# The Need for Dynamic Diversification

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## Main Points:

- What has worked in the past to minimise portfolio risk does not always apply going forward.
- Listed property exposure was the ‘great diversifier’ during the unwind of the TMT bubble (rising 43%). It performed abysmally during the GFC crash (falling 50% and thereby adding to portfolio risk).
- What could blind side investors this time around? The asset class that comes immediately to mind is bonds.

Quite often I find myself writing about diversification. This time it’s a concern that if we are ‘blowing bubbles’ as you might say (or more accurately, central bankers are allowing bubbles to form thanks to their quantitative easing programs), then what worked as a diversifier for reducing portfolio risk during the last market crash may not work as well this time around.

Bonds were the ‘great diversifier’ for protecting returns when it came to the GFC. Will they be the asset class of choice if a looming bubble in asset market runs awry? I think not. Bond markets – by definition – have been materially affected by quantitative easing (or ‘QE’ as it is affectionately known). After all, QE is all about exchanging bonds for cash – thereby artificially lowering bond yields (and driving up bond prices). Any sudden about face by central banks in their bond purchasing programs is likely to cause ‘dislocation’ not just in equity markets but bond markets too.

This would come as a shock to many portfolio constructors using historical asset performances as a guide. We feel a far better approach is to realise that the diversification attributes of assets can change depending upon the format of the particular bubble’s breakdown. Knowing where to hide when things go disastrously wrong is as much of an art as it is a science but here are some pointers.

## 1. Correlation is Time Variant

The above title may come as shock to some people but unfortunately it is simple fact of life. I don’t know how many times portfolio managers have laboured on as to how their portfolios are ‘risk adjusted’ because they use some sort of a historical association (correlation) between asset class performances as a guide to minimise risk. Many software packages specialise in formulating such results. Can they be trusted? The simple answer is ‘no’.

The output from such models is often touted as some form of 'scientific verification' of a manager's conservatism. I don't know how many times a 'conservatively' positioned portfolio seemed to go horribly wrong during the GFC. The response? Many fund managers dismiss their GFC experience as a 'once in a 10,000 year event' and state that the risk models they use are still OK. This is little solace to the poor investor who put money into such vehicles prior to the downturn. A meteorite may only hit the planet once every 10,000 years but it still hurts just the same if it lands on your head.

To put it simply using 'average' associations between assets as a 'be all and end all' approach toward reducing portfolio risk is fraught with danger. The problem with averages – as anyone who has crossed a river in the Gulf Country knows – is that sometimes they can be a little misleading. The 'average' depth of a river up north might be 4 foot. In the dry season this is effectively zero. In the wet season ...... well, drive your 4WD into the river and you find out. In short, an 'average' of association between assets is at best a rough guide as to whether a portfolio's truly diversified or not. If you build a portfolio on the basis that on average bonds will act diversifier against falls in the equity market then sometimes you will be right, sometimes you will be wrong. Is that the best we can do? I don't believe so.

## 2. Dynamic Diversification

To be fair, there are many approaches toward minimising portfolio risk. There's the 'set and forget' approach of static asset allocation (or 'SAA' as it is known). This is where you start by looking to buy a certain percentage of differentiated assets to build a portfolio and then use a historical risk model to tell what the relevant percentages should be. This is a classic case of letting the averages take hold as you ride out the highs and the lows.

Alternately, one can take more of a proactive approach in the form of Dynamic Asset Allocation (or 'DAA' as it is known). This approach typically uses a shorter time horizon for 'rebalancing' the weighting between assets to reflect differing views as to the likely performance of certain assets. [i] Good, but I think we can still do better.

The best approach I feel is to rebalance and test a portfolio's diversification attributes by not just forecasting asset returns but forecasting risk well. In particular, an emphasis should be placed on understanding how the interrelationships between assets evolve over time. I label this approach 'dynamic diversification'. This is a difficult – but not necessarily insurmountable – task.

In using such an approach the big concern right now is bonds. We have elsewhere highlighted that part of the present worry about asset bubbles is the 'displacement' from the onset of 'new age thinking' inspired by central banks printing copious amounts of money – ergo, enforcing an artificially low discount premium (near zero central bank cash rates). This heightens the chance of a mispricing of risk. Bonds have been materially impacted by this.

In short, equity market prices could fall and bond market prices could fall as well – reasserting a positive rather than negative correlation between the two asset classes (unlike what happened post the GFC).

So why have any fixed income exposure at all in a portfolio at the present time? Quite simply to offset forecast risk. What if the much maligned asset bubble doesn't get really out of hand? What instead if the world lurches toward a deflationary environment thanks to some 'unforseen shock' – the massive failure of Japan's monetary experiment for instance? What then? In such a world, already expensive bonds would become even more expensive as QE would effectively continue in spades. Consequently, there is still a need for fixed income exposure in a portfolio to offset against this forecast risk.

That said, there is always the option of 'having a bob each way' all the same. Bond exposures to fixed income managers that have flexible mandates (in the sense that they can invest offshore and can invest across the various stratums of fixed income products) is one way of getting around the problem. More importantly, seeking fixed income managers who can sell short and have displayed a marked aptitude for being good at doing so is also handy. Again, not easily done but not a bad strategy for a portfolio's bond exposure in what appears to be a challenging market environment from a dynamic diversification standpoint.

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[i] Quite often the terms 'DAA' (Dynamic Asset Allocation) and 'TAA' (Tactical Asset Allocation) are used interchangeably but what differentiates them in my mind is that:

- DAA: uses a 3-5 year investment horizon and typically has a 'Cash plus' benchmark;
- TAA: uses a shorter investment horizon (generally around 6 – 12mths) and uses a market index formulated benchmark.

Traditionally, both approaches tend to focus on return forecasts under differing market backdrops. Both generally place less emphasis on forecasting risk.

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