How Fundamental Strategies Can Help Diversify Your Portfolio

Fundamental and market-cap strategies can complement one another—adding another layer of diversification to your portfolio.

We’ve found that combining market-cap and fundamental strategies may provide better risk-adjusted results and a smoother ride for investors. Here’s why.

Performance during market cycles

Market-cap and fundamental strategies perform differently in the various market cycles. Market-cap strategies’ large-cap bias means they are likely to flourish when the biggest companies are outperforming the overall market. On the other hand, fundamental strategies weight securities based on economic factors. Therefore, they tend to outperform in value cycles, where value stocks outperform growth stocks, and in markets where there’s a broadening of market leadership, that is, less dependence on the biggest companies.

Apple Effect

Because of its large weight, Apple helped the Russell 1000® Index when the stock was rising. Conversely, Apple hurt the Russell 1000 Index when the stock was falling.

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Key Points

• Fundamental and market-cap strategies can be effective complements in a portfolio as they tend to perform differently during market cycles.
• Market-cap strategies tend to flourish when the biggest companies are outperforming the overall market.
• Fundamental strategies tend to outperform in value-driven markets.
To illustrate this point, let’s focus on Apple. Apple was the darling of Wall Street, introducing a constant stream of innovative products, ultimately becoming the largest company by market capitalization in the United States. As the data on the previous page reflects, through the first three quarters of 2012, Apple was up 65.42% and was the largest company in the Russell 1000® Index (~4%). Due in part to Apple’s extraordinary performance and large weight in the index, the Russell 1000 Index outperformed the Russell Fundamental U.S. Large Company Index (16.28% vs. 15.13%) over this time period.

Then Apple fell 39.54% from the end of the third quarter 2012 to the end of the second quarter 2013. During this period, the Russell Fundamental U.S. Large Company Index outperformed the Russell 1000 Index (17.94% vs. 14.04%). The Apple effect helped the market-cap index because of Apple’s large weight when it was rising but hurt the market-cap index when it was falling.

**Overall performance to date**

The Russell Fundamental U.S. Large Company Index has outperformed the Russell 1000 Index over its limited existence. As you can see in the table to the right, the Russell Fundamental U.S. Large Company Index outperformed the Russell 1000 Index (15.85% vs. 14.96%) with roughly the same standard deviation or risk (12.74% vs. 12.72%) from March 1, 2011, to December 31, 2013.

**Important Disclosures**

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Past performance is no guarantee of future results.

Investment returns will fluctuate and are subject to market volatility, so that an investor’s shares, when redeemed or sold, may be worth more or less than their original cost. Unlike mutual funds, shares of ETFs are bought and sold at market price, which may be higher or lower than the net asset value (NAV).

Diversification strategies do not ensure a profit and do not protect against losses in declining markets.

The information provided here is for general informational purposes only and should not be considered an individualized recommendation or personalized investment advice. The investment strategies mentioned here may not be suitable for everyone. Each investor needs to review an investment strategy for his or her own particular situation before making any investment decision.

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The Russell 1000® Index measures the performance of the large-cap segment of the U.S. equity universe. It is a subset of the Russell 3000® Index and includes approximately 1,000 of the largest securities based on a combination of their market cap and current index membership.

The Russell Fundamental U.S. Large Company Index ranks companies in the Russell 3000® Index by fundamental measures of size and tracks the performance of those companies whose fundamental scores are in the top 87.5% of the Russell 3000® Index. The index uses a partial quarterly reconstitution methodology in which the index is split into four equal segments at the annual reconstitution, and each segment is then rebalanced on a rolling quarterly basis. Performance includes reinvestment of dividends.

The Russell 3000® Index measures the performance of the largest 3,000 U.S. companies, representing approximately 98% of the investable U.S. equity market.

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**Bottom line**

With the introduction of fundamental strategies, investors now have more choices in selecting market segments. We believe that fundamental strategies are an important complement to market-cap strategies—helping build more durable portfolios with increased diversification.

**Risk/Return**

The Russell Fundamental U.S. Large Company Index has outperformed the Russell 1000 Index with roughly the same amount of risk since inception.

**Source:** Morningstar Direct from March 1, 2011, to December 31, 2013.