



American Century
Investments®

Economic Uncertainty and Effective Diversification



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One of the distinguishing benefits for quantitatively based investing is that it results in an extremely well-diversified portfolio. And with today's highly uncertain economic, market, and investment environments, broad and effective diversification is especially important to minimize risk while maximizing expected returns.

Directional Uncertainty

The current economic environment presents investors with a number of challenges. One of these is an unusual degree of macroeconomic uncertainty. In most situations, we understand where we are in an economic cycle—for example, a growth phase—but we have to deal with the uncertainties of whether growth will be 2% or 3.5% (for example) for the next quarter and how long the growth phase will continue. Today, we find ourselves in an economic environment where the uncertainty is not just what the rate of inflation will be in the coming year but whether there will be inflation or potentially deflation. The same is true for whether the current recovery will continue or possibly lapse into a new downturn. This kind of directional uncertainty is reflected in higher-than-average market volatility along with sudden changes in market sentiment and direction as each piece of new information regarding the economic outlook is released.

In this current environment, it is especially important to diversify broadly and understand the exact nature of the diversification a portfolio exhibits, although diversification does not assure a profit or protect against loss in a declining market. This goes beyond how many companies are held and how much unsystematic risk exposure may be present. It also incorporates an understanding of portfolio diversification and exposure by sector and industry—as these will respond very differently to directional changes in the economic outlook—and relative exposure to investment styles such as momentum and value. These style factors and the companies that most reflect them will also perform very differently with directional macroeconomic changes.

Quantitative Investing and Diversification

Quantitative investing does a very good job of achieving broad and effective diversification because of the analytical tools and techniques it employs. Because it relies more on analytical tools such as company screens and factor analysis, it can employ a much broader investment universe as a starting point for stock selection. And for this same reason, it can effectively manage and monitor a larger portfolio of company stocks. With fundamental analysis, portfolio size is often limited by managers' and analysts' abilities to stay on top of each company in terms of its current status and financial outlook as forecasts and fortunes change.

Quantitative investing—by its nature—has always been among the first investment disciplines to embrace new approaches to risk management (such as risk factor analysis based on exposure to common characteristics such as size, or value versus momentum as noted above). Additionally, quantitative investing normally includes sophisticated portfolio optimization techniques in the final stages of stock selection and portfolio construction where the impact of each stock (and its relative weight) on overall portfolio risk and return characteristics is evaluated.

With higher uncertainty and market volatility, a highly disciplined and systematic investment methodology and philosophy becomes even more important. And quantitative investing, by the very nature of its systematic, technical, logic-driven, and consistent set of rules, offers an excellent approach for achieving this kind of discipline.