Investment Insight
Concentration and Balancing Act

Morningstar Investment Management EMEA

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For Financial Advisers to use with their clients

This year returns from seven giant global technology related companies outpaced most equity markets, calling some investors to question the need for diversification, if it means missing out on higher returns.

The real test of an investment strategy is whether it helps investors reach their goals with greater certainty, in terms of building or preserving wealth. As these goals are longer term, we need to look beyond a seven month period to assess whether diversification does pay off. We can do this by looking at where returns come from, based on long term studies of equity markets. Ultimately there are three sources: income (dividends and share buybacks), growth in corporate earnings and valuation shifts such as when investors become more optimistic or pessimistic and decide to pay more or pay less to own shares. Over decades income and growth dominate returns whilst over shorter term periods such as 10 years, valuation shifts can have a large impact.

The Magnificent Seven

2023's surge of enthusiasm for the so-called Magnificent seven (Microsoft; Amazon; Meta; Nvidia; Alphabet; Apple and Telsa), reflect a change in valuations, in this case reflecting greater optimism about future growth in corporate earnings. The spark for this optimism has been fervour around Artificial Intelligence (see July CIO report for more details) and its potential impact, along with concerns about recession, on other industries such as banks. Unlike the shaky start ups prevalent in the last great innovation mania (1999), this year's market leaders have established credentials as faster growing and more profitable businesses than the broad stockmarket. Morningstar Equity Research has ascribed a MOAT rating to each of them, denoting structural competitive advantages that support unusually high levels of growth and profitability for extended periods. We hold exposure to these higher quality businesses but recognise that there is a price for everything and we know that excessive optimism, big share price gains and high valuations have often led to disappointing returns for even the best businesses: share prices for Apple, Cisco and Microsoft fell 50% or more in the 2000-2003 bear market.

When it comes to guessing the future, even more humility than usual is needed in periods of rapid technological innovation. The pace of change, the birthing of new products, services and dominant companies, did not follow a predictable path in the wake of the steam engine, electricity, internal combustion engines and the internet. All are examples of general purpose technologies that can be applied widely to spur further innovation, generating new and better ways of doing things, much as AI is expected to today.

It is not knowable who the long term winners will be, though we can see the near term impacts. Some of today's dominant companies may still be dominant in the future but there are just as likely to be newcomers and some of today's giants will fail to adapt, a pattern of evolution you can see in the decade by decade shifting make-up of the 10 largest listed US companies. Today's stock market leaders are more inter-related than ever in terms of direct competition, capabilities and as suppliers to each other, hence they are also exposed to similar factors. They are not the only dominant firms, Morningstar has awarded MOAT ratings in all sectors, though these form a small fraction of all companies.

Building a robust portfolio

It is possible to build a portfolio combining great companies, markets offerings great valuation opportunities and complementary asset classes that provide offsets in scenarios especially challenging for equities. Our multi asset portfolios have captured gains from mispriced markets like Korean equities, Mexican equities, high yield, energy and financial services, whilst benefitting from higher longer term growth rates of quality business and recession diversifiers via exposure to defensive sectors, currencies and high-quality bonds.

The end result is a more consistent path to building and preserving wealth that in turn can be a more reliable way for investors to reach their goals. From a behavioural perspective it's also easier to top up or sell down your investments if they are more stable and outcomes don't depend on the fate of a small number of inter-connected companies. Diversification works because it provides greater certainty and that is even more valuable when rapid technological change introduces extra uncertainty.

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