A closer look at the 2016 rally in financials

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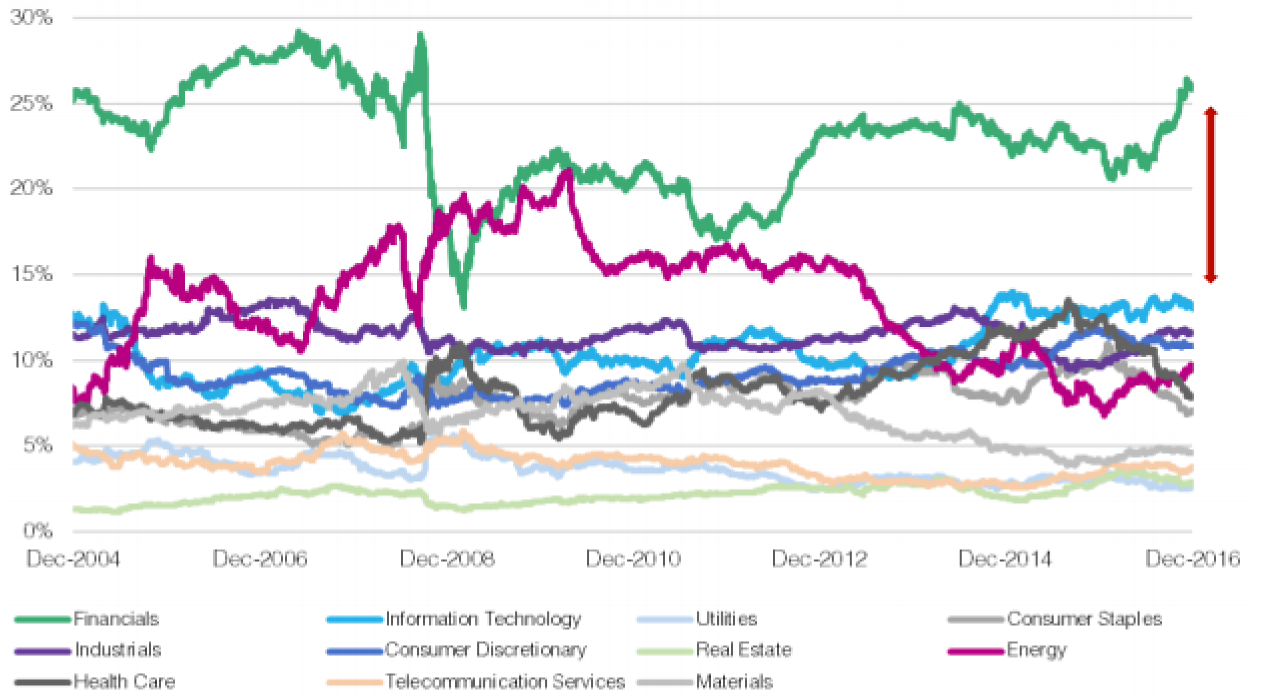
New research out from $9 billion, French asset manager TOBAM suggests that the rally in financials during the second half of 2016 may be an example of index concentration putting more pressure on passive products than investors realize.

According to a research note from TOBAM founder Yves Choueifaty, during the rally, financial sector concentrations in the MSCI index hit levels that actually increased risk exposure and decreased overall diversification within the index. "What happens is the index encourages investors to buy when the asset class is the most expensive," Choueifaty, explains in an interview with Opalesque. "What we want to point out is that when you buy a market cap weighted index you aren't actually buying as much diversity as you might expect."

Choueifaty notes that over time the MSCI index universe has become more correlated, a development which could be worrying if you aren't consistently bullish or assume that there is some level of downside protection in the perceived diversity of the broad index.

The image below shows how those correlations have grown closer over time:

Figure 7: MSCI World Weight by sector time intra and inter correlations:



* Source: TOBAM. The weight of the MSCI World by sector is multiplied by both the intra and inter correlations.

Choueifaty says that the correlations outlined above haven't been seen since 2008 and may be a cause for concern. "Financials are the most highly correlated sector to the rest of the market and they are now very expensive. Buying the index after December 2016 is effectively taking a view that they will continue to go up because the index is concentrated around this sector. We want to point that out because investors need to understand that being passive isn't actually the same as being neutral."

The data findings of this research note also shed a little light on the underperformance of active managers in the second half of 2016. Active managers typically avoid the most expensive sectors of the market at any given time because of their limited upside growth potential. Looking back, Choueifaty notes that many active managers were heavily weighted to sectors that were further out on the yield curve like utilities. Utilities had a lower correlation to the index but also arguably has more upside potential.

"This is the problem with the argument that you can't beat the index. Of course if the biggest sector in the index - financials - goes up significantly, the index will beat you if you are underweight financials. But financials won't go up indefinitely," Choueifaty says.