

Stock Funds That Go Beyond the S&P 500

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Don't put all of your bets on the Magnificent Seven. These stock funds offer true diversification—which will pay off in the next downturn.

BY LEWIS BRAHAM

It's safe to say that John Bogle has won. The founder of Vanguard Group was mocked early in his career for believing that a low-cost index fund tracking the S&P 500 would beat most active managers.

Almost 50 years after the **Vanguard 500 Index** fund's August 1976 launch, there are no doubts. Index fund assets for the first time ever in the U.S. surpassed those of active funds in 2024's first quarter. Just by itself, "Bogle's folly"—as Vanguard's original fund was nicknamed—has exceeded \$1 trillion.

But with that victory come risks. While Bogle, who died in 2019, championed indexing, he also believed in diversification. That wasn't an issue for the S&P 500 in the past, but the index has become a victim of its own success. Its largest stocks are now so popular that they have come to dominate it, and they're primarily in the technology

sector — which constitutes 30% of the benchmark.

The last time the index was so concentrated in tech occurred before the dot-com bubble burst in 2000. Moreover, three of the most highly valued companies in the so-called Magnificent Seven driving the market now — **Amazon.com**, **Meta Platforms**, and **Alphabet** — aren't classified as tech by the S&P 500, but as consumer and communication stocks. The official tech weighting thus understates the sector's impact, says Ben Inker, co-head of asset allocation at GMO: "The market is much more concentrated than anything we have experienced in over half a century now."

This isn't to say that investors should sell their S&P 500 index funds. Many experts think the Magnificent Seven are high-quality companies. But to stay high, their valuations require no earnings surprises. Already, one — **Tesla** — has

stumbled and is down 29% in 2024.

The other six stocks, including much-admired chip maker **Nvidia**, are running on enthusiasm over artificial intelligence. "Whoever coined the expression Magnificent Seven clearly didn't see the film, because four of the seven are dead at the end of it," says Rob Arnott, chairman of Research Affiliates. "The narrative around Nvidia is that AI will change everything. The other part of the narrative is this handful of companies is dominant in AI and will remain the dominant players five and 10 years hence. That's not necessarily true. They're competing against one another, and there's often some new disrupter that comes along."

Let's assume, though, that an S&P 500 fund is the main course of

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your investment meal. You should have some appetizer funds and a good wine fund to pair with it, or your dinner will be incomplete.

Bonds are useful diversifiers — perhaps the vegetables in your meal — but many investors want to maintain a certain level of equity exposure as part of their financial plan. And spreading the wealth is more difficult than it seems. The popular **Vanguard Total Stock Market** exchange-traded fund, for example, has 3,731 stocks instead of just the largest 500, but those thousands of small companies make up only 9% of its portfolio. It still has a 30% tech weighting.

To get true equity diversification, you're going to have to risk thinking differently. One way of doing that is to search for stock funds with little or no tech exposure. Another is to find ones with low correlations to the S&P 500. One measure of a fund's correlation is called R-Squared, or R2, which reveals how much of a fund's price moves are determined by its benchmark. A fund with an R2 of 50 indicates a 50% correlation, while an R2 of 100 equals a 100% correlation. So, predictably, 100% of the time the Vanguard 500 Index fund moves in the same direction as the S&P 500. (The degree of the price moves is measured by another important statistic called beta.) The Vanguard Total Stock Market ETF has a 99 R2. It isn't a good diversifier.

Large-Cap Funds

It's hard to find large-cap funds today with little or no tech exposure that have beaten the S&P 500. **Marshfield Concentrated Opportunity** is one.

Marshfield has an R2 of 75 in the past three years, low for a large-cap fund. It also has proved to be excellent in downside risk control. In 2022, when the S&P 500 declined 18.2%, the fund actually rose 5.1%. Its 17.1% five-year annualized

return beats the S&P 500's 15.2%.

The fact that "concentrated" is in the fund's name is no accident. "The large-cap space is just so hard," says Jack Shannon, a senior research analyst at Morningstar. He has seen only a handful of large-cap managers beat the S&P 500 without Magnificent Seven exposure, and they tend to be super-concentrated. "You have to be very bold to create a unique performance profile," he says.

In Marshfield's case, it currently holds only 19 stocks, but they are high-quality ones that can withstand downturns. "We specifically look for companies that don't necessarily mimic the business cycle," says co-manager Elise Hoffmann. "That produces a pattern of performance that is quite different from that of the market."

One of Marshfield's top holdings is insurer **Arch Capital Group**, which rose 41% in 2022 as the S&P 500 fell. "Property and casualty insurance pricing moves according to disasters," Hoffmann says. "This doesn't necessarily align with the economic cycle." Because insurers were in what is called a "hard market" of multiple disasters, savvier ones like Arch were able to raise their pricing in 2022's downturn and still be profitable.

Interestingly, Hoffmann and her co-managers don't think of the Magnificent Seven stocks as so high-quality because of technology's obsolescence risk. "When we do an evaluation, we're looking to figure out, how long do these competitive advantages last?" says co-manager Chad Goldberg. "With regard to tech companies, if you're trying to do that, it's very difficult. It's really hard to think about 15 years into the future, what **Apple** does."

Small-Cap Funds

Two main avenues of diversification right now are value stocks and small-caps, since both underper-

formed during the tech bull run.

In a recent report by Matthew Bartolini, head of SPDR Americas Research at State Street Global Advisors, he makes the case for both small-caps and value factor diversification, given the exaggerated influence of large-growth stocks in the S&P 500. "The S&P 500 index now has two times more allocated to growth (46%) than value (21%) stocks, where typically the allocations have been the same (31% versus 32%), on average, over the past 30 years," he writes. Moreover, the average return for its top 10 stocks in 2023 was 85.6% versus 16% for the other 490. Those 10 stocks drove 63% of the index's total return for the year, while the "top 10 stocks represented 24% of the [S&P 500's] total return over the past 30 years, on average."

The valuation gap now between small-cap value stocks and the most popular blue chips is extreme. The top-performing **Avantis U.S. Small-Cap Value** ETF has just a 61 R2, only 5% of its portfolio in tech stocks, and an average price/earnings ratio of just 10. The S&P 500's P/E ratio is 21.

Yet there is a problem with small-caps in a high-interest-rate environment, especially today. "If you don't like the [S&P 500's] concentration, it's natural to buy small-caps," says GMO's Inker. "But we get nervous about that, because one thing that has happened in the small-cap arena is these companies have taken on a lot of debt over the past 15 years."

The higher interest rates are, the greater the risk to overleveraged small companies when they have to issue new debt with more onerous interest payments. It makes sense when diversifying into small-caps to seek high-quality ones with either little debt or strong enough cash flows to cover their borrowing.

That's one reason that the Avantis ETF is a worthy option, as the

Life Beyond the S&P 500

These 18 stock funds will help broaden your exposure beyond the most highly valued names and sectors.

Fund / Ticker	Morningstar Category	Tech Weighting	3-Year R-Squared to the S&P 500	10-Year R-Squared to the S&P 500	3-Year Return	5-Year Return	Expense Ratio
Avantis US Small Cap Value / AVUV	Small Value	5.2%	61	N/A	10.6%	N/A	0.25%
BNY Mellon Dynamic Value / DAGVX	Large Value	9.1	78	83	14.1	15.2%	0.93
Centre American Select Equity / DHAMX	Large Blend	24.5	75	81	12.3	16.3	1.36
Fidelity Value Strategies / FLSX	Mid-Cap Value	5.9	76	81	11.2	15.0	0.90
First Eagle Gold / SGGDX	Equity Precious Metals	0	16	6	2.1	10.3	1.19
First Trust Natural Gas / FCG	Equity Energy	0	12	30	31.2	13.2	0.60
Global X Uranium / URA	Natural Resources	1.2	19	23	20.2	22.0	0.69
iShares MSCI Global Gold Miners / RING	Equity Precious Metals	0	15	6	-0.7	9.2	0.39
iShares U.S. Broker-Dealers & Securities Exchanges / IAI	Financial	0	67	62	9.6	16.8	0.40
iShares US Healthcare / IYH	Health	0	65	65	8.3	11.4	0.40
iShares US Healthcare Providers / IHF	Health	0	53	49	3.4	11.3	0.40
Marshfield Concentrated Opportunity / MRFOX	Large Growth	0	75	N/A	15.0	17.1	1.01
Pacer US Cash Cows 100 / COWZ	Mid-Cap Value	9.2	69	N/A	14.5	17.9	0.49
Smead Value / SMVLX	Large Value	2	74	79	14.0	16.4	1.25
SPDR Portfolio S&P 500 Value / SPYV	Large Value	9	86	89	11.8	13.4	0.04
SPDR S&P Oil & Gas Exploration & Production / XOP	Equity Energy	0	14	34	25.9	7.2	0.35
Utilities Select Sector SPDR / XLU	Utilities	0	50	23	4.3	5.9	0.09
WisdomTree Japan SmallCap Dividend / DFJ	Japan Stock	14.5	31	40	2.3	5.3	0.58
Vanguard S&P 500 / VOO	Large Blend	29.6%	100	100	11.4%	15.2%	0.03%

Note: R-Squared data are as of March 31 and returns are as of March 28; three- and five-year returns are annualized.

Source: Morningstar Direct

fund emphasizes both value and quality stocks with strong cash flows.

Mid- and Large-Cap Value Funds

Still, in downturns, investors tend to dump small-cap stocks, even high-quality ones. For added security, one can move up the capitalization ladder to mid- and large-cap value stocks.

Although technically categorized as Mid-Cap Value, the **Pacer U.S. Cash Cows 100** ETF employs a screen for the 100 stocks in the large-cap Russell 1000 index that have the highest free-cash-flow yields. The ETF rebalances its portfolio every quarter to the highest yielders. Energy stocks like **Valero Energy** are currently 23% of Pacer's portfolio, while tech is only 9%. The fund's R2 is a low 69, yet it has beaten the S&P 500 in the past five years.

"Nobody three years ago would

have said energy was high-quality," says Sean O'Hara, president of Pacer ETFs Distributors. "But today, it's maybe the highest-quality [sector]. The companies make gobs of money, and they trade at single-digit [valuation] multiples."

For indexers, there is also the **SPDR Portfolio S&P 500 Value** ETF, which has only a 9% tech weighting. It's a fine fund, but because it's built from the S&P 500's stocks and its portfolio is market-cap weighted to the index's largest ones, it is surprisingly highly correlated to the index, with an 86 R2. The popular **Invesco S&P 500 Equal Weight** ETF solves the market-cap-weighting problem by equal-weighting each stock, but it is 15% in tech and 90% correlated.

If you prefer active management, **Smead Value**, the **Oakmark Fund**, **Fidelity Value Strategies**, and **BNY Mellon Dynamic Value** have all proved to be worthy low-tech mid- and large-cap value options.

Sector Funds

Sector funds also behave differently from the broad market. High-risk by themselves, such funds can pair well with an S&P 500 fund. The R2 stat can help you find lowly correlated funds, but it should just be a starting point, and you should consider the stat over multiple time periods. "If you're doing relatively short-term statistical analysis [with R2 and sectors], you can get tripped up pretty easily," Inker says. "Yet if you go back too far, you can have groups of stocks and industries that have changed beyond all recognition." With sector correlation, Inker recommends looking back at least 10 years to cover different kinds of markets. One must also consider whether anything has happened recently to change the sector.

Of the stock sector ETFs, precious-metals ones have the lowest S&P 500 correlations. The **iShares MSCI Global Gold Miners** has a tiny six 10-year R2 to the S&P 500.

Others with low 10-year correlations include **Utilities Select Sector SPDR**, **Global X Uranium**, **First Trust Natural Gas**, and **SPDR S&P Oil & Gas Exploration & Production**.

Utilities funds aside, the sector funds above tend to benefit from inflation, which hurts the rest of the market. “Gold has historically worked as an inflation hedge,” says Gargi Chaudhuri, chief investment and portfolio strategist, Americas, at BlackRock. But there is a difference between how gold bullion and gold miner stocks behave as investments. Miner stocks are more volatile, so it makes sense to hire an active manager in such a risky sector.

First Eagle Gold is one of the best gold stock funds. Although it invests primarily in mining stocks, it will normally have an allocation to bullion, as well. This helps stabilize returns. When precious-metals stock funds fell an average 14.8% in 2022, First Eagle Gold lost only 1.6%.

Utilities can be an excellent hedge, depending on the environment. In a period of rising interest rates like we’ve had, they suffer from competition with higher-yielding bonds. But in an economic slowdown with falling rates, utilities do well. By contrast, natural-resource and energy funds outperformed in 2022’s inflationary upsurge, but performed poorly in the 2020 pandemic slowdown.

Chaudhuri likes energy, but not utilities, as interest rates remain high. Instead, for diversification, she recommends that investors stick to “lovable laggard” sectors such as healthcare and financial services, which have underper-

formed tech recently. She thinks a better-than-expected economy will support broker-dealers and favors the **iShares U.S. Broker-Dealers & Securities Exchanges** ETF. Meanwhile, healthcare stocks have “robust earnings expectations.” She believes that hospitals and insurers are particularly attractive quality-wise in **iShares U.S. Healthcare Providers**. For broader exposure, there’s **iShares U.S. Healthcare**.

Such dramatic moves are best left to professionals. But a skilled manager like Abate could add the diversification your portfolio needs.

More-popular market sectors like these, which have greater weightings in the S&P 500 than utilities and energy, tend to be more correlated, but they still have diversification benefits. The **iShares U.S. Healthcare** and **U.S. Broker-Dealers** ETFs have 65 and 62 respective 10-year R2s. The narrower industry-focused **iShares U.S. Healthcare Providers** has a 49 R2. By contrast, the **SPDR S&P Oil & Gas Exploration & Production** ETF has a lower 34 R2, and the **Technology Select Sector SPDR** ETF has a higher 83 one — a testament to how tech-driven the market is now.

International Funds

International stocks are good diversifiers and should, like bonds, already be a dedicated part of most investors’ portfolios. Still, some specific country exposure can add

extra spice. “If you’re looking for markets that have a low correlation with the U.S., Japan comes right at the top of the list,” Inker says. “We love Japanese small-caps.” He likes both their valuations and the fact that the yen has been trading at its cheapest levels versus the dollar in decades. The **WisdomTree Japan SmallCap Dividend** ETF provides small-cap exposure, and has a low 10 average P/E ratio and a 40 10-year R2. But you have to be truly gutsy to venture so far off the beaten path to a single country’s smallest stocks.

Hedging

There are diversified stock funds with significant tech weightings that still manage to have low correlations with the market. They do this via hedging.

For a large-cap stock fund, **Centre American Select Equity** has an unusually low 75 R2 in the past three years, despite having a recent 25% tech-stock weighting. That’s because manager James Abate may hedge his portfolio with put options if valuations seem stretched and the cost of hedging is low.

In 2022, he was heavily invested in energy stocks while hedging simultaneously, so his fund fell only 3% while the S&P 500 fell 18%. In 2023, he saw companies like Meta “have an inflection in their profit margin improvement” while he started to see deterioration in energy. So, he took the hedge off and swapped energy for tech. He has since put a full hedge on again.

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