Rethinking Diversification

Beyond Asset Allocation to Investment Process

Executive Summary of a Comprehensive White Paper

Dr Steven J. Bates and John Bennett, Future Index Partners Ltd.

1. Diversification is Essential but Often Imperfect

Diversification is a foundational principle of portfolio construction. In practice, it is typically implemented through a combination of asset classes, regions, and investment styles.

While this approach is well established, it primarily defines **what is held**, rather than **how investment decisions are made**.

Modern portfolios continue to face structural challenges. Market concentration leads to hidden fragility, with a small number of companies driving a large share of market returns. At the same time, adjusting exposures is inherently difficult. Reducing positions introduces timing risk, while maintaining them increases vulnerability to reversal.

These challenges are compounded by investor behaviour. Periods of volatility and drawdown often lead to reactive decision-making, undermining long-term outcomes.

This raises a broader question: *Should diversification extend beyond assets to include the investment process itself?*

2. The Approach: A Rules-Based Framework

This summary paper explores a rules-based or systematic approach to equity sector allocation based on relative momentum.

Rather than forecasting future returns, the process evaluates sectors based on observed relative price behaviour. Capital is then allocated towards stronger sectors and away from weaker ones.

The framework follows a transparent and repeatable process:

- Define a broad sector universe and rank sectors based on relative momentum
- Select higher-ranked sectors and weight according to relative strength
- Rebalance at regular intervals and publish the strategy as a replicable index.

The portfolio remains fully invested in equities and operates within a benchmark-aware structure. Decisions are governed by predefined rules, removing the need for discretionary judgement, which is particularly important during periods of market stress.

3. Portfolio Relevance: Diversifying Process, Not Just Assets

This approach is best understood as a complementary building block within a broader portfolio.

Traditional diversification combines assets and managers but often relies on discretionary decision-making within each allocation. A systematic framework embeds discipline directly into the investment process thus diversifying outcomes over time.

In practice, this provides a structured and repeatable way to:

- Adjust exposure as sector leadership evolves, not predictive but reactive
- Maintain or increase participation in areas of relative strength
- Reduce allocation to, or exit from, persistently weaker sectors
- Consistently apply a set of predefined rules without the need for forecasting.

By focusing on process rather than prediction, the approach aims to help portfolios adapt to changing conditions while reducing reliance on subjective timing decisions.

4. Evidence Reviewed: Long-Term Behaviour and Characteristics

The behaviour of a systematic sector rotation approach is best evaluated over long time horizons and across different market environments.

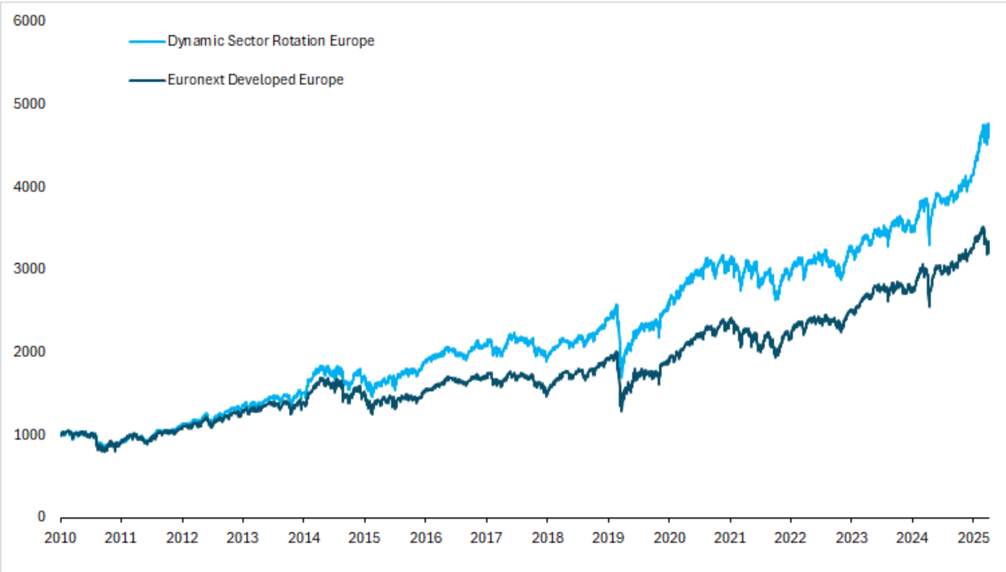

Figure 1: Strategy performance versus the benchmark, as of 31st March, source Euronext, Bloomberg FIPSRDEE

Figure 1 illustrates the long-term performance of the strategy relative to a broad European equity benchmark, combining a 15-year backtest with recent live data. The strategy has been running out-of-sample since the start of 2026. The performance reflects sustained participation in rising markets, with periods of divergence as the strategy adjusts to changing sector leadership.

Table 1 below summarises key characteristics observed over the test and recent live periods:

- Annualised excess return of over 2.5% and a return-based alpha of 3.3%
- Volatility at the same level as the benchmark
- Beta below one, indicating moderated market sensitivity
- Tracking error consistent with the target of moderately dynamic allocation
- Comparable maximum drawdown in this test with evidence of a stronger recovery phase. Further testing discussed in the full White Paper shows evidence for consistently lower drawdowns and improved recovery statistics in other crises.

These results should be understood as long-term statistical properties derived from systematic application across time, rather than point estimates or forecasts.

Metric	FIP Dynamic Sector Rotation Europe	Euronext Developed Europe
Annualized return	10.69%	8.03%
Volatility	15.74%	16.18%
Max Drawdown	-34.25%	-35.20%
Tracking error	5.23%	
Sharpe ratio	0.63	0.46
Beta	0.92	
Alpha	3.30%	
Information ratio	0.63	
YTD return	12.26%	-1.29%
1Y return	23.21%	9.84%
3Y return	56.42%	40.39%
5Y return	68.26%	57.75%
10Y return	189.77%	131.56%

Table 1: Key statistics as of 31st March 2026, source Euronext

5. Interpretation: Behaviour Over Prediction

The observed outcomes are consistent with the underlying design of the process. Rather than predicting precise turning points, the approach focuses on:

- **Participation** in sustained periods of relative strength
- **Avoidance** of persistently underperforming sectors
- **Adaptation** as leadership rotates across sectors.

This leads to a return profile characterised by asymmetry, where positive periods have tended to be both larger in magnitude and more frequent than negative periods over rolling horizons. On an annual basis, the strategy also consistently holds greater weights in leading sectors than in laggards.

The effectiveness of the approach is closely linked to performance dispersion. When differences in sector performance are more pronounced, the opportunity for relative allocation increases, providing a practical framework for understanding when the strategy has been more effective without relying on predictive assumptions.

This has been particularly evident in the recent live period in early 2026, where the strategy delivered double-digit positive performance against a negative benchmark.

6. Conclusion: Extending Diversification Through Process

Diversification remains a central principle of investing. However, in practice it is often limited to combining different assets, regions, and managers.

A systematic, rules-based approach to sector allocation offers an elegant way to extend diversification to the decision-making process itself.

By applying a consistent framework based on observed market behaviour, the approach provides a structured mechanism to adjust exposures as conditions change. It does not seek to replace existing portfolio components, but to complement them by introducing a different form of diversification, one grounded in discipline rather than discretion.

The full White Paper and associated presentations explore the methodology, behavioural foundations, and empirical evidence in greater depth. Contact us for more information.