INSIGHT

THE GREATEST WEALTH IS **YOUR PEACE OF MIND...**

BARNETT
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WEALTH MANAGEMENT

The Downside Upside of Tilting Your Portfolio

VALUE STOCKS
SMALLER COMPANIES
PORTFOLIO
DOWNSIDE
UPSIDE

The Downside Upside of Tilting Your Portfolio

All investors face choices about what should be in their portfolio. For those who start with academic theory and empirical evidence, the initial choice is to own the entire market. Beyond that, evidence-based decisions can be made to overweight, or 'tilt' towards, parts of the market with higher expected returns in reward for taking on higher risks. This involves investing in companies where investors are willing to pay a lower multiple of, say, earnings or book value (known as value stocks) relative to other stocks in the market, or by owning smaller companies.

Investors rightly focus on the upside opportunity. Taking a hypothetical 'tilted' portfolio with 60% invested in global developed market equities, 20% in global large value companies, and 20% in global small companies[1] over the past 50 years (1975-2024), the tilted portfolio has outperformed the world developed equity markets index by around 1% a year (after inflation and hypothetical portfolio costs of 0.3% per year deducted). The tilted portfolio returned 7.7% per annum versus 6.7% for the broad market. That may not sound like much, but £1 invested in the tilted portfolio – through the magic of compounding returns over long periods of time – became £40, compared to £25 for the broad market. To be fair, over the past 10 years, the tilted portfolio has underperformed by 1%. But that is the way premia work. If there were no uncertainty as to whether an investor would pick up the premium, there would be no risk in doing so, and thus, no reward either.

With their focus unsurprisingly on the upside, investors often miss the additional benefit of tilting portfolios to capture additional premia. In practice, not all positive premia appear at the same time - they are imperfectly correlated, in investment terms. The impact of this can help smooth the returns from the equity portion of a portfolio, and potentially shorten the recovery time from market declines. The chart below illustrates the worst-case outcomes over different time horizons, adjusted for inflation (which is what investors should focus on) from 1975-2024.

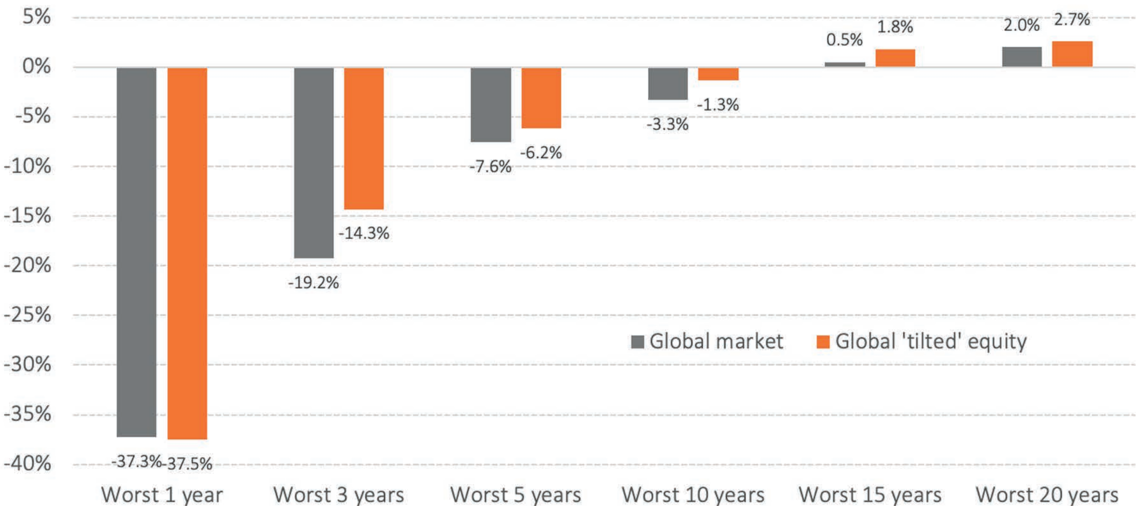

Figure 1: Tilting to value and smaller companies can improve worst-case outcomes

Source: Albion Strategic Consulting. Data: Dimensional Returns Web – annualised returns after inflation

Again, these may not seem like dramatic differences, but even small, annualised falls in value can compounded into significant losses over time. The chart below illustrates the impact of these worst-case periods on £100 of purchasing power (i.e. how much your money can buy after inflation).

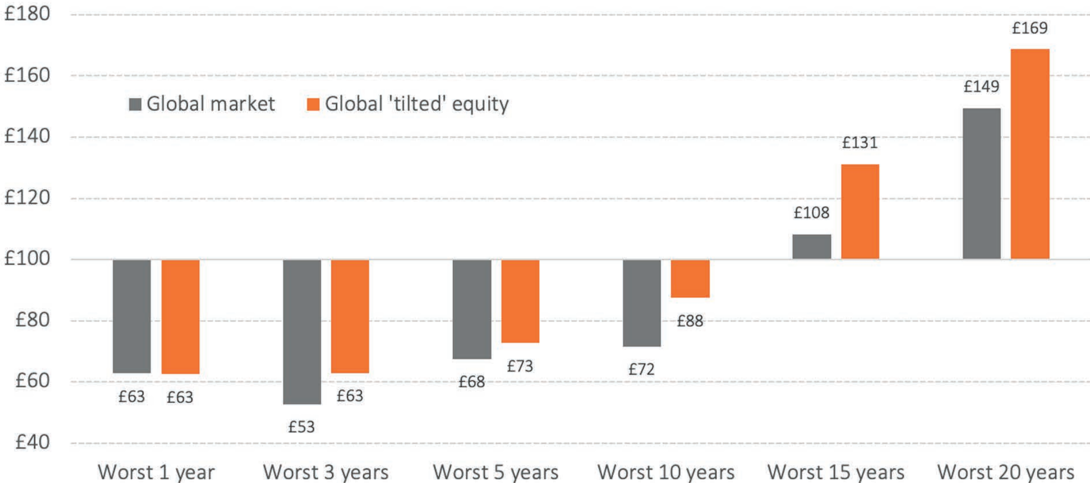

Figure 2: £100 of purchasing power and worst-case periods (1975-2024)

Source: Albion Strategic Consulting. Data: Dimensional Returns Web – annualised returns after inflation

Conclusion

Perhaps the starkest insight from these data are that equity markets and inflation can result in material falls in portfolio value over prolonged periods of time. Not every market decline is followed by a quick recovery, although many are. Owning an appropriate level of bonds is an important component of many investors' portfolios, depending upon their own unique circumstances.

The second insight is that the 'downside upside' of incorporating factor tilts such as value and smaller companies into a portfolio, as illustrated above, can potentially help preserve purchasing power better than simply owning the broad market (e.g. through a global equity index fund alone).

The third insight is that premia are uncertain from year to year - including the basic premium of owning equities over holding cash. Patience is essential in investing, but fortunately, most investors have long-term horizons, making it more likely they will capture these rewards.

Enjoy the upside but also value the 'downside upside' of tilting.

End notes.

1.

Global developed markets – MSCI World Index (net div.) in GBP, global value stocks - Dimensional Global Large Cap Value Index, global smaller companies - Dimensional Global Small Index. UK RPI to 1/1988, UK CPI thereafter.

Other notes and risk warnings

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