SCHLINDWEIN ASSOCIATES
INVESTMENT COUNSEL

Tracking

Many mutual funds, especially exchange-traded funds ("ETFs"), are managed to track a specific market index. An attraction of such funds for investors is the opportunity of a "one-stop-shop" investment, especially for exposure to broad markets. In addition, such funds often come with low expenses. Proper investor due diligence warrants taking a closer look at the index being tracked to understand the range of exposures within the index to various sectors. An index may have exposure to a sector that is incompatible with an investor's individual preferences. A review of some tracking indexes can provide perspective for portfolio construction ahead.

PERSPECTIVE

The two largest sectors of the world stock market are U.S. stocks and *"All Other Countries"*. Chart I shows how these sectors have changed over time. Over the whole period, each sector has averaged 50% but the range has varied widely. U.S. stocks have been as low as 31% and as high as 70%. Changes have occurred over relatively long cycles. The U.S. stock attribution has moved relatively higher since 2010. The relative return outcomes for a portfolio not tracking these changes could have varied significantly, either favorably or unfavorably. Investing in a fund tracking the world stock index at this time should be made with an understanding that the U.S. sector return attribution comes at an all-time high.

Credit quality is a key differentiator among bonds. Chart II shows the return attributions among three credit sectors. Over the whole period, the return attribution of the U.S. Treasury sector has averaged 66%. The remainder has been split between investment-grade corporates and high-yield corporates, the latter with the lowest credit ratings. Sector attributions have varied with interest rate and credit spread cycles. The U.S. Treasury sector has less interest rate sensitivity, i.e., a relatively lower duration. As yields rise and credit spreads widen, the return advantage shifts to the corporate sectors. Investing in a fund tracking the U.S. bond market index at this time should be made with an understanding of the potential impact of ongoing U.S. debt issuance.

The U.S. stock market often is viewed by the relative capitalization of its individual stocks. Chart III shows the return attributions from three cap sectors, large, mid, and small. The return attribution of large cap has dominated over time with an average of 58% for the whole period. Mid cap follows at 35% with small cap at 7%. Notable recent out-performance of some large cap growth stocks has pushed the large cap return attribution near its all-time high of 64%. Return attributions of both mid cap and small cap have varied widely. Notable was the disappearance of any small cap return attribution in 2010-2011. Investing in a fund tracking the U.S. stock market at this time comes with a clear large cap bias.

INVESTMENT IMPLICATIONS

Portfolio construction may be simplified by investing in a few funds that track broad market sectors. At the same time, a good principle is to review the various sector exposures from any investments. If one is indifferent to such exposures, then the review may prove unnecessary. However, any strong preferences would suggest more diversification within the portfolio is warranted. Such diversification can bring meaningful variances in tracking return, and the goal of the diversification is positive variance. Simple thoughts – know that in which you invest and how returns may vary relative to expectations.

CHART I

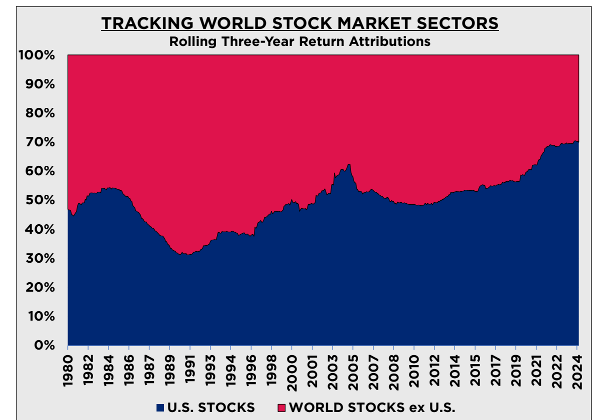


CHART II

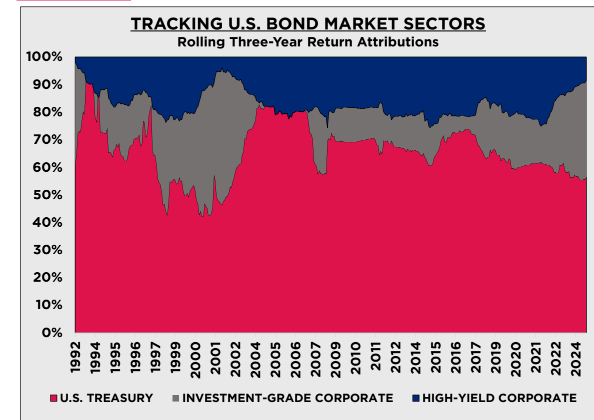
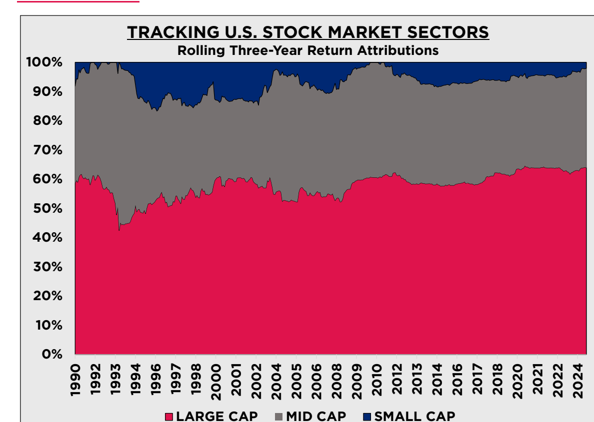


CHART III



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