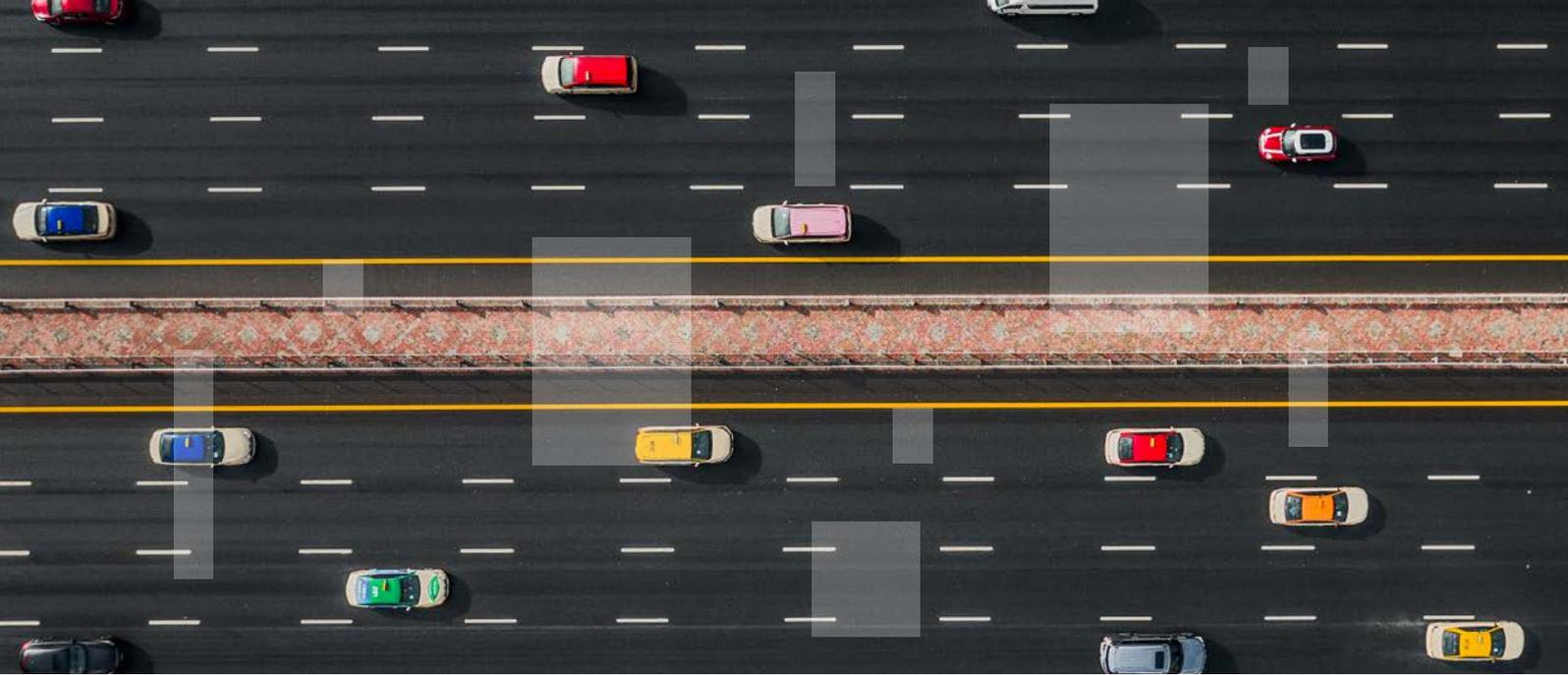


Keep calm and diversify





Many investors have built diversified investment portfolios with the aims of generating returns without too much volatility, and of limiting the downside in falling equity markets. They should understand from the start that when any one asset class is performing extremely well, the diversified portfolio is unlikely to keep pace, and the investor is likely to regret, to some degree, at least that they reduced their exposure to that asset class in favour of greater diversification.

Very unusually both equity and bond markets have delivered excellent returns over the last ten years. In fact, as illustrated by *Figure 1* below, the last two rolling 10-year periods have been periods of exceptional performance for a 60/40 equity/bond portfolio.

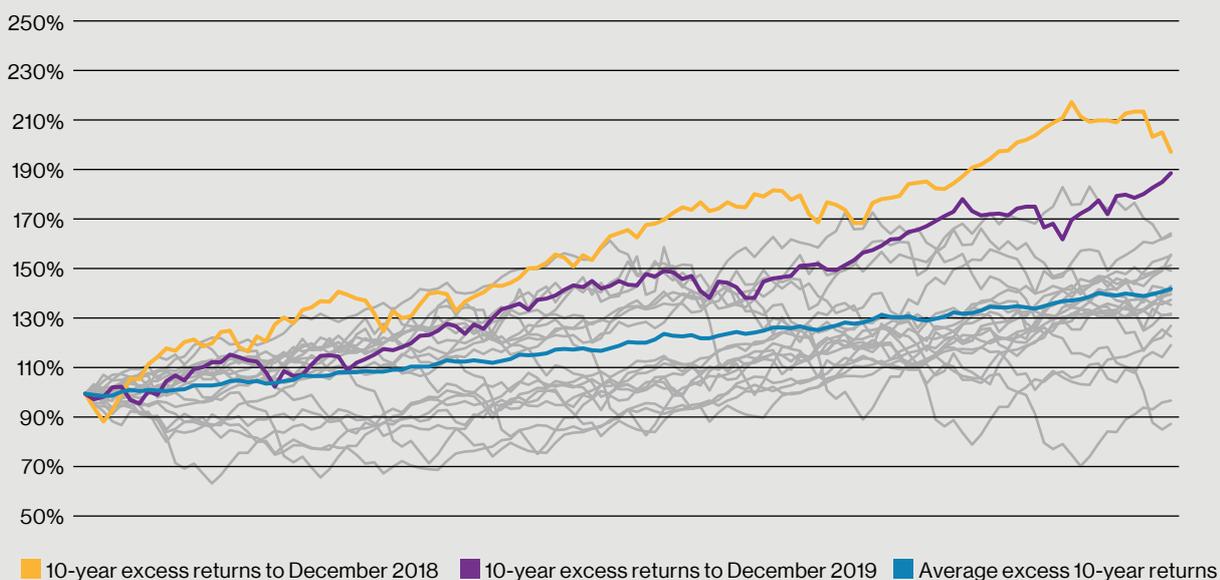
This performance, and the environment that allowed it to occur, must test the patience of investors and portfolio managers alike when it comes to diversification.

It is difficult to believe, however, that the next 10-year period will look similar to the period that has just gone, and this may be the worst time to change approach.

Diversification offers 'insurance' against getting it wrong (which is arguably the most likely outcome) and, unlike your home insurance, it is an insurance that offers a positive return.

Taking an even longer-term view – looking back over the last 300 years, equities and bonds are close to all time historic levels of returns.

Figure 1. 60/40 reference portfolio 10 year rolling returns in excess of cash (1990-2019)



Notes: Performance data sourced from eVestment, 31 December 2019.

Reference portfolio is comprised of 60% MSCI ACWI and 40% Barclays Global Aggregate Index, both in USD. Cash is USD 3 month LIBOR.

But what is diversification?

In our opinion, most institutional portfolios are dominated by equity risk and almost all are dominated by corporate cash flow risk; risks that have been very well rewarded in the last ten years. We believe investors will be better served going forwards by building robust portfolios that exploit a range of return drivers such that no single risk dominates performance.

True diversification is achieved by investing in strategies that have varying levels of correlation to traditional asset classes and in some instances have none. Equity and corporate credit risk can be reduced in favour of other return drivers such as illiquidity premium, skill premium and diversifying strategies which should result in a more efficient portfolio, generating a higher return for a given level of risk.

Diversifying strategies have a low correlation by design...

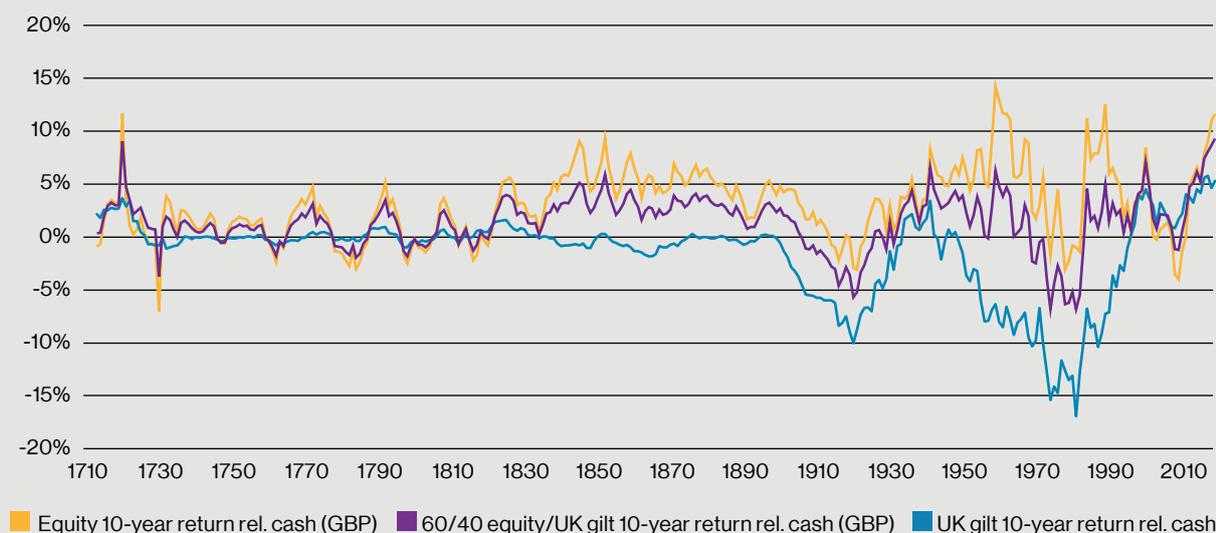
Many diversifying asset classes have their roots in the hedge fund industry and it is no secret that this asset class as a whole has found market conditions challenging over the past decade while volatility and price dispersion has been low. Whilst disappointing, we have taken this

opportunity to negotiate lower fees and isolate the activities in this area that we think are most likely to add value. As market conditions change, we expect these investments to produce stronger returns over the next 10 years compared to the last 10 years.

Unsurprisingly, genuinely diversified portfolios will lag equities when these perform exceptionally well, but of course the opposite is true in that these have a significant advantage if equity markets were to crash, something we remain very cautious about in the late market cycle we find ourselves in. Diversifiers, which generate their returns independent of traditional asset classes, should fare much better than most. Historically this has been true as evidenced by the fact that hedge funds (measured by the HFRI Fund Weighted Composite) have outperformed equities by 35% in the last five US recessions.

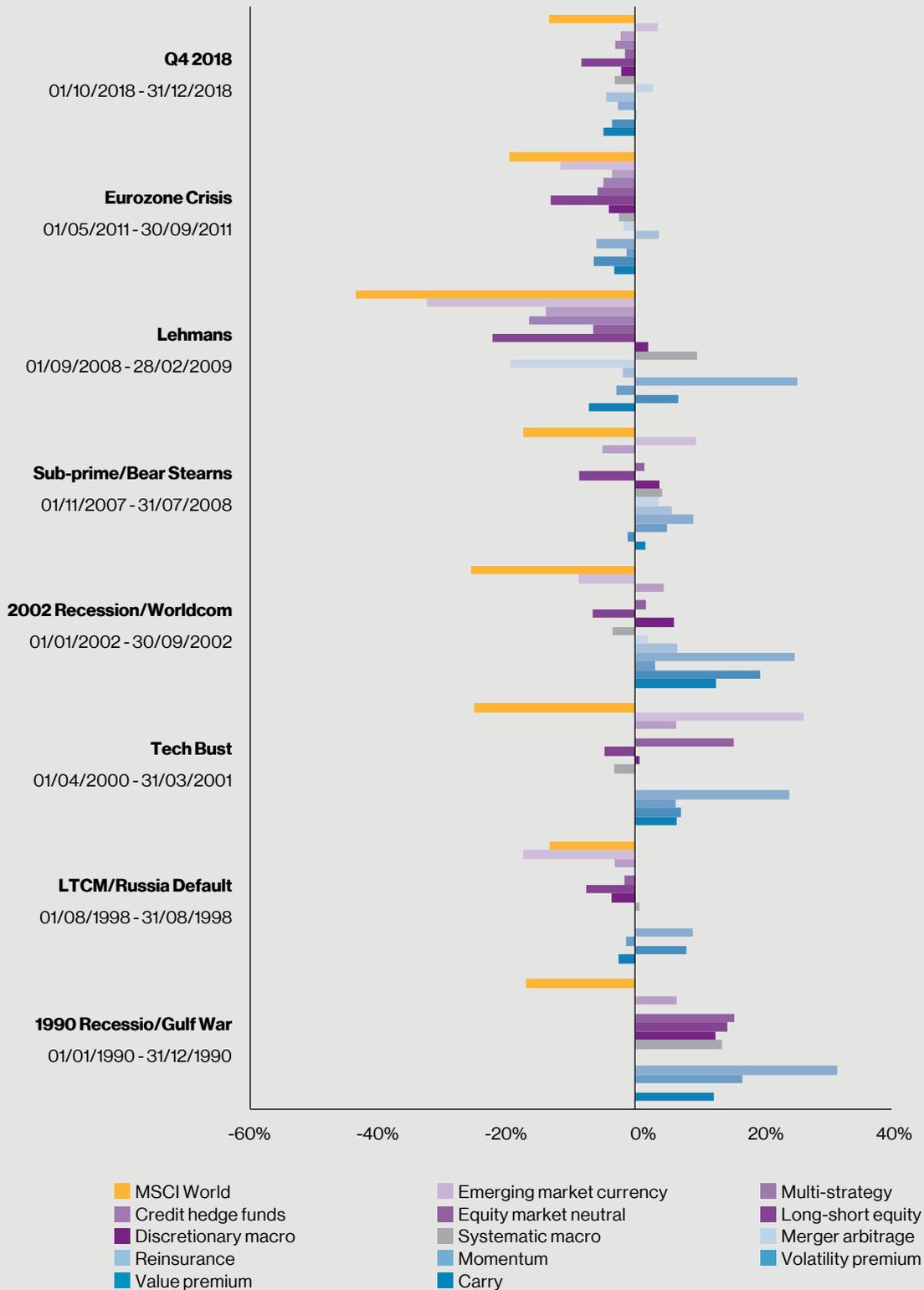
Figure 3 overleaf provides further evidence that diversifiers can perform much better than equities in a market sell off by comparing the performance of various diversifiers to equities during several market crises. We see that diversifiers come out on top most of the time. This all means that we strongly support maintaining a meaningful allocation to diversifiers within portfolios.

Figure 2. Rolling 10 year returns relative to sterling cash



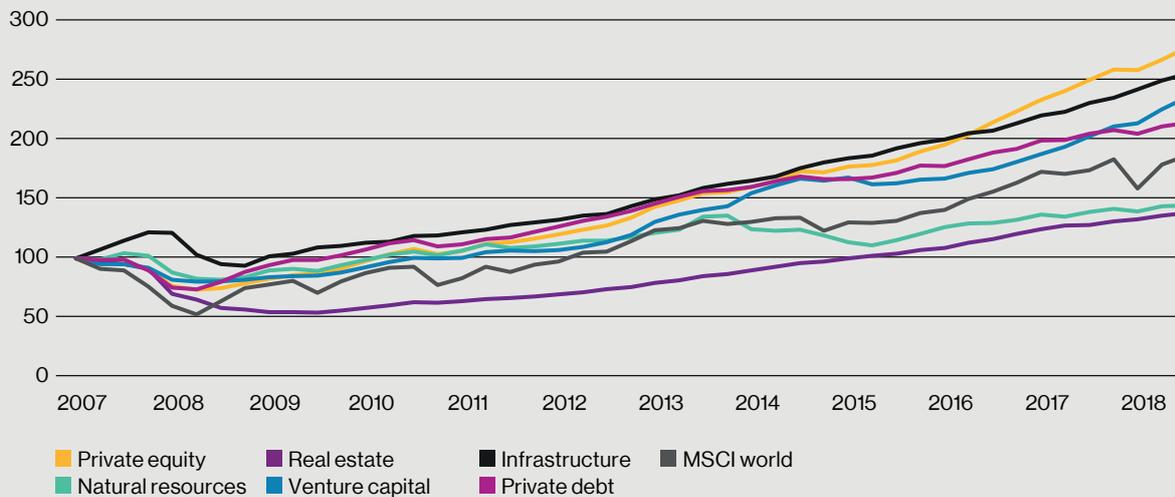
Notes: Performance data sourced from MSCI, Bank of England, Barclays, Grossman (1997), Acheson et al (2009), Mirowski (1981), Reuters, and ICE. Equity is MSCI World (unhedged in GBP), Barclays UK equity price index prior to 1970, and a spliced index comprised of 520-1150 UK securities weighted by market capitalisation prior to 1900 (Grossman 1997), 681 companies weighted by market capitalisation prior to 1870 (Acheson et al 2009), and an unweighted average of six companies to 1810, Gayer Rostow and Schwartz index (1958) excluding mines 1811-1826 (Mirowski 1981) prior to 1826. Equity price returns prior to 1900 have been manually uprated by an assumed dividend yield of 4.5%. UK Gilt is United Kingdom 10-year Government Bond total return index, Barclays UK Gilt index prior to 1989, Yield on Consols prior to 1900, Yield on 3% perpetual annuities prior to 1753, and Yields on new long-term issues prior to 1727. Cash is 3m GBP Libor, T-bill Yields prior to 1986, Prime Commercial bill rates prior to 1923, and Minimum Lending Bank Rates prior to 1718 sourced from the Bank of England.

Figure 3. Strategies that can provide protection, especially during crisis



Source: Willis Towers Watson, HFRI and Manager Supplied Performance, equities is represented by MSCI World. Where indicated, performance periods reflect the performance of individual alternative beta strategies during certain designated "stress periods." This comparison is intended to exhibit the benefits of diversification. Performance over shorter periods generally does not reflect how a strategy will perform over a market cycle. Other periods selected may have different results, including losses. Data as at 30 June 2019.

Figure 4. Private Markets Index Rebased (2007 – 2Q 2019)



Past Performance is not a reliable indicator of future returns
Source: Preqin 2019

Finding treasure in private markets

There is a huge universe of investments in private markets, it is possible to find some real gems if you know where to look. With fewer companies choosing to list¹ and greater restrictions on the banking sector's ability to lend, the case for investing in private markets is strong. Managers in this space may still produce high returns in a low-return environment, as their cash flows are less dependent on mainstream markets.

Building a robust private markets portfolio requires inclusion of ideas across the widest opportunity set. These can range from investments in the acquisition, development, and operation of natural resources, infrastructure and real estate assets, fast-growing companies in overlooked parts of capital markets, and innovative early-stage ventures that can benefit from long-term megatrends.

Continuing the theme of lending where the banks cannot, we believe there are still attractive opportunities to be found where borrowers' genuine need for capital isn't being met by traditional lenders due to regulation and other barriers. We are particularly biased towards private debt investments focused on consumer credit where we like and understand the underlying assets, and that are often too niche / small for other institutional investors to consider.

We remain of the view that true diversification is the best way to achieve strong risk adjusted returns and that portfolios with these characteristics will fare better than equities and diversified growth funds with high exposures to traditional asset classes in the years to come.

Over any given period, diversification will have won or lost but as that period gets longer diversification is more and more likely to win...

Further information

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¹Source: Thinking Ahead Institute: The evolving role of public and private equity markets



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