# MARKET COMMENTARY

## EQUITY ANALYSIS

### IS DIVERSIFICATION OVERRATED?

**Diversification is often regarded as the bedrock of sound investing. It is widely believed to reduce risk, smooth out returns, and provide stability in uncertain markets. However, this assumption deserves scrutiny, especially when considering the realities of bear markets.**

## MARKETS HAVE TWO ENVIRONMENTS: BULL AND BEAR

Investors must remember that markets operate in two distinct environments: bull markets and bear markets. While bull markets can be enjoyable—lifting nearly all stocks and creating an illusion of stability—bear markets expose vulnerabilities.

This reality is particularly important for:

- Investors with shorter time horizons, who may not have decades to recover from losses.
- Retirees or those dependent on portfolio income, who cannot afford dividend cuts or prolonged drawdowns.
- Individuals without steady income from a job, who cannot easily rebuild wealth lost in a downturn.

A portfolio that thrives in a bull market but collapses in a bear market is not a well-designed portfolio—especially for those who cannot afford to take long-term risks.

## THE COMMON MISCONCEPTION ABOUT DIVERSIFICATION

Many will assume that the best way to handle risk is to diversify. The logic seems simple: by spreading investments across different sectors, asset classes, and geographies, losses in one area will be offset by gains in another.

We disagree—because diversification can unintentionally introduce unwanted risks and distract from attaining specific goals. A diversified portfolio is not necessarily a better portfolio. In fact, excessive diversification can:

- Dilute exposure to high-quality investments
- Reduce a portfolio's ability to withstand bear markets
- Introduce unrecognized risks, rather than mitigate them

For these reasons, we believe concentration in high-quality investments is a more effective strategy.

## QUALITY FIRST, DIVERSIFICATION SECOND

Investing success does not come from owning more stocks—it comes from owning the right stocks. High-quality businesses tend to demonstrate:

- Lower debt levels
- Higher profitability
- More consistent earnings and dividends

These characteristics make them resilient in bear markets. However, if we diversified portfolios indiscriminately, we inevitably would end up with lower-quality businesses. Over time, diversification-for-diversification's sake would water down the very qualities that we seek to provide protection and sustainable returns.

*To use a sports analogy: a championship team is built by concentrating on elite players, not by ensuring an "even mix" of skill levels across the roster. A football team that drafts a mix of top-tier and mediocre players for the sake of diversity will underperform compared to a team that prioritizes excellence.*

Similarly, a portfolio that prioritizes diversification over quality will inevitably hold underperforming stocks that drag down returns—especially in bear markets.

## THE FRAGILITY OF HIGH-YIELD INVESTING

The introduction of diversification for diversification's sake can easily cause a lack of focus. In our experience, the pursuit of high current income is a frequent distraction that draws portfolios into lower-quality areas, creating risk in the process. It is a common misconception that maximizing income through high-dividend stocks is the best way to build a stable portfolio. We have heard this argument more than once. However, our research shows a clear *negative* correlation between quality and dividend yield—meaning the *highest-yielding* stocks are often of lower quality (Chart A, page 3). The chart groups the largest 1,000 stocks in the U.S. by our WCA Quality grade and highlights higher yield stocks in red and lower yield stocks in blue. Notice what quality grade the higher yield stocks tend to earn!

From this analysis, we conclude that chasing yield likely leads to:

- Overexposure to leveraged companies
- Businesses with unsustainable payouts
- Industries that are highly cyclical and vulnerable to downturns

For example, portfolios with large exposures to high dividends in financial stocks before 2008 suffered enormous losses when those companies cut or eliminated dividends. A similar situation unfolded in the energy sector in 2015 when oil prices collapsed. Had focus remained on high-quality businesses with sustainable and growing dividends, instead of chasing the allure of high yield, portfolios may have been far better protected in these downturns.

### THE HIDDEN RISK OF GROWTH INVESTING

On the opposite end of the spectrum, many investors assume that prioritizing growth over value is the best way to maximize returns. However, our data shows a positive relationship between growth expectations and stock beta—meaning high-growth stocks tend to be the most volatile (Chart B, page 4). While high-growth companies can thrive in bull markets, they often suffer disproportionately in bear markets. Their valuations are based on future expectations rather than current fundamentals, making them highly sensitive to economic shifts.

***For example:***

*The dot-com bubble of the late 1990s saw speculative tech stocks soar—only to collapse when sentiment shifted. The 2021 growth stock bubble saw high-momentum names skyrocket—only for many to decline 50-80% when interest rates rose. A portfolio that overemphasizes growth may look strong in a bull market but will collapse when risk appetites change. This is why we concentrate on businesses that demonstrate steady earnings, strong balance sheets, and consistent profitability—regardless of market conditions.*

### THE HIDDEN RISKS OF OVER-DIVERSIFICATION

Many people assume diversification is the best way to reduce risk. However, this belief is dangerously incomplete. Consider the following:

- **Correlations Rise in Market Stress**
  In bear markets, assets that typically seem uncorrelated suddenly move together. This means that diversification fails exactly when it is needed most (Chart C, page 4).
- **Diversification Doesn't Eliminate Weakness**
  If a portfolio holds a mix of strong and weak businesses, the weak companies will still hurt performance when conditions deteriorate.
- **False Sense of Security**
  Investors often underestimate their risk because they believe their portfolio is protected by diversification.

In reality, portfolios that put diversification above all else may end up exposed to hidden vulnerabilities.

**CHART A | HIGH DIVIDEND YIELD TEND TO BE LOW QUALITY** Source: WCA, Bloomberg

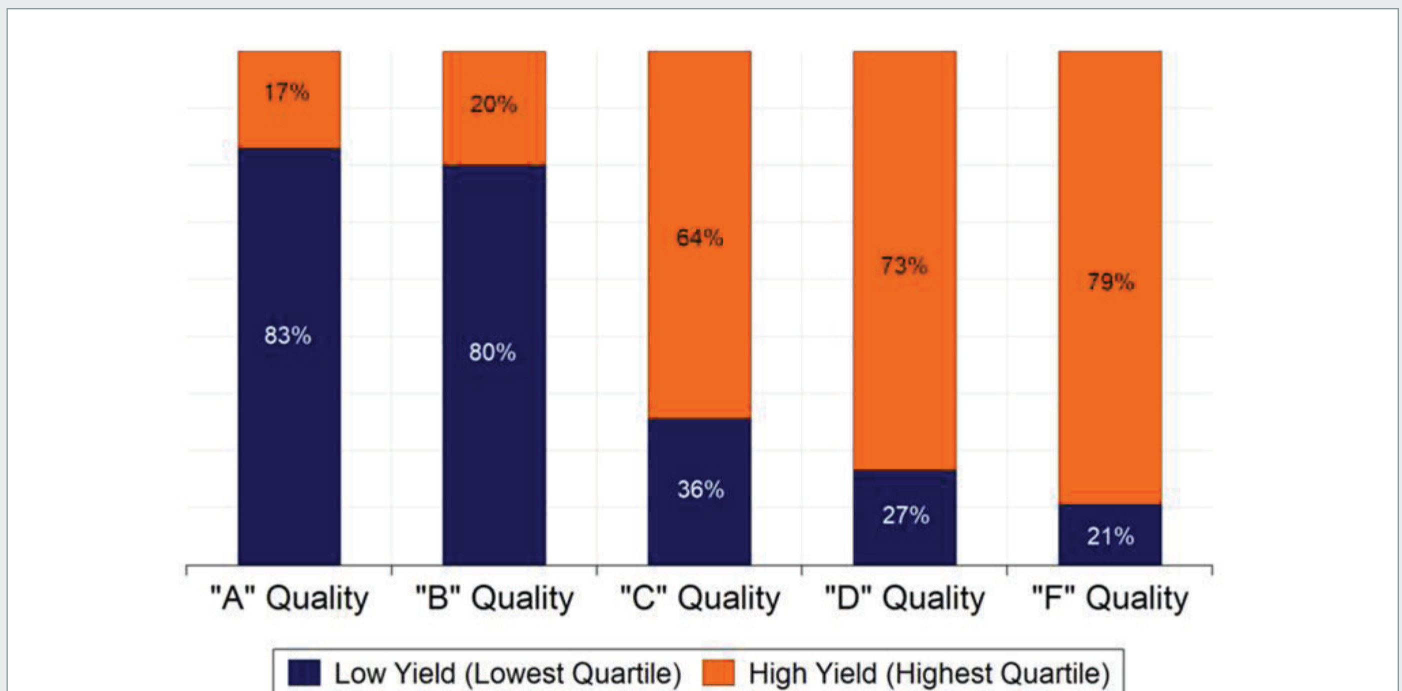


**CHART B | HIGHER GROWTH IMPLIES HIGHER RISK** Source: WCA, Bloomberg

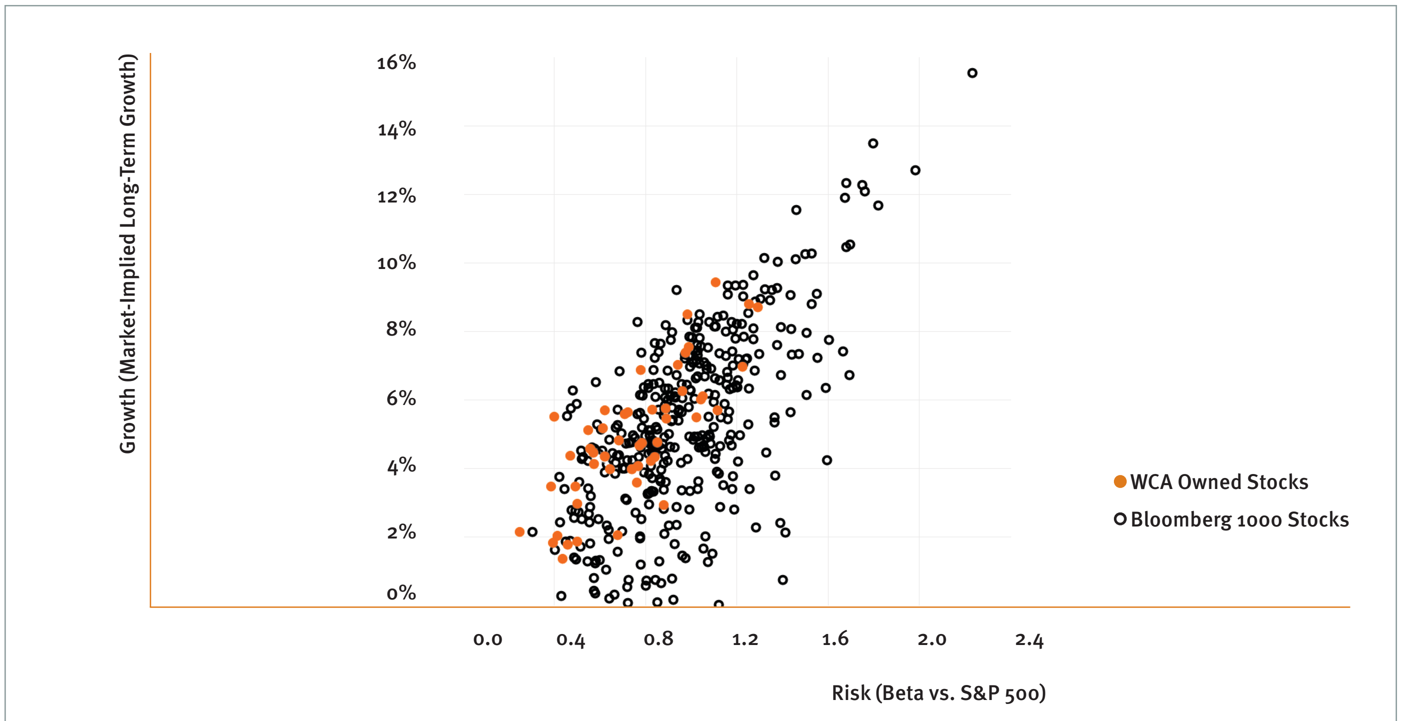
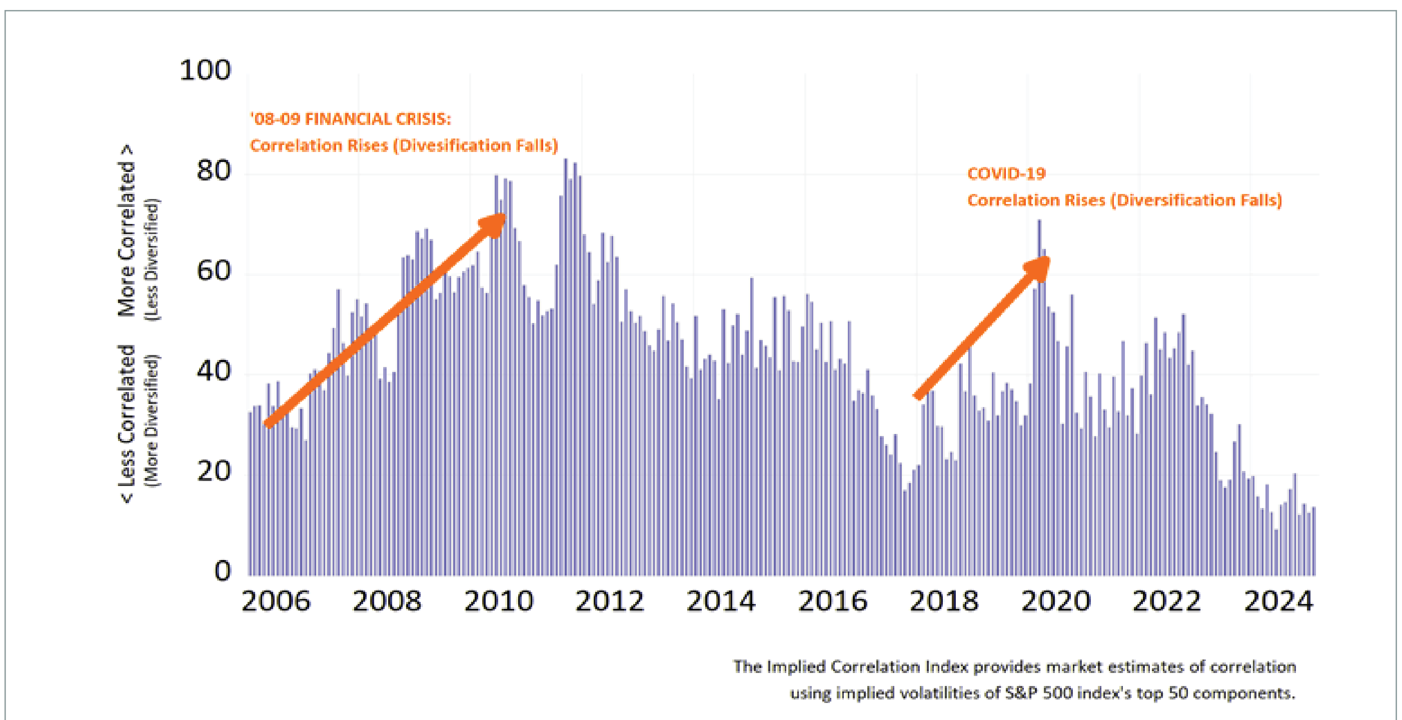



**CHART C | DIVERSIFICATION WITHIN THE S&P 500 OVER TIME** Source: Bloomberg, CBOE



# CONCLUSION

## CONCENTRATION AS A STRATEGY FOR SUCCESS

A well-designed portfolio is not one that holds more investments—it is one that holds the right investments. By concentrating on high-quality companies, we seek three key objectives:

- Downside protection in bear markets
- Solid risk-adjusted returns over time
- A growing, dependable stream of income

Diversification can dilute these benefits and introduce risks that remain hidden until market sentiment shifts. Rather than diversify for its own sake, we focus on companies that we believe can withstand both bull and bear markets.

Just as an elite sports team prioritizes top talent over arbitrary balance, we prioritize quality over-diversification. The result? A strategy that is designed to be resilient, consistent, and reliable—attributes needed to navigate both good times and bad.

**IMPORTANT DISCLOSURES**

Standard & Poor's 500 Index (S&P 500) is a capitalization-weighted index that is generally considered representative of the U.S. large capitalization market.

The S&P 500 Growth measures constituents from the S&P 500 that are classified as growth stocks based on three factors: sales growth, the ratio of earnings change to price, and momentum.

The Washington Crossing Advisors' High Quality Index and Low Quality Index consist of the largest 1,000 U.S. stocks by market capitalization. After these stocks are determined, each one is assigned a letter grade (A, B, C, D, F) based on consistency (earnings and stock price volatility), leverage (debt/enterprise value), and profitability (return on assets). Companies that are assigned an A or B rating will be included in the High Quality Index, while companies with C, D, and F ratings are included in the Low Quality Index.

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Beta is a measure of the volatility, or systematic risk, of a security or a portfolio relative to the market as a whole. A beta of one is considered as risky as the benchmark and is therefore likely to provide expected returns approximate to those of the benchmark during both up and down periods. A portfolio with a beta of two would move approximately twice as much as the benchmark.

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