Playing Good Defense in Diversification

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Anu Rajakumar: The age-old lesson, don't put all your eggs in one basket, has long been a core foundation of investing, reminding us of the importance of diversification. This basic principle serves as an important reminder that investing across a variety of securities, sectors, asset classes, geographies, and styles can help mitigate overall risk within a portfolio. But as the investment environment evolves, so, too, must the approach the diversification. What should an investor do when traditional diversifiers, like treasuries, aren't playing the role they have historically? And, with return expectations lower going forward, how can investors be creative in closing the return gap without increasing overall risk? My name is Anu Rajakumar, and to answer these questions and more, I'm pleased to be joined by my multi-asset colleagues, Erik Knutzen, who's the Chief Investment Officer of Multi-Asset Class here in New York, and joining us from London, we have Joe McDonnell, Head of Portfolio Solutions for EMEA. Erik and Joe, thank you very much for joining me.

Erik Knutzen: Great to be back, Anu.

Joe McDonnell: Yes, thanks Anu. Great to be here.

Anu: So it's great having you both here with me today, chatting in a slightly different environment than our typical day to day, but as members of the multi-asset class team, the three of us spend a lot of our time engaging with clients all over the world, in an effort to help them solve some of their biggest concerns. So Erik, starting with you, would love you summarize some of those key concerns that the investors we're speaking to are really grappling with at the moment, and share an explanation, given the macro backdrop.

Erik: Yeah, great. This is a fun conversation, because the three of us often are having these conversations with clients, so now we get to share this in a podcast format. As we engage with investors, really all around the world, the two key challenges that, that we find that they're facing are, first, how do they close the return gap; that is to say, how do they meet their long-term investment objectives in an environment where the expected returns, particularly for traditional asset exposures like equities and fixed income, are lower than they have been historically. The second is, how do they manage risk in what we believe will be a more complex risk environment going forward. On the return side, this has been a challenge. We do expect that, once we get through this initial reopening of the, the, the post COVID environment, that it is likely that we'll be, once again, facing lower growth, uh, lower equity return expectations and, with very low yields on the fixed income side, certainly lower expected returns in fixed income assets. On the risk side, we do expect volatility to continue going forward, that we are entering, to a certain extent, very new territory in the post COVID environment; that central banks have already significantly expanded their tools for managing volatility in order to address the pandemic and the recovery, so they will have less opportunity to use their tools to manage volatility going forward; and we're already in an environment where interest rates are quite low. At the same time, we face the potentially increased specter of inflation. These are all much more challenging from the risk-management standpoint.

Joe: Yeah. I mean, I would just add to that, in terms of investors that we're speaking to, on the risk side of things, they, they recognize, in fact, three states of the world in regard to diversification. They recognize a state when diversification can work, a state when diversification is irrelevant, and a state when diversification doesn't work. And in terms of this higher volatility we're expecting on a forward-looking basis, it's a big concern for them. So historically, diversification has worked. It means, you know, sovereigns have been able to slash interest rates to support markets, and that's meant that, when equities sell off bonds, have done well, diversification is irrelevant. We've seen that for long periods, where you have very low rates, but you still have balance sheet expansion, and you have fiscal stimulus, and we've seen that, obviously, over the last 12 months; and all boats rise together. And then you have the worst possible state, which is when diversification does not work at all. And that's what people are most focused on now, that possibility of that third state, where essentially bonds and equities do not, uh, diversify.

Anu: Yeah. No, I think that's a great backdrop. Thank you very much, both of you. I want to share a real-life example with our listeners. You know, we spoke to an institutional investor recently who was asking whether or not government bonds can really continue to provide diversification or essentially said another way, the client was really doubting the future effectiveness of sovereign debt as a hedge for equity-market volatility. Erik, what was your response to that investor?

Erik: This really gets at the nub of the challenge. And Joe was highlighting this in terms of thinking about regimes where different diversifiers will be effective or not. Over the last 10, 20 years, investors, in the putting-all-their-eggs-in-one-basket, you know, metaphor, they really only needed to own equities and government bonds. Government bonds were negatively correlated with equities. They acted as a very strong hedge during equity risk-off environments. And other assets, whether inflation-sensitive assets or other uncorrelated assets, were not really needed to help create diversification and help edge, hedge, long-term growth assets like equities. Well, now we find ourselves where, perhaps, that environment is quite different; and that was the challenge that we were being given by this, uh, this investor. They were looking at their investment-grade bond portfolio which, in their case, was an all-sovereign bond portfolio. And they were the – and we helped them think through the role that that sovereign bond portfolio could perform for them.

And historically, you were expecting government bonds to really provide three benefits in a portfolio. Uh, first of all, you wanted yield. Second of all, you wanted diversification of equities, and third, you wanted liquidity. And as you look at a global government-bond portfolio, with a yield, perhaps, below one percent, with interest-sensitivity as measured by duration of six or seven years, perhaps it's less likely that that bond portfolio is going to be able to deliver that yield you need, and perhaps very little diversification if rates rise. If that's the cause, if inflation is the cause of the next equity drawdown, then perhaps that bond portfolio will not help you. It certainly is going to struggle to help you achieve your long-term return target, but it may not even be a good diversifier. And that's where we're really turning to seek to help investors think more broadly about diversification, away from just government bonds.

Anu: Now, for everything that you just said, Erik, I think the question that listeners will have is: So where do you go from here? You know, uh, with returns, for almost all asset classes expected to be lower over the next decade, you have high equity-market valuations, low bond yield, and you touched on the potentially positive correlations between fixed income and equities, changing relationships. How should investors think about expanding the opportunity set? Joe, maybe I can turn it to you, given some of your conversations that you've been having across the pond.

Joe: So, so we know that the, as, as Erik points, pointed out there, the opportunity cost of holding bonds is, is actually quite high. You're not compensated for, for holding that asset class; and if that that asset class is less effective as a diversifier on the risk-off situation, then it's, it's a very expensive asset class to potentially hold. Now, there are structural reasons and liability-management reasons where various investors do hold government bonds, but if they're looking to still make their expected returns, they have to look for a wider breadth of strategies that have returns which are not necessarily that linked to the general equity market. They also have to think about, um, active management. Now, to, to Erik's point, when, uh, diversification works, that 60/40 portfolio historically has done close to double-digit returns. Active management is not necessary to, to investors. Actually, if they look back at it now, they'd say, well, that was, that was a wonderful way of investing passively. It was cost efficient, and I didn't need to have idea generation in different places.

But if you think of your overall expected returns, on a forward-looking basis, you're going to be disappointed, because potentially, long-term growth will, will, will return to, to, you know, a low trend, disappointing, a disappointing level; and, um, uh, you're going to have situation where, you know, maybe mid-digit expected returns from, from equities in that scenario. Then it's, its, in the case that the, the excess return that comes from active management has relatively far more contribution to total return. So active management, in all its forms, could potentially add value. So that means definitely, you know, active management in, in equity management, in traditional markets; active, obviously, in fixed-income markets, more in constrained, fixed-income management; but also, active management from an allocation perspective, thinking about embracing broader, alternative investments; which could have, potentially, a lower correlation to equities, but also have, you know, their own particular return drivers, which would be different from public-equity markets. That's all very important for an investor to consider.

Anu: Yep, absolutely. No, totally agree with that. Erik, you know, earlier on, you also mentioned inflation being a key risk. Maybe you could also talk through how investors should be thinking about asset allocation, given the potential risk of an inflation surprise.

Erik: Yeah. This is a very common topic of discussion with investors, right now. Many of us, [laughs] over the last 10, 20 years, especially in the last 10 years, we really haven't seen significant and meaningful inflation in the environment. And exposure to inflation-sensitive assets has actually been disappointing. Either it has not delivered strong returns, or even negative returns. Many investors, as a result, have allowed inflation-sensitive assets to get squeezed out of their programs, or really diminished as a part of their asset mixes. We would suggest that the risk of outsized inflation over the coming investment, planning horizon has increased. That is as a result of changing central bank policies, where the Fed and other central banks have indicated that they are going to remain extremely accommodative until they see inflation overshooting their targets.

We also have seen the potential impact, uh, on inflation. Well, we're seeing the short-term impact on inflation of the post COVID environment of supply-chain challenges, supply shocks, and labor challenges. And whether this is transitory or sustained, we think it is likely to be stickier than perhaps transitory. Regardless of how it plays out, we think it is very important that investors contemplate the notion that inflation surprise should be a greater probability going forward than, certainly, we saw over the last 10 years post the Great Financial Crisis. To seek to address this, we're working with investors to look at different components of their portfolio that can be sensitive to inflation, and also generate a positive return, and in liquid markets these can include TIPS and global linkers. But those are fairly fully valued now. An area that we think is particularly attractive are commodity markets where you can gain exposure to a collection of assets that have a very high beta to inflation and inflation surprise, but where many of the commodities are trading at an attractive valuation; and now commodity-future curves are actually in positively sloped. You're actually getting paid to own commodities in the forward markets white count which makes them additionally attractive. And then there's an array of other investment components that can be good inflation hedges, ranging from REITs to energy-infrastructure exposures to private real assets, from real estate to infrastructure to other components of the private markets. And we're engaging with many investors right now who are looking to refresh or even increase their exposure to these categories of investments.

Anu: Yeah, perfect. Thank you very much. You know, I think we've covered a lot of really good information here. As we begin to wrap up this episode, I'd love for both of you to share some other, final thoughts on how investors really might want to think about diversification in today's environment, maybe starting off with you, Joe.

Joe: Well, I think, I think it's important for investors to think about, perhaps, nonconventional defensive protection, as well, as a part of their portfolio. If, you know, maybe the second-largest asset class they own today, government bonds, are going to be less effective, uh, going forward, for the reasons that, that we've outlined; uh, then you need to really be thinking about, perhaps, a range of strategies, which, which could potentially play a role in, in terms of managing that. So there's a range of things you can look at. You can think about, well, you know, your big concern would be a fall of, say, 20 percent in equity markets. What does well in those, uh, in that environment? The answer is the list is not particularly long. You could consider, for example, a quality equity portfolio that – build on that versus the market. You can think about, well, what happens when that market correction happens. Generally the U.S. yield curve flattens. When the yield curves potentially steepen, you could potentially, uh, position accordingly, to capture that. You could think about trend strategies. You know, trend strategies tend to do well when markets rally hard, but also when, when markets correct significantly. So I wouldn't necessarily pick one of those strategy, those three examples. Clearly there're other examples. The issue you have with diversification, the issue you have when you think about building portfolios, is the source of volatility changes. So COVID was a particular, unique source of volatility. Uh, it's very different from the financial crisis. What works in one environment doesn't necessarily work in another—which means, actually, clients should really think about a portfolio approach to building defensive protection into their portfolios.

Erik: Yeah, and I'd add some additional exposures that tend to be uncorrelated. Those can be uncorrelated active strategies, in addition to what Joe mentioned; you know, the hedge fund or active strategies that tend to be uncorrelated and tend to do well when markets sell off; but also, risk premia that may be uncorrelated, for example, inflation-linked securities or catastrophe bonds. Those can be important parts of portfolios that tend to be fully uncorrelated with risky assets. And then finally, back to the active notion of exposures to, you know, being willing and able to be a little bit more nimble and opportunistic from a tactical standpoint, during periods of higher volatility, can add a tailwind to investment portfolios.

Anu: Yep. Those are some terrific thoughts. Thank you very much. Bonus question for today's episode: you know, we like to do this for our, for our guests here. Um, I opened today's episode talking about this, uh, this age-old idiom: Don't put all your eggs in one basket. You know, you're both experienced investors. You're also both parents, so I'm sure you have a list of idioms in your back pocket. What are each of your favorite idioms or phrases that you love to use or, or share with your friends and family? [Laughs]

Erik: Oh, yikes. Okay, so, so this is, uh – you, you, you get to surprise us with these. I'm not sure what the exact idiom or cliché would be, but my – I have three children in their 20s. And they appear to know pretty much everything; uh, whereas the older I get, I think, the less that, that I'm sure I know. And I think that, that the saying that I would suggest along with that is the importance of humility in investing. And I'm writing a CIO blog on the book, "Think Again," which I recommend to folks. It helps people rethink their investment processes, and reminds people of the importance of humility, and the humble mind and the humble approach, to taking delight in being wrong – which my kids delight in pointing out – uh, and, and the importance of that humility and, in terms of thinking about markets, in terms of thinking about investing and when we think about this, this issue of diversification, and trying to be ready to, and prepared to help manage volatility through uncertainty. I think that humility and being ready to be humble and proven wrong and, and continually rethink, or, to, to improve your decision-making process, is probably pretty important.

Anu: Absolutely. I totally agree. Joe, what about you?

Joe: Oh, idioms, oh, I'm, I'm not so sure about this. The one that I've always found fascinating was the one that, you know, um, "people in glass houses shouldn't throw stones," which I've always thought, kind of, visually is a very strange thing. Who would ever throw a stone in a glass house? But being self-aware, understanding we all have kind of the same challenges, you know, being appreciative that there's more than one way to do things, we don't necessarily – to the point of, that Erik mentioned, you know, have some humility in what you're doing as well. So I think, I think, I'm not sure that's a great connection, but, in fact I always found that a very strange idiom. You know, it's like, it's almost common sense. But [again], I've never had the instinct to throw a stone in a glass house. But –

Anu: [Laughs] It's good to know. Terrific, you know, on that note, I think we'll wrap up today's episode. You know, I think, as we've discussed for asset allocators, finding the right balance between risk and reward, it is becoming more challenging; but Erik, Joe, hearing your, your thoughts on this topic has, hopefully, provided our listeners with some food for thought as they navigate the complex investment landscape; so thank you, both, once again.

Erik: Thanks, enjoyed it.

Joe: Thanks, Anu.

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