Diversification: free lunch or fallacy?

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Diversification, spreading risk to reduce exposure to particular events or scenarios that may damage returns, is regarded as an important concept by most investors. If applied correctly, diversification can help achieve desired outcomes and goals, such as providing greater certainty of growth in real returns than would otherwise be the case. The benefits that result have even led to diversification being described as "the only free lunch in finance."

However, it is critical that investors do not take this phrase at face value and misunderstand what it takes for diversification to be truly effective. Namely, rather than necessarily just owning lots of different assets, it is important to understand the fundamental drivers of assets, how assets are likely to behave and the role they can play, in order to build a properly diversified portfolio. Investors who have relied on the former so-called "diversified" portfolios have tended to have a poor experience with diversification and ultimately, with their performance outcomes.

In this article, we draw on what we have learnt and experienced in successfully managing total return multi-asset portfolios for over 20 years to discuss the topic of diversification. We start off by briefly re-stating the arguments for taking a diversified approach. We then talk about the misconceptions or fallacies around the concept of diversification that we have identified. Finally, we touch on our approach to building diversified portfolios.

How does diversification work and why is it so important?

Diversification is the principle of spreading wealth across a number of different investments, with the objective of providing a desired level of return with as little risk as possible. So just how does the principle of diversification work?

The theory is simple – combining investments that exhibit different return patterns means that large fluctuations seen in individual investments can be smoothed out. This means that the overall portfolio can benefit from the different return sources in aggregate but with a dampening of the variability of these returns compared to just holding one of the investments in isolation.

Why is it so important to reduce risk? Very simply, in order to improve outcomes. Greater risk means greater uncertainty. Most investors have limited appetite for uncertainty. By reducing risk, investors can achieve greater confidence in achieving specific goals, such as the growth of capital in real terms, by narrowing the range of potential outcomes they are facing.

Local government pension schemes, for example, are facing the challenges of the need to grow assets but with limited tolerance to experience the type of falls that have been experienced by equities in the past. Clearly, a diversified approach that can provide sufficient returns, and with limited risk, is very appealing for the LGPS market.

The practice of finding investments that exhibit different behaviours to each other and combining them in a way that delivers an enhanced risk-adjusted return is harder than the theory might suggest. The next section deals in particular with some of the reasons why this is the case.

The three fallacies of diversification

Having explained the benefits of diversification above, it would seem obvious that diversification should be an attractive concept for most investors. In practice, however, there has often been a gap between the perception of what "diversification" should bring and the reality of what it has achieved. We have identified, based on our experiences of investing in multi-asset portfolios, three main misconceptions, or fallacies, around the concept of diversification, which have contributed to sub-optimal experiences for investors. These fallacies are as follows:

Fallacy #1: Lots of colours on a pie equals diversification

There are some approaches that purport to be diversified purely on the basis that they invest in a number of different positions. Indeed, this illusion of diversification is typically propagated by showing the portfolio using a pie chart, with many different colours.

In practice, however, these portfolios are often loaded with assets with common fundamental drivers, for example equities, with each colour used to describe a different equity segment rather than distinct assets with differing fundamental drivers. However, as noted above, potential diversification benefits are negated in instances where there is commonality in the fundamental return drivers prevalent. Therefore, a portfolio loaded with equities will leave the benefits from "diversification" as limited at best. Investors should be cautious about assuming that products with the word "diversified" in their name and that show lots of pretty colours on a pie chart are actually diversified.

Breadth of holdings alone does not guarantee diversification. Rather, it is important to assess the underlying characteristics of assets and build a portfolio with a mix of return drivers.

Fallacy #2: Asset class labels accurately describe their behaviour

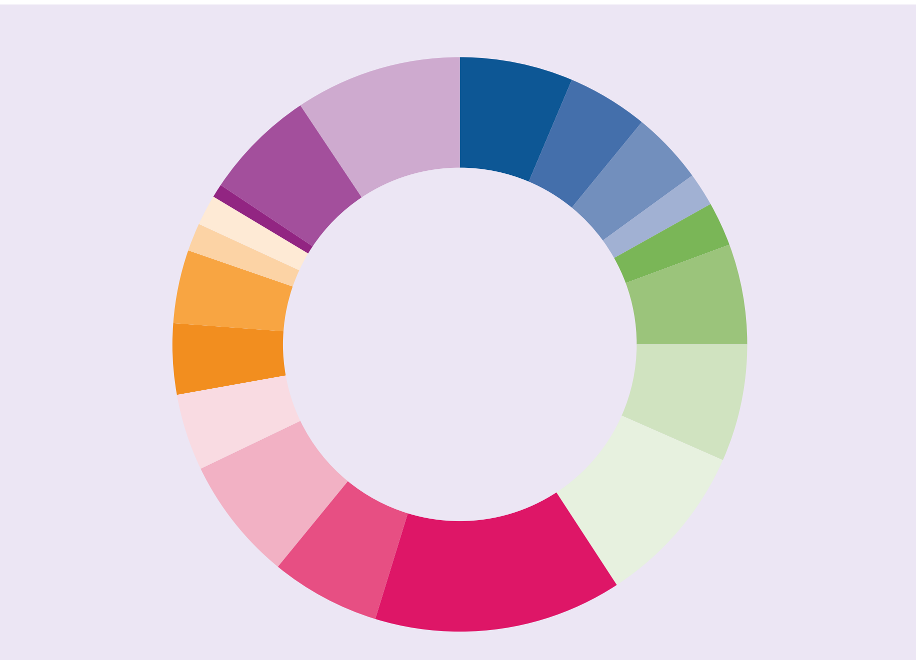
Market convention suggests that "bonds" should behave differently to "equities", and "alternatives" should behave differently to both bonds and equities. However, we believe this convention is overly simplistic, inaccurate and dangerous. There are certain assets tagged as "bonds" that actually behave more like "equities", and certain assets tagged as "alternatives" that do not behave differently to either equities or bonds.

We therefore believe it is important to look beyond the labels of asset classes, and rather to focus on the underlying behaviours of asset classes, in determining their role within a portfolio. There is an old saying, the so-called "duck test", which suggests "If it looks like a duck, walks like a duck and quacks like a duck…then the chances are that it is a duck." The sentiment behind this saying is useful in determining the behaviour of assets in our view. Just because a high yield bond, for example, is classified as a bond it does not mean it has to be considered as such. We would prefer to treat it like an equity based on the way that it "walks and talks".

Fallacy #3: Asset relationships are constant over time

The final fallacy we have identified relates to the view that the historical behaviour of assets to one another cannot be relied upon to determine how they will behave in the future. For example, it is assumed that government bonds are always

Figure 1: Can we assume XYZ Multi-Asset Fund is diversified given the number of colours on the pie chart?



Source: Investec Asset Management. For illustrative purposes only.

negatively correlated to equities, or that emerging market bonds have a low correlation to equities. However, it is our view that asset relationships can vary significantly over time.

We believe that the behaviours of assets require continuous evaluation in order to better determine the optimal role they can play in the diversification of portfolios.

Our approach to diversification

The core aspect of our approach to diversification is to focus on asset behaviours rather than their labels when building portfolios. When assessing opportunities and determining their role in a portfolio, we do not think in terms of "equities", "bonds" and "alternatives", but rather three distinct categories of "Growth", "Defensive" and "Uncorrelated" assets. Growth assets have returns which are directly related to expectations of real economic growth, and react positively to overall risk appetite. Equities, as well as assets conventionally regarded as bonds or alternatives such as high yield bonds, emerging market debt, property and certain commodities are included in this category.

Defensive assets react positively to declining expectations of real economic growth, and should provide safe havens in market crises. Developed market government bonds, index-linked bonds and hedging/protection strategies reside in this category.

Uncorrelated assets have a variable relationship with growth and risk appetite, with performance generally unrelated to real economic growth. Examples include gold, infrastructure and reinsurance.

In addition, we also take active currency positions, which can be regarded as either Growth, Defensive or Uncorrelated depending on their nature.

Owning an optimal mix of Growth, Defensive and Uncorrelated assets goes a long way to achieving superior diversification. However there is one additional aspect that needs to be considered – ensuring that allocations are sized appropriately. Any potential diversification benefits would be negated if, for example, a portfolio was comprised of 95% capital in Growth assets, 3% in Defensive assets and 2% in Uncorrelated assets.

In ensuring appropriate diversification, we believe it is important to think about individual positions in respect to how risky they are – both on a stand-alone basis and in relation to how they interact with other positions. We test the impact of positions on the overall risk of the portfolio prior to inclusion, which allows us to calibrate their size accordingly. Secondly, we will vary the sizing of individual positions, and the overall split between Growth, Defensive and Uncorrelated assets, over the course of a cycle.

Conclusion

Diversification, if applied correctly, can substantially improve outcomes for investors and should lie at the heart of a multi-asset approach. However, in our view, many "diversified" approaches have not delivered to expectations in the past, owing to various reasons which they have in common. By highlighting these fallacies, and by describing our approach to building truly diversified portfolios, we hope that this article will help LGPS investors to understand the underlying characteristics of a multi-asset portfolio and the likely path of returns.

Figure 2: Assessing asset classes on their behaviours not their labels

Growth	Defensive	Uncorrelated
Equities	Government bonds	Infrastructure
High yield debt	Index linked bonds	Insurance
Emerging market debt	Investment Grade bonds	Commodity trading
Commodities	Volatility strategies	Gold
Property		
Private equity		

Source: Investec Asset Management