EVOLVING PERCEPTIONS

February 2025

THE PURSUIT OF BETTER
INVESTMENT PERFORMANCE

I find that because of modern technological evolution and our global economy, and as a result of the great increase in population, our world has greatly changed: it has become much smaller.

However, our perceptions have not evolved at the same pace; we continue to cling to old national demarcations and the old feelings of 'us' and 'them'.

The Dalai Lama
An Open Heart: Practicing Compassion In Everyday Life
2001

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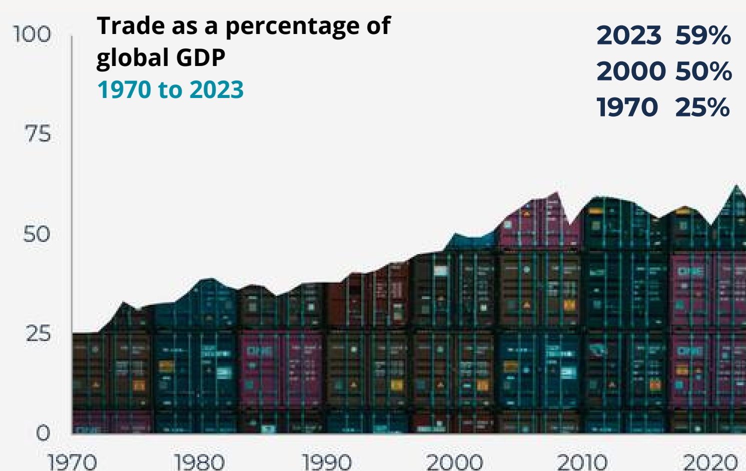
Despite President Trump's talk of self sufficiency and threats of imminent and significant trade tariffs, trade as a percentage of global GDP stood at 59% in 2023, only slightly below the all-time high of 63% the previous year.



This compares to around 25% in 1970 and 50% at the turn of the century.

It is fair to say that global economies have never been more interdependent.

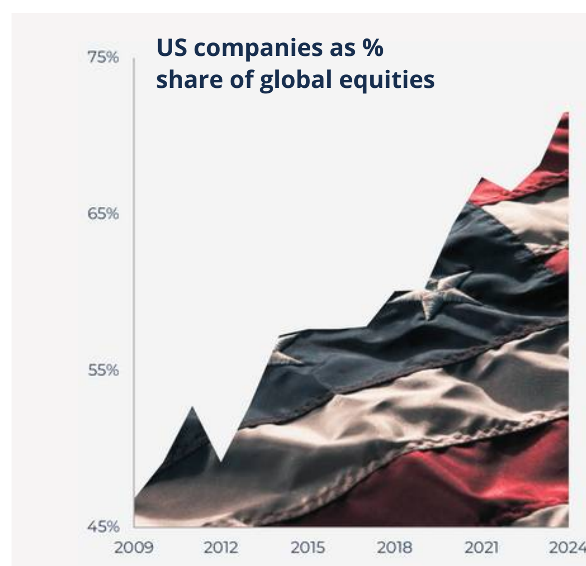
Source: World Bank national accounts data, and OECD National Accounts data files

US companies have been in the vanguard of globalisation, with technology companies led by the now infamous Magnificent Seven or 'Mag7' (Alphabet, Amazon, Apple, Meta Platforms, Microsoft, Nvidia and Tesla), standing out as the clear winners.

The foreign sales of the US information technology sector represented 59% of overall sales in 2023 (*www.visualcapitalist.com*). Reflecting the global dominance of US companies in general, and the Mag7 stocks in particular, the US equity markets have substantially outperformed their foreign counterparts.

At the end of 2024, US stocks made up almost three quarters of the global developed equity market by market capitalisation, up from approximately 47% around the time of the Global Financial Crisis in 2008.

The Magnificent 7 alone now make up 24% of world equity market capitalisation.



Source: iShares/Bloomberg

GOOGL	AMZN	APPL	META	MSFT	NVDA	TSLA	RTN USD
▲ 283%	▲ 438%	▲ 252%	▲ 125%	▲ 179%	▲ 2192%	▲ 1348%	5 YEARS TO DEC-24

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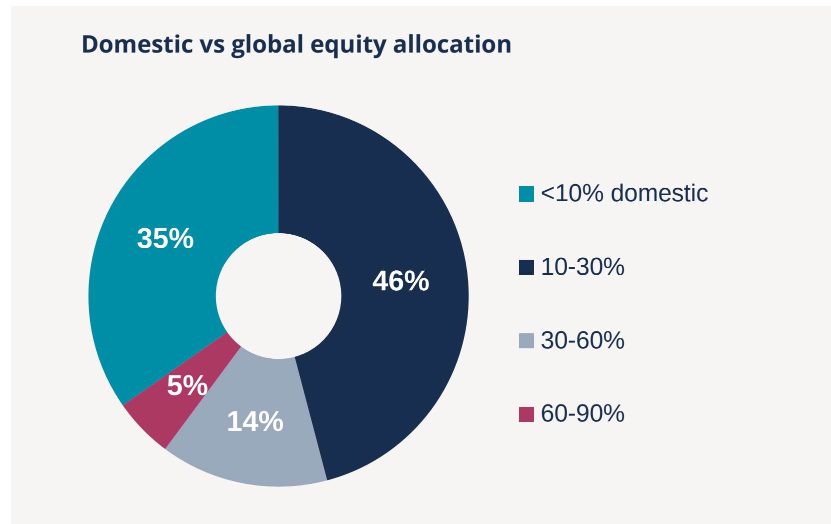
What does this mean for discretionary fund managers?

We recently polled all discretionary fund managers ('DFM's) who are ARC PCI Data Contributors asking for their split between domestic and non-domestic equity exposure.

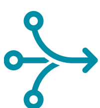
The results of this survey confirmed a trend for Sterling denominated portfolios towards the adoption of a global approach for the management of equity exposure.

The minority that do maintain a modest home bias still tend to invest the majority of their equity allocation on a global basis.

Source: ARC Research, 57th Market Sentiment Survey, December 2024

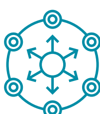


Over the last decade, an international approach to equity investing has clearly been beneficial. The rise in the interdependency of regional economies, the dominance of US stocks within global equity markets and the increased stock specific concentration of the US market, has presented DFMs with several challenges:



The shrinking benefits of geographical diversification
As global economies have become more interdependent, it follows that they have also become more correlated, especially during periods of economic instability. That brings into question the benefit of risk diversification by country or region.

The dilemma of geographic tactical asset allocation
The dominant weighting of US stocks within the global market makes tactical asset allocation by geography problematic. Given that the 2nd and 3rd largest countries within the global equity market are Japan at approximately 5% and the UK at less than 3.5%, significant underweights at the country level are simply not possible. Meaningful country tilts have effectively become a binary bet on the US market.



The stock selection conundrum
The increasing concentration of the US equity market, personified by the Mag7, means that stock selection has become tricky and, unlike the formulaic index ETFs, few DFMs have chosen to hold 25% or more of their equity allocation in the Mag7.

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Time for a rethink?

Given these challenges to tactical asset allocation at the country or regional level, perhaps a better starting point for DFMs would be global sector exposure.

An insightful way of thinking about the concentration of a data set, usually applied to the number of stocks within a portfolio, but equally applicable to the number of countries or sectors in an index, is the "**effective count**".

The effective count takes into consideration not only the number of objects in a set, but also their respective weight.

$$\frac{1}{(0.5^2 + 0.5^2)}$$

An equally weighted portfolio holding two stocks would therefore have an effective count of **2**.

$$\frac{1}{(0.9^2 + 0.1^2)}$$

If the two stocks were held with a ratio of 90:10, the effective number of stocks would be just **1.2**.

Effective count, a variation of the Herfindahl–Hirschman index

$$\frac{1}{\sum_{i=1}^{N}(w_i)^2}$$

A common measure of concentration

Using this formula, we find that global investors have an "effective" choice of 7.0 sectors but only 1.8 countries.

The table below illustrates the composition of global equity markets by market capitalisation, broken down by country and sector. We also show the return contribution of each country or sector to overall global equity returns. The dominance of US equity markets over recent years is clear to see, whereas the contribution from sectors is more evenly spread. It is helpful that the Mag7 stocks are spread across three of the eleven sectors, but there have also been meaningful contributions from financial, industrial and energy sectors which are absent of these stocks.

		Contribution to Global Equity Return (%)		
Country	**Weight**	**2024**	**2023**	**2022**
United States*	73.9%	90%	74%	74%
Japan	5.3%	3%	5%	6%
United Kingdom	3.4%	2%	2%	1%
Canada	3.0%	2%	2%	3%
France	2.6%	0%	3%	2%
Switzerland	2.2%	0%	2%	3%
Germany	2.2%	1%	2%	3%
Australia	1.7%	0%	1%	1%
Netherlands	1.1%	0%	2%	2%
Other	4.6%	2%	5%	6%
Effective Countries	**1.8**			

		Contribution to Global Equity Return (%)		
Sector	**Weight**	**2024**	**2023**	**2022**
Information Technology*	25.2%	40%	44%	38%
Financials	16.0%	21%	11%	9%
Consumer Discretionary*	11.0%	12%	15%	23%
Industrials	10.6%	8%	10%	7%
Health Care	10.4%	2%	2%	3%
Communication Services*	8.2%	13%	12%	18%
Consumer Staples	5.9%	2%	1%	3%
Energy	3.8%	1%	1%	-8%
Materials	3.2%	-1%	3%	3%
Utilities	2.5%	2%	0%	1%
Real Estate	2.0%	0%	1%	4%
Effective Sectors	**7.0**			

** includes Mag7 stocks*

Source: iShares/Bloomberg. Country and sector weights as of 7th January 2025, performance data as of 31st December 2024.

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Sectors are composed of companies operating in the same industry group and exposed to a similar set of factors.

Many of these factors will be macro-related and common to all stocks, but some will be unique to a single sector. That means we should expect to see lower correlations between sectors than between countries or regions.

The following table shows the 24-month correlation between sectors (top right) and countries/regions (bottom left).

24-month correlation matrix

Sector vs country

	Fins	Inds	HealthC	ConsDis	CommServ	ConsStap	Energy	Materials	Utilities
IT	0.3	0.5	0.4	0.7	0.8	0.3	-0.1	0.4	0.1
Fins		0.8	0.6	0.6	0.4	0.6	0.6	0.7	0.5
Inds			0.7	0.8	0.5	0.7	0.5	0.9	0.7
HealthC				0.4	0.4	0.8	0.4	0.6	0.6
ConsDis					0.7	0.4	0.3	0.7	0.3
CommServ						0.4	0.2	0.6	0.2
ConsStap							0.4	0.7	0.8
Energy								0.6	0.4
Materials									0.7

	US	UK	Europe	Asia-Ex	Japan
UK	0.6				
Europe	0.7	0.8			
Asia-Ex	0.7	0.8	0.7		
Japan	0.8	0.7	0.8	0.8	
EM	0.7	0.6	0.8	0.9	0.7

Source: ARC Research, iShares/Bloomberg

High levels of correlation are highlighted in red, whilst lower levels are highlighted in green. All of the green cells are found within the sector matrix, supporting the assertion that sectors are likely to be less correlated and therefore provide the DFM with a superior toolkit.

The broader scope for tactical tilts, combined with lower levels of correlation, should enhance the overall opportunity set for DFMs with a sector focus.

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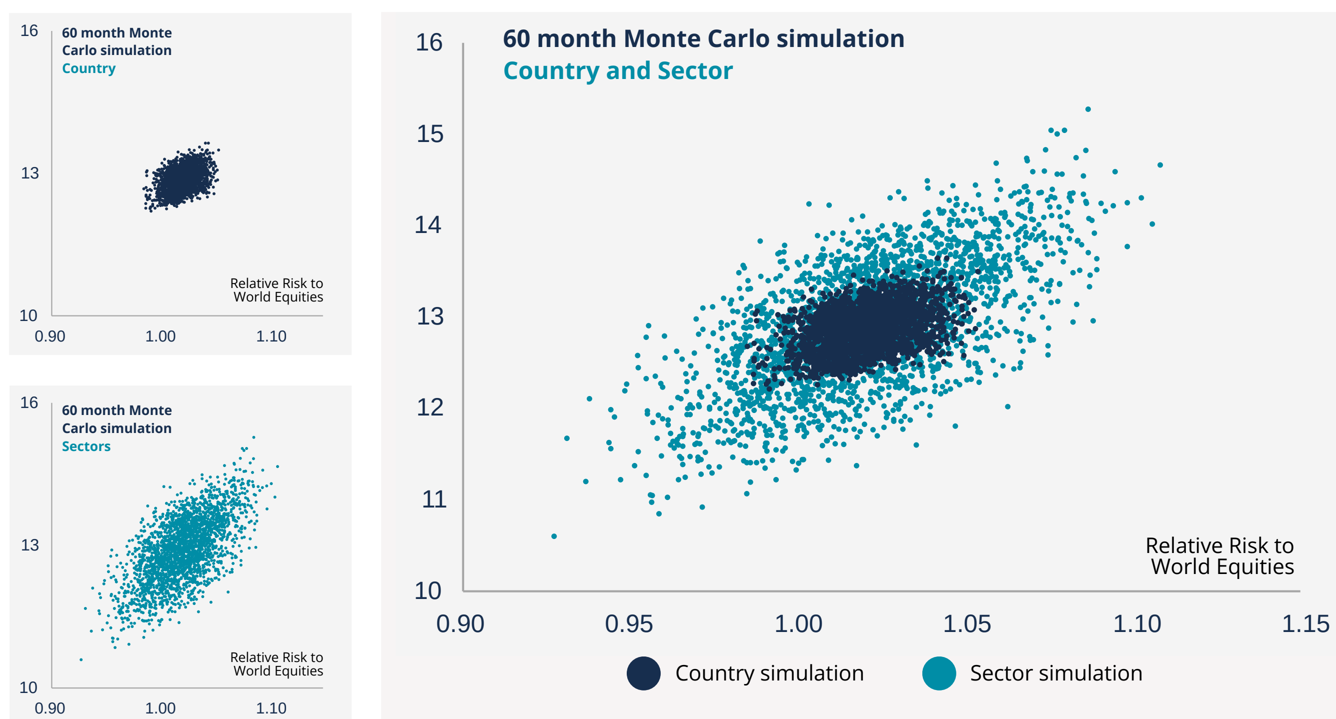
In order to test this thesis, we calculated the risk-adjusted performance of a random set of simulated portfolios with tactical allocation tilts around the global index.

The example portfolios were constrained to have a +/-10% active overweight/underweight tilt at the country or sector level. The minimum country/sector exposure was set at 0% and each portfolio was forced to be 100% invested.

The 2,500 Monte Carlo simulations for each data set are shown below:



Source: ARC Research

It can be seen from this analysis that the dispersion of possible outcomes (the opportunity set) was significantly greater for portfolios managed tactically at sector level than at a country level, emphasising the positive impact of moving to a sector based allocation model.

Monte Carlo Simulation

Named after the famous casino in Monaco, because the method relies on random chance and probability.

The simulation uses random sampling to predict the range of possible outcomes for an uncertain event.

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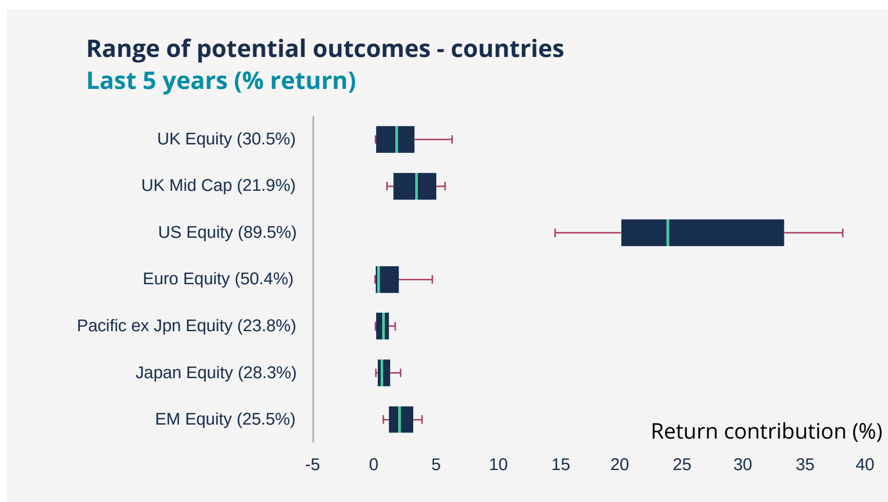
The benefit of a wider opportunity set is also evident when comparing the range of estimated return contributions for portfolios managed by DFMs within the ARC Indices.

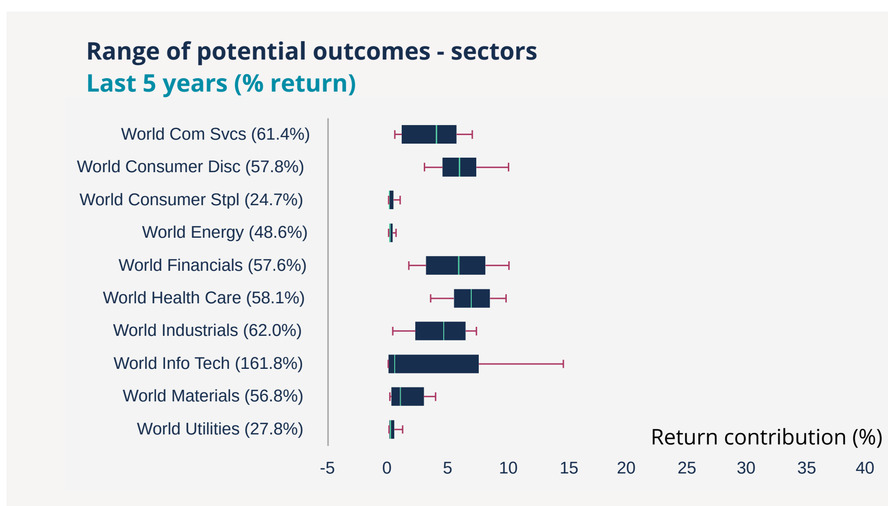
This is calculated by performing multiple regressions on the returns of each DFM to estimate the factor exposures within their portfolios. The factor return is then applied to determine the range of potential outcomes across the peer group.

The following tables show the estimated results for the ARC PCI GBP Equity Risk Peer Group's equity exposure using regional and sector factors.

This analysis highlights the crux of the issue.

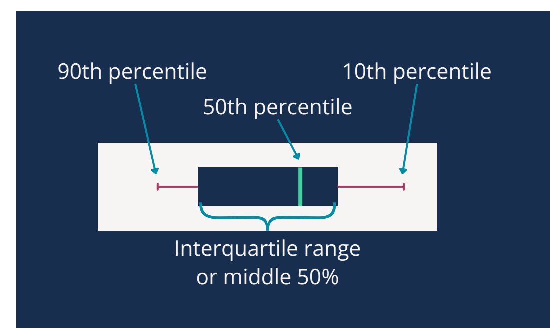


If considering global equity exposure from a regional perspective, the only significant decision is whether to position the portfolio as underweight or overweight the US.



Source: ARC Research

Viewing the same exposure through a sectorial lens provides more insight and brings with it more opportunity for a DFM to add value through tactical asset allocation across those sectors.



CONCLUSIONS

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Viewing global equity exposure through the lens of geography has become an increasingly binary approach, with the decision on the allocation to US shares dominating all other decisions.

Globalisation, the growing dominance of US stocks in global equity indices and high levels of market concentration have materially reduced the potential to add value through tactical tilts at the regional and country level. Thinking about exposure at the sector level gives DFMs the opportunity to generate excess returns through tactical asset allocation. At the same time, it helps minimise the problem of unintended factor exposures and binary bets on the fortunes of a small number of US companies.

Viewing equity allocation through the lens of sectors provides more scope for DFMs to add value

To quote the Dalai Lama, "*our world has greatly changed: it has become much smaller. However, our perceptions have not evolved at the same pace*".

Perhaps it is time for perceptions to evolve and for sector exposure to be more carefully considered, at a minimum in parallel with geography.

DFMs may need to evolve systems and processes to adopt sector-based investing or risk lagging their peers

Of course, making such a transition is easier said than done as it will require DFMs to re-examine their investment philosophy, process and control systems, as well as their client reporting.

Adapting to change is never easy but failing to adapt ultimately leads to extinction. Just try to find a DFM who hasn't embraced globalisation!

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A full list of Data Contributors to the ARC Indices is available at **www.suggestus.com**

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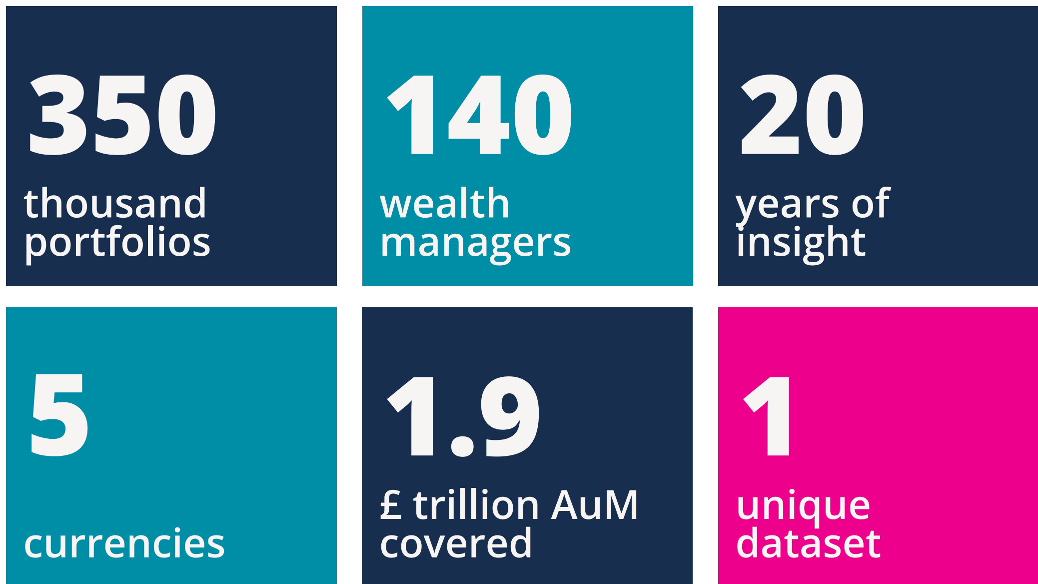

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