CIBC ASSET MANAGEMENT

GUIDE TO PORTFOLIO CONSTRUCTION

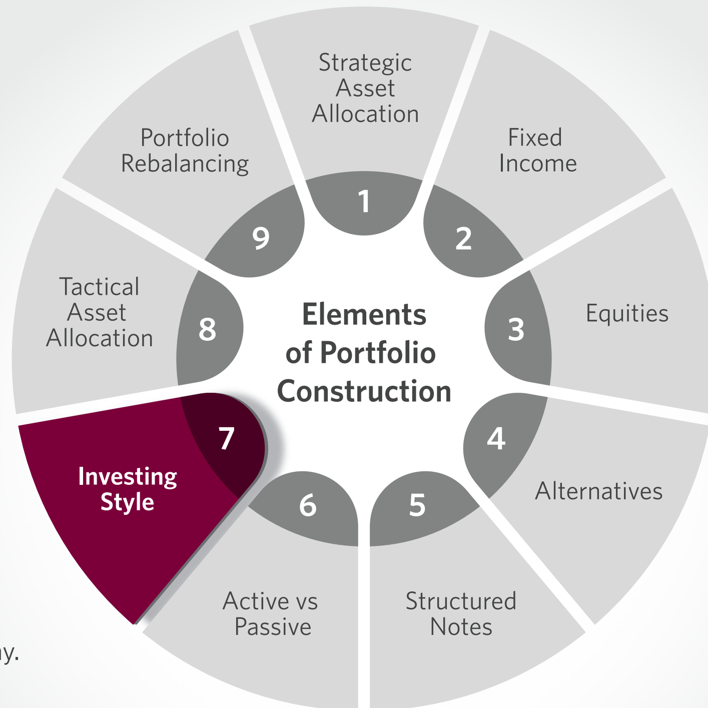
The role of style diversification

Guide to portfolio construction

Market and economic uncertainty, combined with relatively low expected returns for many asset classes, are making it harder for individuals and institutions to reach their financial goals. A thoughtfully designed portfolio that helps you embrace market opportunities while preparing for the unexpected has never been more important.

There are several components of a well-constructed portfolio, including a robust strategic asset allocation that's consistent with your long-term goals and objectives. A mix of asset classes such as equities, fixed income and alternatives, and strategies such as tactical asset allocation, active versus passive investing, and portfolio rebalancing all have a role to play.

This guide highlights how investing style can help improve portfolio performance and smooth the path to achieving your ambitions.



Investing style—Combine styles to help smooth your portfolio returns

All investors—from individual investors to professional money managers—have their own style that reflects their investment philosophy and objectives. While a particular style can outperform the broad benchmark in certain periods, forecasting when a style will be in or out of favour can be difficult. Investors should be aware of specific style (factor) risks and look beyond a single style concentration in equity portfolios.

Explore this guide to learn more about investing style

- What is investing style?
- Diversifying across styles
- Value vs. growth investing
- Regional style diversification

What is investing style?

Investment style is the philosophy used to tilt portfolios towards certain factors or characteristics. There are a number of well-established equity classifications based on these characteristics including value, yield, growth, quality, core, momentum and market capitalization styles (e.g. small-cap or large-cap). Each style differs in its performance pattern relative to broader benchmarks, which have traditionally been comprised of a blend of various styles.

The typical characteristics for equities within each style include:

Value	• Above-average tangible assets • Below-average market value, earnings, cash flow and sales growth
Growth	• Above-average earnings, sales growth and forward price-earnings (P/E) ratio • Below-average price-to-book and dividend yields
Quality	• Stable returns, sales, earnings and cash flows • High market share within their industry • Strong management and capital efficiency
Momentum	• Higher returns over the past 3 to 12 months vs. other names in the universe
Small cap	• Market capitalization between $300 million and $2 billion • Tend to outperform in periods of economic recovery from recessions

There are two main views that help explain the difference in performance between different equity investment styles:

1. **Efficient market theory:** This theory states that riskier assets should provide a return premium in the long run. Value investors believe that companies trading at cheaper valuations (i.e. value stocks) or small-cap companies with unproven market positions or business models should earn a premium because of their greater inherent investment risks.
2. **Behavioural finance theory:** This theory states that returns are driven by behavioural elements such as momentum trading (concentrating on stocks with accelerating price appreciation), or investor tendencies such as overvaluing new or glamourous innovations, geographic biases, chasing winners, overconfidence, etc. These investment decisions, based on things other than financial fundamentals, result in some investing styles that will underperform at different periods in time.

Diversifying across styles

At CIBC Asset Management, we believe the foundation of long-term outperformance comes from combining multiple styles and factors in each asset class and geographic area. A rotation between styles, where a particular style or factor may outperform over a given time period (Figure 1), is common. As a result, limiting a portfolio to a certain style can limit the return potential of a portfolio over the long run.

Quality, momentum, growth and value investments have all outperformed or underperformed at different times in the investment cycle. For example, while factors within growth, momentum or small cap typically outperform during periods of recovery, quality factors tend to do well during market drawdowns. By optimally diversifying across style factors, investors can smooth out significant downturns and volatility during each market cycle.

Figure 1 – Historical performance of six global equity investment styles

2022	2021	2020	2019	2018	2017	2016	2015	2014	2013
High Dividend -4.7%	Quality 25.7%	Growth 33.8%	Quality 36.1%	Momentum -2.8%	Momentum 32.1%	Small Cap 12.7%	Momentum 4.1%	Quality 8.4%	Small Cap 32.4%
Value -6.5%	Value 21.9%	Momentum 28.3%	Growth 33.7%	Quality -5.5%	Growth 28.0%	Value 12.3%	Quality 3.7%	Momentum 6.5%	Momentum 29.7%
Momentum -17.8%	MSCI World 21.8%	Quality 22.2%	Momentum 27.7%	Growth -6.7%	Quality 26.0%	High Dividend 9.3%	Growth 3.1%	Growth 6.1%	Quality 27.1%
MSCI World -18.1%	Growth 21.2%	Small Cap 16.0%	MSCI World 27.7%	High Dividend -7.6%	Small Cap 22.7%	MSCI World 7.5%	Small Cap -0.3%	MSCI World 4.9%	Growth 26.7%
Small Cap -18.8%	High Dividend 15.8%	MSCI World 15.9%	Small Cap 26.2%	MSCI World -8.7%	MSCI World 22.4%	Quality 4.6%	MSCI World -0.9%	Value 3.7%	MSCI World 26.7%
Quality 22.2%	Small Cap 15.8%	High Dividend 0.0%	High Dividend 23.2%	Value -10.8%	High Dividend 18.1%	Momentum 4.2%	High Dividend -3.2%	High Dividend 2.5%	Value 26.6%
Growth -29.2%	Momentum 14.6%	Value -1.2%	Value 21.7%	Small Cap -13.9%	Value 17.1%	Growth 2.8%	Value -4.8%	Small Cap 1.9%	High Dividend 21.9%

Source: Bloomberg, as of December 31, 2022. Annualized monthly returns are in $USD based on the following indices: Quality: MSCI World Quality Index; Momentum: MSCI World Momentum Index; Value: MSCI World Value Index; Growth: MSCI World Growth Index; High Dividend: MSCI World High Dividend Yield Index; Small Cap: MSCI World Small Cap Index; MSCI World: MSCI World Index.

Value vs. growth investing

Growth and value are the two most common equity style classifications. They offer different advantages and historical periods of outperformance.

Value

- Value investors focus on stocks with **lower valuation characteristics**. These are typically equities with below-average price-to-book multiples (a company's market value compared to its book value). Value companies typically own more tangible assets than their growth counterparts. Consequently, they have less flexibility when attempting to adapt to unfavourable environments[1].
- Value investors believe that investing in undervalued stocks carries more risk than investing in the broader market. As such, for stocks with lower multiples, the value premium exists as **compensation for higher real or perceived risk**.
- The behavioural finance rationale for a value stock premium over the long run is investors' tendency to overreact to unfavourable company news for low-multiple stocks. As a result, these stocks can at times trade relatively cheap versus their long-term value.

Growth

- Growth names are characterized by **high forward-looking earnings growth** and a greater focus on dividend reinvestment into future growth opportunities. Investors are willing to pay for high price-to-earnings multiples with the expectation of selling at even higher prices as the company continues to grow.
- While growth names are **expected to outperform during growth periods**, the COVID-19 recession amplified existing structural changes in the economy. This led to growth materially outperforming in 2020. This is an example of how growth companies are positioned to take advantage of technology advances or disruptive trends, regardless of economic conditions.

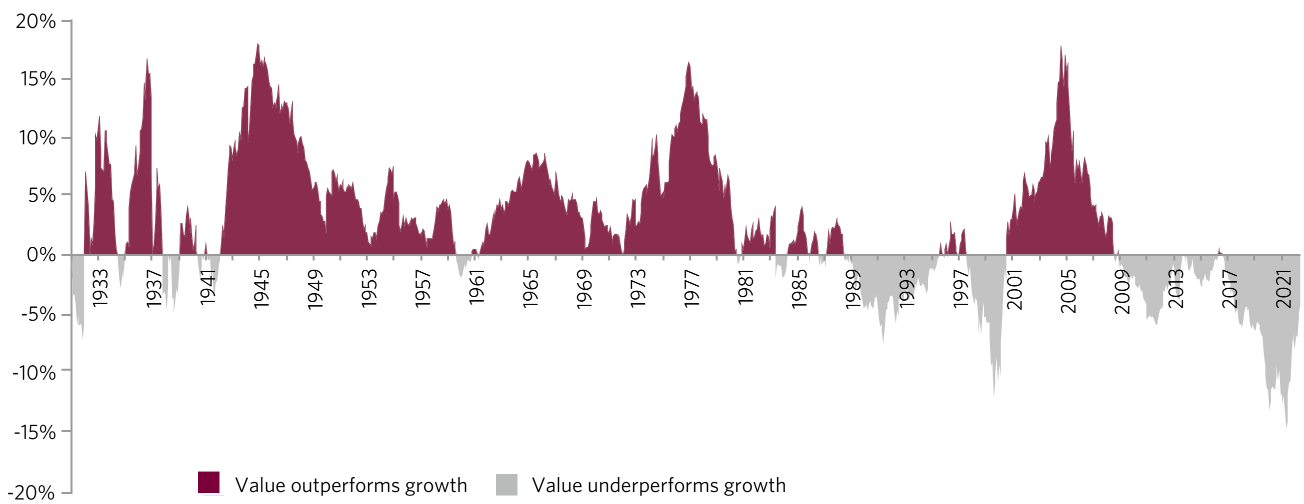
The long-term relative performance of value vs. growth investing further supports our view that portfolios should be balanced across factors and styles to avoid longer-term periods of underperformance over the entire market cycle.

[1] The Value Premium, Lu Zhang, July 2005; New Facts in FInance, John Cochrane, Jul 2000.

Long-term performance data shows that value had a long period of outperformance in the last century until growth stocks took the lead in the 1990s. Value stocks pulled ahead again after the tech bubble burst in 2000, but since the 2008 Global Financial Crisis value stocks have been at a disadvantage (Figure 2).

In particular, the COVID-19 crisis exacerbated structural changes that have benefited many growth stocks. In addition to the impact of COVID-19, low interest rates have created an environment where growth opportunities are cheaper to pursue. The decade-long growth outperformance has also resulted in a large valuation gap between value and growth stocks. This leads us to reaffirm our investment principle that being overly concentrated in one style can result in considerable long-term underperformance.

Figure 2 – Historical performance of value vs. growth (5-year rolling returns)



Source: Bloomberg, as of December 31, 2022. The value style is proxied by the Russell 1000 Value Index (Jan 1, 1983- December 31, 2021) backfilled by the Fama and French Value Factor (Jan 1, 1931 – December 31, 1983). The growth style is proxied by the Russell 1000 Growth Index (Jan 1, 1983- December 31, 2020) backfilled by the Fama and French Growth Factor (Jan 1, 1931 – December 31, 1983).

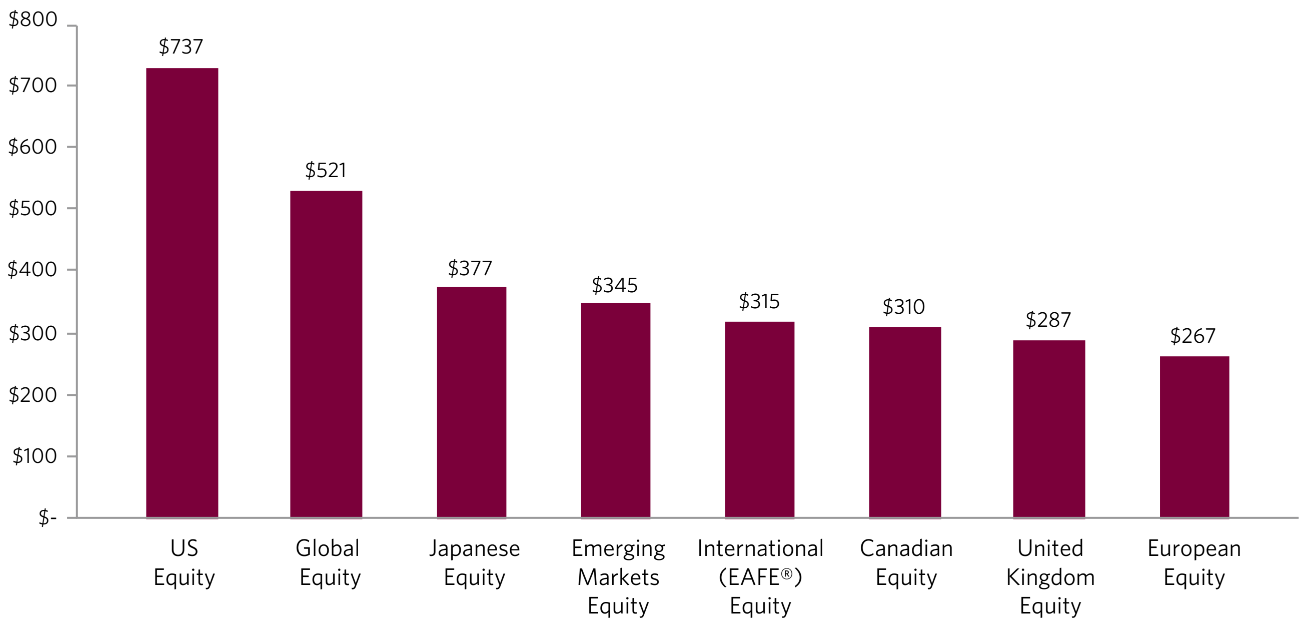
Regional style diversification

Value and growth diversification can also be viewed through the lens of geographic diversification, as certain global equity indices are tilted towards specific styles. For example:

- **European, Canadian or Japanese** broader market indices are considered value focused. This is due to the overconcentration of these markets in value-oriented sectors such as energy, financials and industrials.
- **U.S. and emerging market (EM)** equity indices are considered more growth-leaning, due to the dominance of the technology and consumer discretionary sectors in those markets.

From this perspective, the benefits of sector neutrality suggest that a greater focus on country diversification is a prudent risk management strategy. Style neutrality and reduced portfolio risk are achieved through measured exposure to both value-tilted (Canada and international) and growth-oriented markets (U.S. and EM). Figure 3 shows that, since the Global Financial Crisis, the accelerated growth of the technology sector within the U.S. has contributed to this country outperforming other developed countries.

Figure 3 – Growth of $100 (CAD) invested post Global Financial Crisis



Source: Bloomberg, as of March 1, 2009- December 31, 2022. Returns are based on the following indices: Canadian Equity: S&P/TSX Composite Index (CAD); Global: MSCI World Index (CAD); International: MSCI EAFE® Index (CAD) EM: MSCI Emerging Markets Index (CAD) US: S&P 500 Index (CAD); European: Euro Stoxx 50 Index; Japan: Nikkei 225 Index; UK: FTSE 100 Index. EAFE is a registered trademark of MSCI Inc., used under license.

Key investing style considerations:

- The long-term return potential of your portfolio could be limited if the portfolio is narrowly confined to a particular style.
- Style diversification can help you smooth out the significant downturns and volatility that may occur in your portfolio during market cycles.

Let’s partner on your portfolio construction

Changing market conditions don’t change your goals, whether it’s saving for a home, a child’s education or investing for retirement. Careful portfolio construction that helps you embrace market opportunities while preparing for the unexpected has never been more important.

Your CIBC advisor can help you develop a targeted investment approach using the multi-asset solutions that work best for you.

Contact us today to tailor your portfolio and help you get where you want to be.

To learn more, contact your CIBC advisor.

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