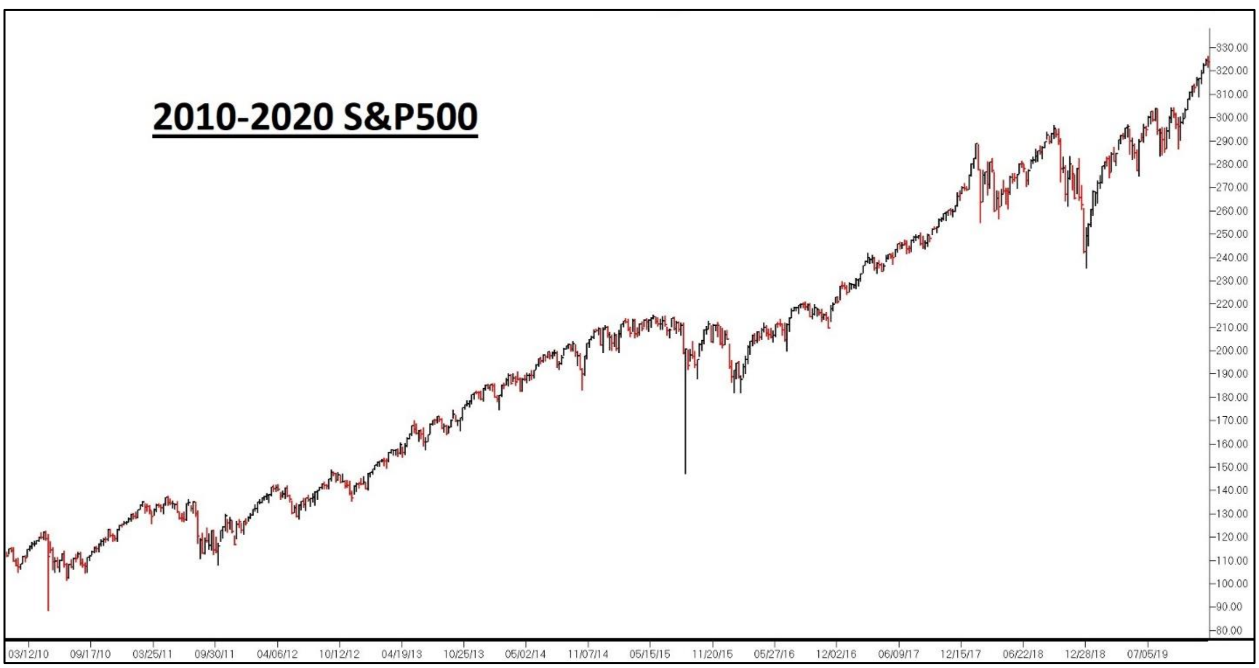
WINTER 2024

Info SIGMA

Does diversification still work?

The surge in American large caps in recent years could give the impression that the future only belongs to the S&P 500, the NASDAQ or the Magnificent Seven. The S&P500, having had an average annual return of 15% over the last 10 years compared to 7.50% for the TSX, 6.70% for international stocks and 2% for government bonds, one could easily be forgiven for doubting the benefits of diversification. Portfolio managers with a heavy concentration in large-cap U.S. growth stocks are the heroes of the day, just as fund managers of dividend stocks and value stocks were seen as demi-Gods from 2000 to 2012. The names on everyone's lips during the 2000s are mostly forgotten today in favor of new stars.



**Source : FBN Thomson One*

Unfortunately, the decades come and go but are rarely the same. As the chart below shows, the S&P500 had a terrible whole first decade of the new millennium: volatility, huge corrections, and an average annual loss of 4.50% (in CAD) INCLUDING its dividends* were the result.

**Source : FBN Thomson One*

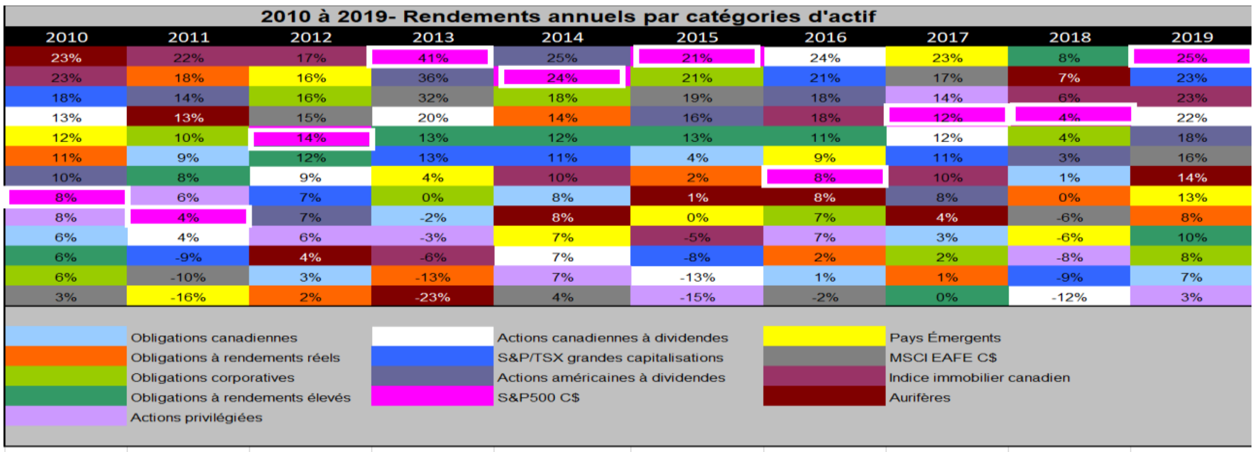
The table below represents the annual return of asset classes from best to worst for the years 2000-2009. During this "lost decade", the S&P500 (highlighted in white rectangles) never managed to climb to the top of the table among the best performing asset classes. Dividend stocks, real estate investment trusts (REITs), gold and emerging markets made the significant contributions to performance. At the time, everyone tended to compare their portfolio to emerging markets, dividend funds and managers like Warren Buffet and Stephen Jarislowsky.

2000 à 2009 - Rendements annuels par catégories d'actif

2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
29%	30%	23%	28%	18%	31%	33%	19%	29%	55%
28%	19%	15%	27%	17%	25%	26%	12%	8%	55%
21%	15%	13%	27%	17%	25%	25%	10%	6%	38%
21%	12%	9%	26%	14%	24%	23%	3%	0%	35%
17%	9%	7%	14%	14%	15%	19%	1%	-7%	27%
17%	8%	1%	13%	12%	14%	17%	0%	-16%	25%
10%	6%	-2%	10%	8%	11%	16%	-5%	-17%	14%
9%	4%	-6%	7%	7%	7%	16%	-6%	-23%	12%
7%	3%	-7%	6%	6%	6%	11%	-7%	-29%	12%
1%	1%	-10%	6%	4%	3%	8%	-10%	-31%	10%
-1%	-7%	-12%	4%	3%	1%	5%	-10%	-33%	7.49%
-11%	-13%	-17%	-2%	2%	-1%	4%	-13%	-38%	5%
-27%	-16%	-23%	-2%	-2%	-1%	-3%	-20%	-42%	-5%

Obligations canadiennes
Obligations à rendements réels
Obligations pays émergents
Obligations à rendements élevés
Actions privilégiées
Actions canadiennes à dividendes
S&P/TSX grandes capitalisations
Actions américaines à dividendes
S&P500 C$
Pays Émergents
MSCI EAFE C$
Indice immobilier canadien
Aurifères

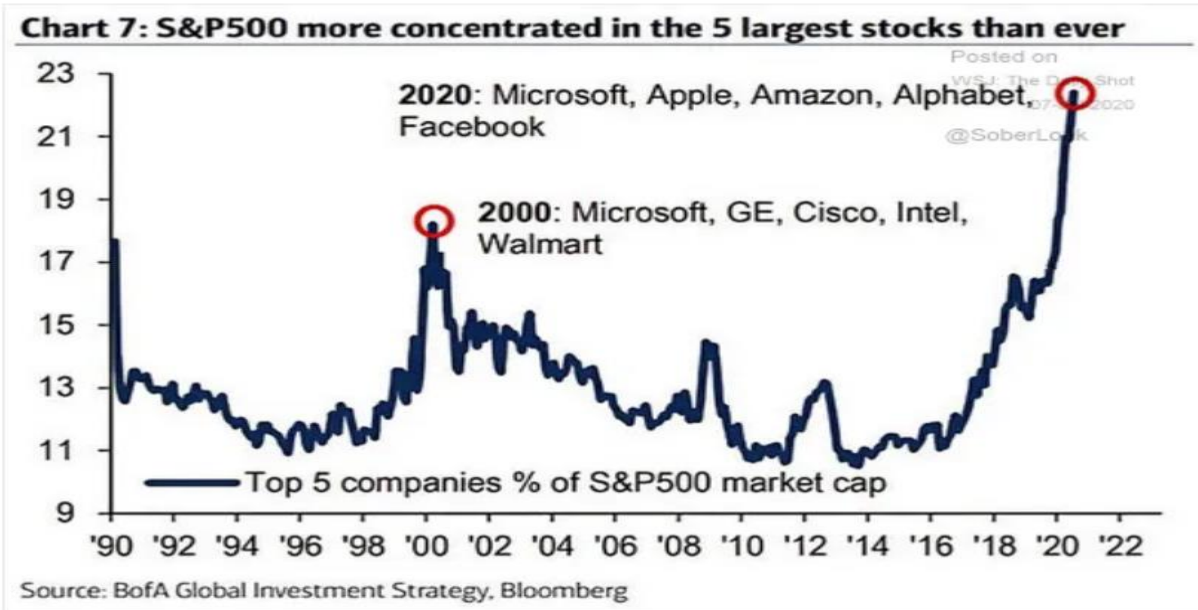
The picture is quite different during the second decade, especially starting from 2012. The S&P500 seems to have adopted permanent residence among the best performing asset classes! This performance also contributed to the performance of our baskets, thanks to our positions in the S&P500 index which we always hold in our Balanced and Income portfolios, as well as a tactical position in our Rotation portfolios. We also hold the specific index of large cap US growth stocks (in our Balanced and Income baskets).



2010 à 2019- Rendements annuels par catégories d'actif

2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
23%	22%	17%	41%	25%	21%	24%	23%	8%	25%
23%	18%	16%	36%	24%	21%	21%	17%	7%	23%
18%	14%	16%	32%	18%	19%	18%	14%	6%	23%
13%	13%	15%	20%	14%	16%	18%	12%	4%	22%
12%	10%	14%	13%	12%	13%	11%	12%	4%	18%
11%	9%	12%	13%	11%	4%	9%	11%	3%	16%
10%	8%	9%	4%	10%	2%	8%	10%	1%	14%
8%	6%	7%	0%	8%	1%	8%	8%	0%	13%
8%	4%	7%	-2%	8%	0%	7%	4%	-6%	8%
6%	4%	6%	-3%	7%	-5%	7%	3%	-6%	10%
6%	-9%	4%	-6%	7%	-8%	2%	2%	-8%	8%
6%	-10%	3%	-13%	7%	-13%	1%	1%	-9%	7%
3%	-16%	2%	-23%	4%	-15%	-2%	0%	-12%	3%

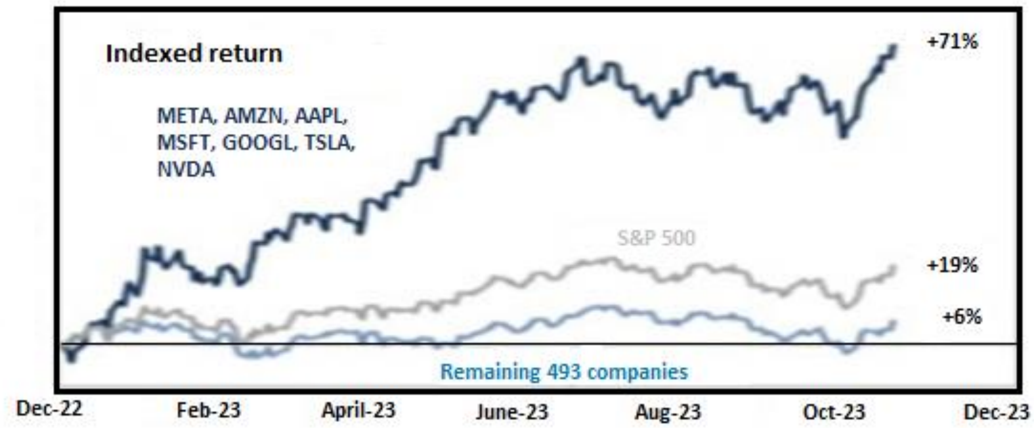
But there are some indications that the S&P500 may have peaked, or at least that the easy gains are behind us. Concentration of returns among a small number of securities is usually not sustainable in the long term and can lead to a correction. The Magnificent *Seven* (or 1,4% of the 500 names within the index) account for 23% of the combined value of the 500 S&P500 stocks! As the graph below demonstrates, we must go back to 1990 or 2000 to see such a concentration. The index posted significantly weaker returns in subsequent years. In fact, the S&P 500 didn't reach its 2000 levels until 2013*, including* dividends



The underperformance of the S&P500 during the “lost decade” allowed it to go from its euphoric levels of 2000 to much more attractive levels in the mid-2000s. Since 2020, on the other hand, we note that the index may have risen too high and too quickly following its outperformance beginning in 2012, reaching peaks recalling the 1990 and 2000 eras.

The concentration of returns among a limited number of securities is also of some concern. As we can see in the chart below, the other 493 stocks in the S&P500 cumulatively returned 6% for the year, with the Magnificent Seven accounting for 13% of the S&P500's 19% return (as of mid-November). This indicates that markets are not as robust as one might believe from superficial observation of index levels.

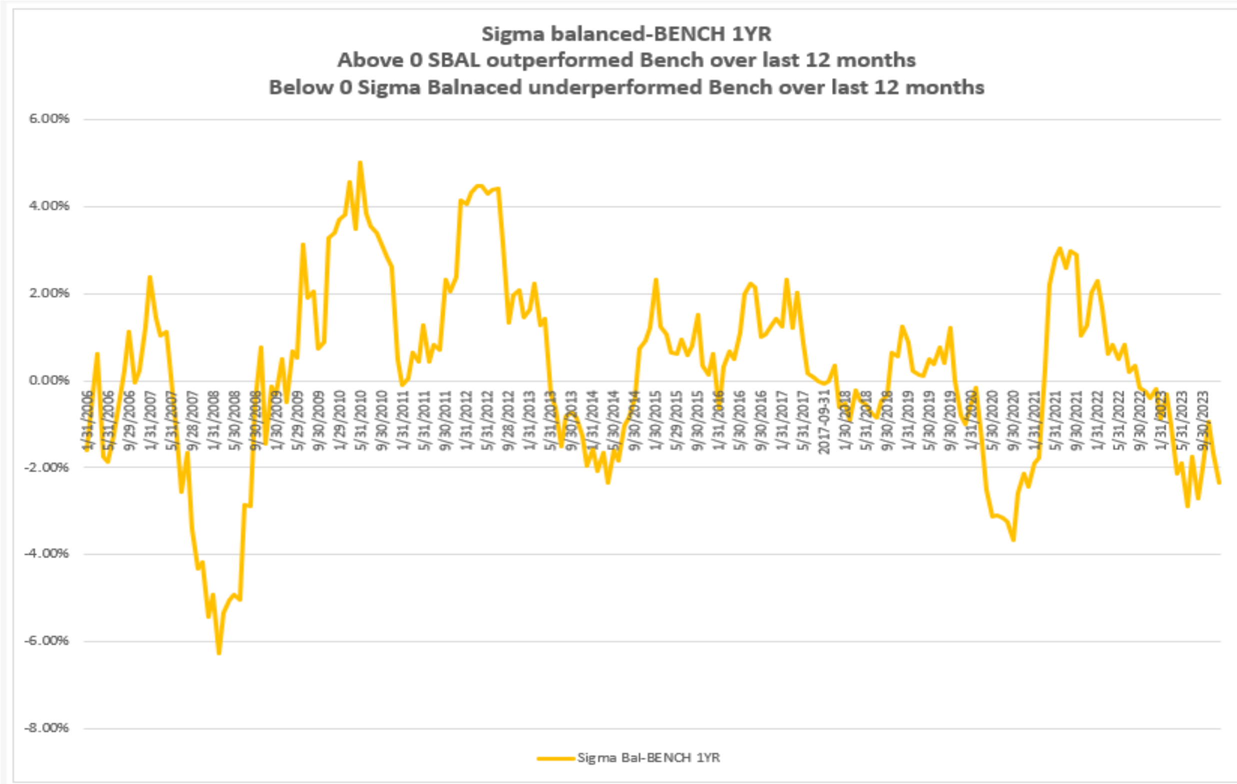
Exhibit 23: The Magnificent 7 has led the index higher in 2023



Source: FactSet. Goldman Sachs. Global Investment Research

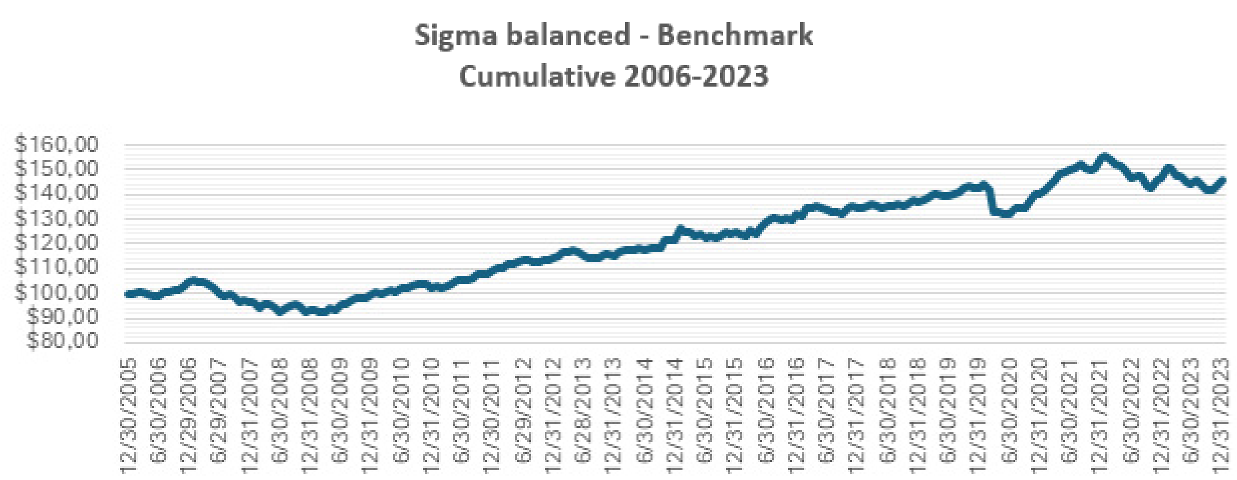
Does this mean we should exit the S&P500 completely? Not at all. As always, for our Sigma Balanced and Sigma Income baskets we recommend a diversified approach across a large number of asset classes, stock market segments and fixed income types. The US stock market accounts for 20% of the stock market securities in the Balanced basket.

Diversification has not been very well rewarded in 2023. The best-known indices, large cap growth (S&P500, EAFE, TSX) occupy 3 of the first 4 ranks (see the graph in the market review section which follows). The asset classes and stock segments we rely on to further diversify our portfolios have underperformed. As can be seen in the graph below, diversification has underperformed compared to a less diversified benchmark portfolio since the start of 2022. Such periods are inevitable from time to time. (The alternative would be that we outperform continuously, and that would not be a very realistic contention!) The graph below shows the performance of the Balanced basket compared to the reference portfolio since its launch in 2006. When the line is above zero, the basket has performed better than the reference portfolio over the last twelve months. For example, over the 12 months ending December 31, 2023, the basket, unfortunately, has underperformed by 2.34%. Since the end of September 2022, the basket has underperformed the reference portfolio (as the line has been below zero since then). Since 2006, other periods of underperformance have occurred, such as during the years 2020, 2013-2014, and 2007. Conversely, Sigma balanced outperformed the benchmark by 3% in 2021. In fact, periods of underperformance have been attractive opportunities as they have usually been followed by periods of outperformance. Generally, we see that the positive periods are more frequent and more considerable in amplitude than the down periods. Another way to express this is to see that the area of the graph covered by the line above zero is quite larger than the area under the curve.



Source : Gestion Sigma / FBN-Croesus

We can also look at it cumulatively. Although there are certain periods of decline in the performance of the basket such as in 2007 until October 2008, or even in 2020, we can see that the portfolio accumulates outperformance over time despite the recent plateauing.



Source : Gestion Sigma / FBN-Croesus