bear markets. **FIGURE 4** shows the performance of a combination consisting of 60% exposure to the S&P 500 Index and 40% to the Bloomberg Aggregate Bond Index, which does not represent the performance of an actual portfolio.

**FIGURE 4:** The longer the duration, there is potential for consistent returns



Source: Citi Investment Management, as of May 2, 2024. The chart shows the historical probability of positive and negative returns from holding 60% in the S&P 500 Index and 40% in the Bloomberg Aggregate Bond Index between 1977 and 2023, on a one-, five- and ten-year view. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees, or sales charges, which would lower performance. See Glossary for definitions. **Past performance is no guarantee of future results. Real results may vary.**

## How diversified is your portfolio?

Even if you have a portfolio built upon a long-term investment plan, it can still end up overly concentrated if it deviates from the plan, perhaps via a lack of rebalancing. The bulk of our investor questions have tended to focus on short-term factors – election outcomes, geopolitical risks – and whether the stock market is too high for a particular moment in time. What so often gets neglected is the structural balance in a portfolio. A misaligned portfolio for the long run can potentially accumulate either excessive idiosyncratic risk or lost opportunities akin to enduring a bear market, if hidden beneath the surface over time.

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High quality (very strong)	Aa	AA	AA
Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
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Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

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