

## RICHER DIVERSIFICATION

Helping your clients better understand industry classifications so they appreciate your expertise

If you ask most investors to explain why they should allocate assets across industry classifications, their response is likely to be some variation on the old saying: “Don’t put all of your eggs in one basket.”

That certainly makes sense. After all, an investor can reasonably expect the defense industry to benefit from a different set of micro and macro economic drivers than luxury retail. Sufficient diversification increases the odds of capturing the opportunities these drivers present.

But, traditional methods of diversification by using a standard classification system or matching the industry weightings of an index have some shortcomings. By helping your clients develop a more nuanced understanding of industry classifications, they will be better able to understand the decisions made when building their portfolios—and recognize that deviating from expected portfolio weightings might not be a cause for alarm.

Consider the practice of matching the sector weightings of a particular index. In many cases, this may provide ample industry diversification, but there are drawbacks. For one, the industry profile of most indices is driven by market capitalization. Fundamental measures of intrinsic value are not part of the equation. Nor is there any consideration for the specific attractiveness of the component stocks.

Style indices, such as growth and value, tend to cluster in certain industries. Also, you may feel that current index weightings reflect a cyclical run up within an industry that is not sustainable. Helping your clients understand why you are not reflecting index weightings will help them recognize the value you are bringing to their portfolio.

The most common method of assigning companies to appropriate sectors is probably the Global Industry Classification Standard (GICS), which identifies 10 major sectors. These are further divided into 24 industry groups, 67 industries and 147 sub-industries. That may appear to be a granular breakdown, but globally speaking, that divides nearly 35,000 firms across fewer than 150 categories.

Clearly, company specific characteristics, as well as the effects of broad economic drivers, can vary significantly within the same industry grouping. A portfolio that appears to match the industry profile of a particular index or benchmark may, in fact, hold stocks that contribute a very different economic sensitivity and risk profile.

Globalization has helped diminish the importance of geographic diversification, at least within the developed world. For global players, industry has primacy over country. In today’s cross-border reality, Ford, for example, has more in common with Toyota than it does with other U.S. companies. The same could be said about drug makers Pfizer, based in New York, and Roche of Basel, Switzerland.

Finally, ongoing investment research suggests that commonalities among stocks may equal the influence of industry and region on portfolios. Factors that have shown a common impact include changes in yield curves, credit spreads, currency values, volatility and momentum. Dividend yield and P/E ratios are also seen as common factors that may drive performance.

Your clients need to know that understanding the structural hierarchy and limitations of industry classification are more important than adhering to a static definition of diversification. ■



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