



While correlations tend to rise when markets fall, skilled asset allocators look for the holy grail of uncorrelated returns while navigating shifting markets. By implementing their best ideas across a broad universe, in the most cost-effective manner, active asset allocators offer investors true diversification. This provides a return profile that passive strategies cannot readily match.

Most asset classes delivered negative returns in 2018 except for the US dollar and German bunds. See Fig. 1.

In such instances, investors may be forgiven for wondering if diversification really works.

Interestingly, various studies have observed that the correlation between equity markets tends to be asymmetric². This means that correlations tend to increase in down markets, especially during sharp downturns, and fall when markets are rising.

This is bad news, as investors desire diversification most when markets are falling.

Why *do* market correlations rise, when markets fall? It is believed that this occurs because risk aversion is highly contagious, and investors tend to react more strongly to bad news than to good.

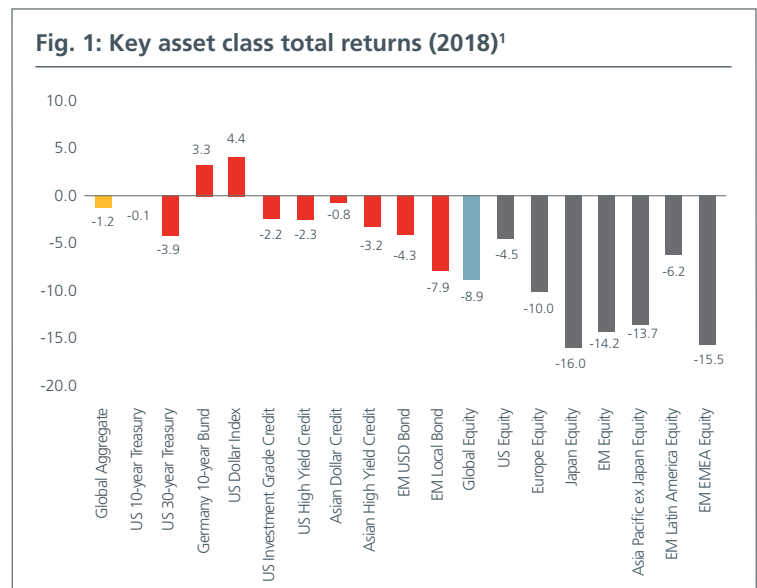
On a more comforting note, studies also suggest that the low or negative correlations between equity and bond prices are more



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persistent³. Equity and bond prices tend to move in opposite directions when market uncertainty is high⁴. Apart from changes in the macro environment and valuations, investor risk sentiment

Fig. 1: Key asset class total returns (2018)¹



has an important impact on the relationship between equity and bond prices. Very often during periods of market turbulence, the equity risk premium demanded by investors rises, relative to the term premium for bonds. This “flight to safety” in turn causes the prices between bonds and equities to diverge.

The negative correlations between stocks and bonds are also more enduring when inflation expectations are low. This is because rising inflation expectations drive up discount rates which hurt bonds. On the other hand, at high levels of inflation, the changes in the discount rates dominate the changes in cash flow expectations for equities, in turn causing bond and equity prices to move in the same direction. With inflation expected to remain subdued in the foreseeable future while markets stay choppy, bonds can still offer some diversification benefits for investors. See Fig. 2.

That said, we note that with US Treasury bond yields currently around 2.7% (down from 6% since the Global Financial Crisis), and Japanese as well as European government bond yields hovering around

0%, many government bonds will not be able to provide sufficient protection for portfolios in sharp market corrections.

This is partly why traditional balanced funds with a 60% allocation in global equities and 40% in global bonds have evolved into multi asset offerings that include more granular asset classes, such as currencies, rates, inflation and alternatives.

In today’s fast-moving markets, dynamic asset allocation - and the ability to hedge portfolio risks as asset correlations rise during down markets - *is needed* to achieve genuine diversification for investors.

BRINGING VALUE UP

Understanding correlations and anticipating how historical relationships between asset classes will change, is at the heart of what we do. Even as correlations change, there is a need to assess if the changes are temporary or permanent (i.e. is it a ‘regime change’?). The ability to navigate changing markets, cycles and correlations requires considerable experience, skill, and rigorous

Fig. 2: The interconnectedness of markets⁵

Recent market corrections	Equities (%)					Bond (%)	
	US	Asia Pacific ex Japan	Japan	Europe	Emerging Markets	Global Investment Grade	Global Government
16 Sep 2008 – 9 Mar 2009	-43.4	-34.0	-33.5	-45.7	-37.6	-0.5	-0.2
15 Apr 2010 – 25 May 2010	-11.2	-18.6	-11.2	-21.6	-17.9	-1.5	-1.2
8 Jul 2011 – 4 Oct 2011	-16.0	-27.0	-12.0	-25.4	-28.0	+1.4	+2.9
24 June 2015 – 12 Feb 2016	-10.3	-24.4	-22.2	-20.6	-27.1	+3.9	+5.6
21 Sep 2018 – 26 Dec 2018	-15.3	-11.0	-18.0	-15.0	-9.3	+0.1	+0.5

analysis – things that passive strategies simply cannot achieve. To illustrate, Fig. 3. shows how the correlations between the S&P 500 and the euro has changed over the years.

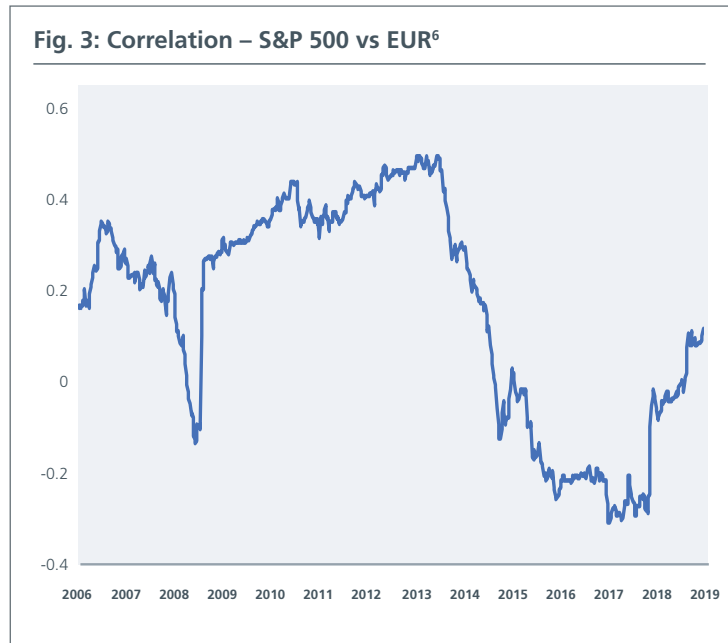
Skilled asset allocators look for the holy grail of uncorrelated returns. This can come from relative value investment strategies in currencies – an example being long Yen short Euro; or from gaining exposure to selected portions of the interest rate curves e.g. receiving AUD rates. These exposures can often only be achieved through more advanced instruments such as currency forwards or interest rate derivatives – something that many investment managers, including simple passive strategies, are not set up to do.

Importantly, some of the most valuable strategies can actually be those that contribute relatively small absolute returns by themselves. This is due to the larger, more important role they play in the overall portfolio. Often, because these trades have low or even *negative* correlations to the existing assets in the portfolio, they help **lower** the portfolio's overall **volatility**, thereby allowing other return-generating strategies to be deployed in larger size, whilst adhering to the blended fund volatility objective.

Active asset allocators add value not only by identifying good ideas, but also in showing the courage of their conviction even when markets are volatile. Active asset allocators can add value by adjusting the time frames on their views according to valuation, macro and sentiment drivers in the market. See Fig. 4. for some of the tactical moves we have implemented in our multi asset portfolios over the last 6 months, as an example of how active asset allocators can navigate even some of the most challenging market conditions.

KEEPING COSTS DOWN

The multi asset universe, by definition, offers a large and diverse hunting ground for investors. The exposure to all geographical regions can be accessed in multiple ways, including equities,



bonds and currencies - as well as through some of the more advanced techniques. For investors who are looking to build up their own multi asset portfolios by combining diverse building blocks,

considerable expertise and resources are needed to assess and monitor a wide range of asset classes and markets, including how they interact with each other. Outsourcing is therefore a good option for many investors.

There are cost considerations when deciding to employ different strategies. For example, it may be more cost efficient to use futures to increase or decrease position sizes. Exchange traded funds (ETFs) can also be a cost-effective way to gain broad exposures to the more developed markets which are deemed to be more efficient. Our multi asset strategies, for example, use ETFs to gain exposure to the US equity market, but favour a more active approach while investing in Asia, where we see greater alpha opportunities. We believe that a *combination* of active and passive strategies, offers investors the optimal approach to multi asset investing, as it balances cost-effectiveness with alpha generation.

BEING TRULY DIVERSIFIED

Following the market rally since the start of 2019, the negative returns experienced by most asset classes in 2018 may soon become faint memories for many investors. In the midst of rising markets, the need for diversification can often become a secondary consideration.

Yet, many of the concerns that plagued investors in 2018 have not permanently gone away. While the central bank 'put' may be in force at this time, uncertainties over global growth, earnings, monetary policy and trade can easily roil markets again. Volatility has subsided, for now. It will, however, increase again in the future. Investors still need to seek the holy grail of true diversification.

Sources: ¹Source: Bloomberg, December 2018. ²Asymmetric Dynamics in the Correlations of Global Equity and Bond Returns. Capiello, L., R.F. Engle and K Sheppard. 2006. ³Why does the correlation between stock and bond returns vary over time? Maghus Andersson. Elizaveta Krylova. Sami Vahamaa. 2004. ⁴Bloomberg. Total returns in USD. ⁵Bloomberg, March 2019. ⁶Thomson Reuters. Eastspring Investments. 11 Feb 2019. For illustration purposes only.

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