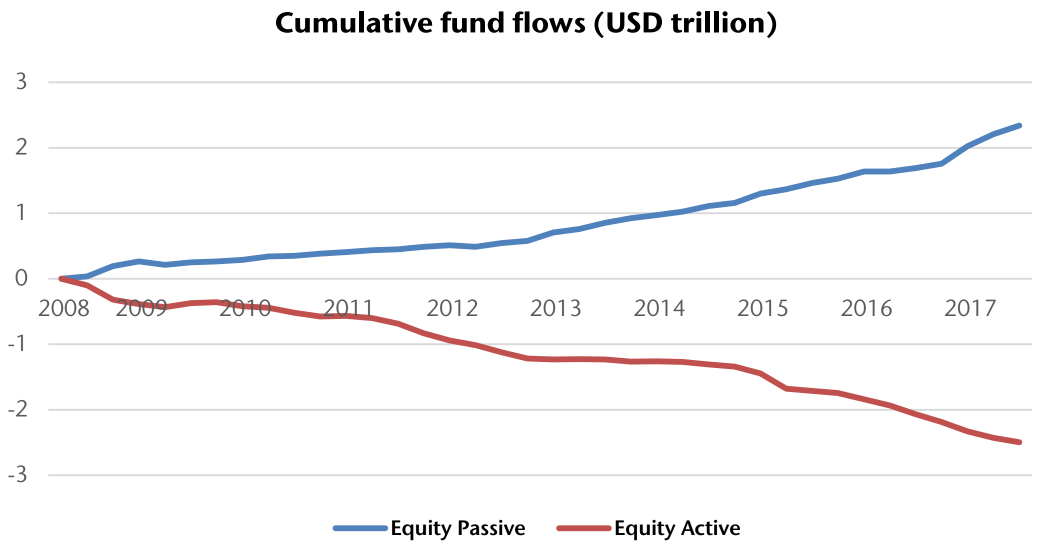
Who wants an Apple the size of Australia?

Empower Results®

Equity markets have had it easy for 10 years

Since the nadir of the financial crisis in 2009[1], investors have enjoyed strong equity returns - the MSCI World has returned around 15% p.a. in local currency terms in that time.

With equity indices providing returns like that, it has made life hard for active managers to demonstrate added value so it's easy to see why passive investment has grown in popularity.



Source: BIS, Lipper

In broadly the same period, global investment in passive equity management has grown by $2.3tn, while active investments have shrunk by $2.5tn, and these passive investors have been rewarded with "easy" money.

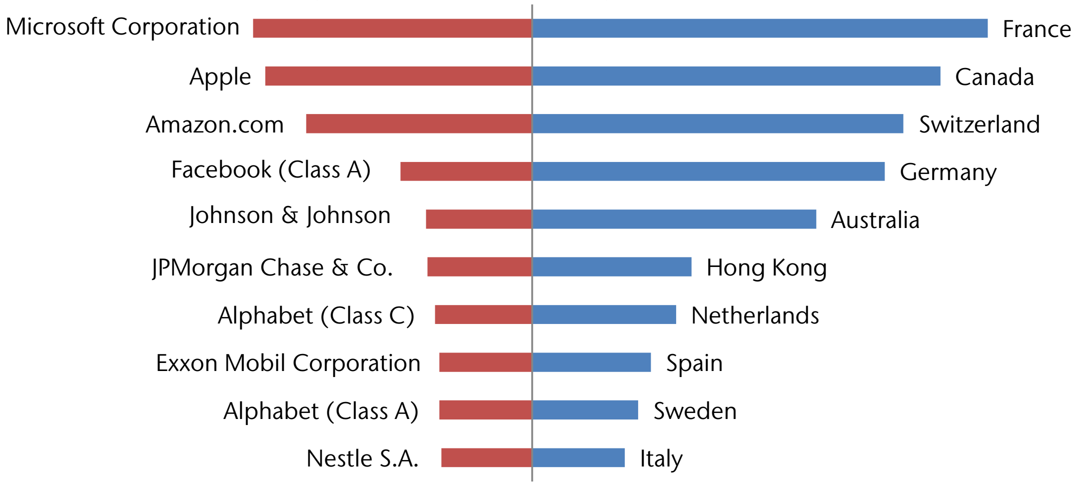
We are well advanced in a transitional phase in global markets, from a period where risky assets have performed well to one where volatility is likely to remain elevated. Perhaps now is the time to pay a bit more attention to what's in your equity portfolio.

1 *March 2009*

An Apple the size of Australia

Passive investing provides exposure to a great many stocks, but it's not necessarily true that passive investors enjoy great diversification. Market cap indices have high levels of stock concentration in the largest companies. For example, the top ten holdings of the MSCI World (c13% of the Index) have the same weight as the smallest 877 stocks in the Index[2].

Largest stocks versus the largest countries in the Index*



Source: MSCI

*Largest nations by market capitalisation excluding US, Japan and UK.

The global market is just as dependent on a few companies as it is on entire nations with large economies. Apple alone is the size of Australia.

This is not necessarily a problem if you have consciously decided on this allocation but, by definition, most passive investors have not.

In Q4 2018, the MSCI World experienced its largest quarterly drawdown (-13.0%) for seven years, back when Greece was perilously close to defaulting on its government debt. A sizeable portion of this (approximately one sixth) can be attributed to the top ten companies, which make up less than 1% of the number of stocks in the index. Markets have clearly regained some composure in the first half of 2019, but volatility spiked again in May, with major US tech firms leading market losses.

There are likely to be headwinds ahead for global markets and this could well be the start of a sustained period of volatility from which passive investors have no place to hide.

2 *Figures based on percentage of Market Cap of the MSCI World Index as at 30 June 2019.*

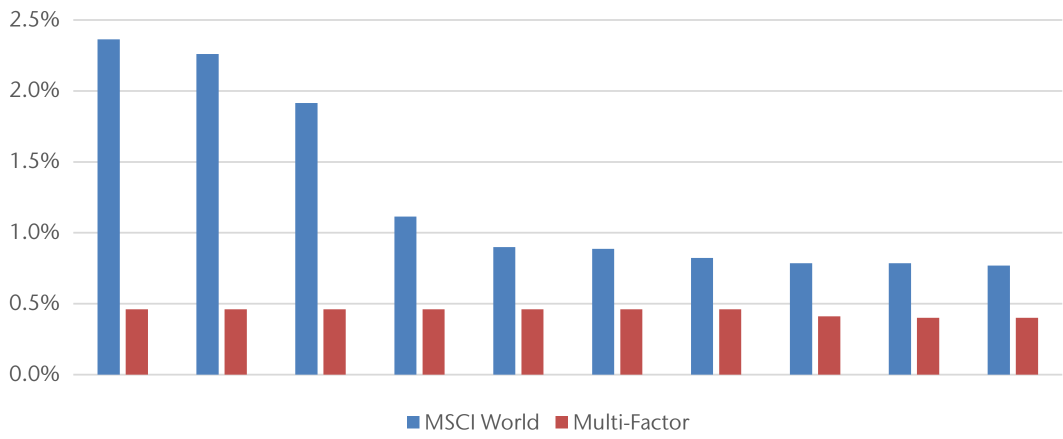
Factor in a potential alternative

Active equity management is one potential solution to the problem. However, that requires greater governance and commands higher costs so it's not right for everyone.

If you're looking to keep the benefits of passive investing (low cost, high liquidity, limited governance) then factor-based investing presents a compelling alternative.

Factor based investing systematically allocates to stocks based on technical information and company fundamentals targeting specific drivers of return. Evidence shows that, if properly constructed, it ought to add value over and above the market cap equivalent over the long term. Added to which, no single stock should dominate the index.

Top ten largest stocks MSCI versus Multi-Factor



Source: MSCI (MSCI World Index as at 30 June 2019), Scientific Beta (SciBeta Developed High-Factor-Intensity Multi-Beta Maximum Deconcentration Index as at 21 June 2019)

The chart compares the index weight of the top ten stocks in the MSCI World Index versus one such multi-factor index which has been carefully constructed to avoid meaningful biases. In doing so it avoids outsized allocations in any one stock, even within the top 10.

Factor-based investing is not a silver bullet but, in potentially volatile times, it avoids taking such large bets on individual companies, which may be an advantage.

If you are a passive investor, the chances are it's worked well in recent times. But now may be the right time to reconsider how you gain exposure to equity markets.

About Aon

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