

Diversify your diversifiers

by Alex Harvey, CFA

Genghis Khan is considered by many to be perhaps the greatest conqueror of all time (sorry, Guillaume de Normandie), and ruled over an empire that at its peak spanned as far west as modern-day Poland and as far east as the Russian Pacific seaboard. Mongolia today is a 'fraction' of that size but still in the world's top 20 largest countries and would knock Kazakhstan down into 10th place if you included the Mongolic autonomous region of the People's Republic of China¹. As the least densely populated country in the world it fits the population of Wales into a land mass the size of Western Europe. It's that empty.

I was fortunate to have visited this beautiful landlocked country three years ago and journey overland through the Gobi desert and beyond. As is customary we travelled in a convoy, not because we were important (far from it!) but because if you break down out there, no one is going to find you. The lack of mobile reception was part of the 'Detox draw' but with that comes no search and rescue. That 10yr old land cruiser might have served you well in the past but it can still go wrong (and it did). In the vast empty Mongolian plains, you need a back-up plan.

The same can be said for modern portfolio design. For years investors have relied on the classic '60/40' portfolio (consisting of 60% equities and 40% bonds) which has provided investors a handsome return – and diversification – through the great 30-year bond bull market. Going forward however the maths just doesn't stack up; a 30 year annualised return of 5.2% but a yield today of sub 1%². As we see increasingly these days bonds are not the antidote to a sell off in equities, they can be the cause. Recent wobbles in equity markets have followed moves higher in bond yields and some of the most sensitive names to this creep higher are the growthier tech companies whose future earnings growth feels the negative effect of a higher discount rate more acutely. With a handful of these 'FAANG'ier³ type names driving index performance due to their size and concentration, it is unsurprising that the rate effect has become more pronounced.

Indeed, it was arguably ever lower rates that helped lift the information technology sector weight, within the US equity market, to its post 2001 TMT highs in the first place. At 0.34⁴ the three-month bond – equity correlation is currently at its highest level for over five years, having only briefly been higher in the last twenty. 'Correlation does not imply causation' goes the saying but the effect is evident today. Add to this several testing liquidity episodes in the last few years for US Treasuries, the world's most liquid 'risk free' asset, and investors would be wise to hedge their diversification bets.

At Momentum we have long advocated embedding a truly multi asset exposure into client portfolios and funds. Our multi asset, multi style and multi manager approach builds in additional diversification levers that help to smooth the investment journey that we create for our clients. Credit, convertibles, inflation linked bonds, infrastructure, property, gold and alternatives are among the asset classes we use to build portfolios, whilst value, quality and growth exposure provides style diversification. Our modelling shows that over the last 20 years a broad strategic asset allocation increases the diversification benefits of a 60/40 portfolio by over 70%⁵. Some currency exposure is naturally embedded within both allocations but an explicit exposure to a perceived haven currency like the Japanese Yen could further improve the portfolio effect. The inflated returns from DM sovereign bonds in recent decades may give false comfort to those banking on the same for the future. Yes, bonds are an important part of a multi asset portfolio but today arguably provide more of a 'return free risk' than a 'risk free return'. By diversifying your diversifiers you can reduce your risk of coming unstuck in the proverbial investment desert.

1 Source: Wikipedia

2 Source: JP Morgan Global Government Bond index

3 The FAANG index refers to Facebook, Amazon, Apple, Netflix and Google. They represent 17.4% of the S&P500 index by market value today

4 MGIM

5 The diversification benefit for a multi asset portfolio was 2.6% compared to 1.5% for a risk equivalent global 60/40 portfolio



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