

The Actuarial Profession
making financial sense of the future

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**Absolute return investing with
equity and fixed income**

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Diversification – does it exist anymore?

- Diversification exists but it has become more difficult to find, and is not encouraged by some of our conventional investment approaches
- Why we have moved away from the conventional approach
- What we have done to create genuine diversification in our multi-asset portfolios
- Finally I will deal with measurement. What metrics might I use to assess diversification?

Can conventional balanced funds cope?

- The asset mix is often very restricted
- The typical balanced fund has 50-70% exposure to equity markets
- The overall risk is dominated by the equity weight
- In a connected world the internationalisation of equity and credit markets provides limited benefit
- Although the asset allocation stance dominates return....
- ...there is often very little scope for added value from active asset allocation
- **Conclusion: Balanced funds are far from balanced**

How much do you want to rely on equity returns?



- Some global equity markets have delivered negative returns over long periods, prompting a review of equity allocations
- Nonetheless Cash + 5% may be a reasonable long term equity risk premium
- But what other choices are out there?

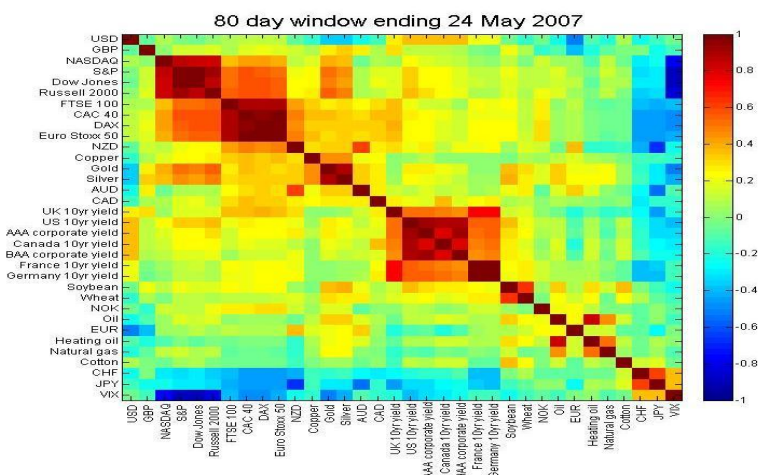
Source: Standard Life Investments

What about a new balanced/diversified growth approach?

- A wider range of asset classes brought into play, everything in a balanced fund plus
 - Real estate
 - Infrastructure
 - Private equity
 - Commodities
 - Loans/distressed credit etc.
- Increased role for asset allocation to influence the outcome
- But there is still a strong linkage to economic growth
- There may only be 'fair weather' diversification

Correlations were once low ...

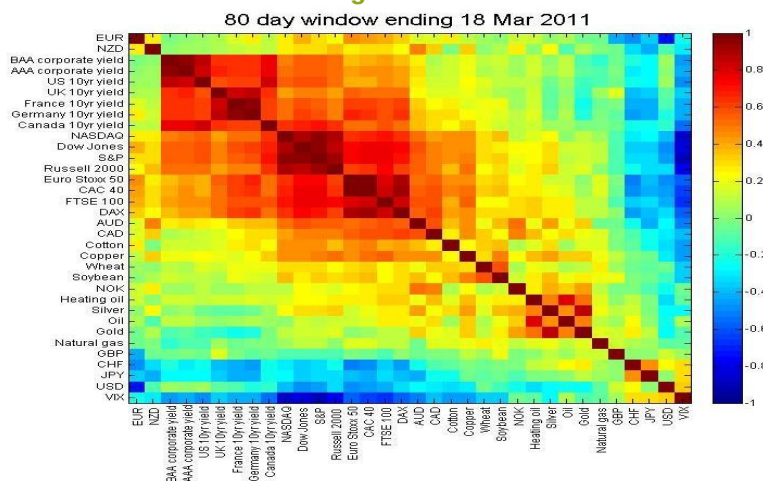
Pre-crisis correlations low



Source: HSBC

... now it's a risk on or risk off world

Post-crisis correlations remain high



Source: HSBC

We favour an absolute return approach

- Why can an absolute return approach offer better diversification?
- Widest possible opportunity set allowing greater opportunity for strategic asset allocation choices to influence return
- Permits precision in investment strategies
- Manager is accountable for all risk and for any adverse performance
- Much higher dependence on manager skill in asset allocation

Our approach to multi-asset absolute return

A broad range of return opportunities

Market returns

- Equities, Bonds and Property
- Good long term return expectations
- But can be negative returns over shorter periods



Stock selection

- Active stock selection
- Uncorrelated with market returns

Directional

- Specific directional investment ideas
- In markets with little or no long term risk premium
- With significant return potential on a 3 yr view

Relative value

- Seek highly correlated markets or segments
- Where their relative valuation is strained
- We exploit their realignment

Seeking real diversification

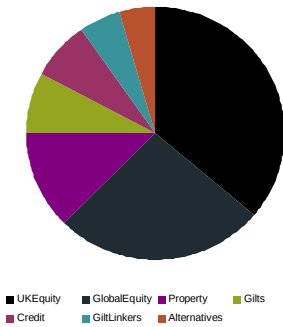
How do you measure diversification?

- More than one metric is needed
- VAR analysis, by strategy and in aggregate
- Principal component analysis – measured by absorption ratio
- Scenario analysis

Diversification - standalone risk contributions

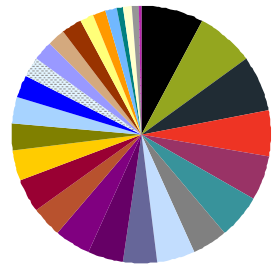
Balanced Portfolio – stand alone contributions

Expected Portfolio volatility 10.43%



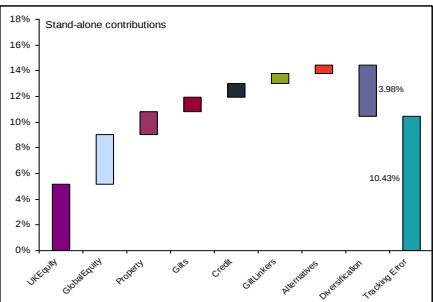
Absolute Return Portfolio – stand alone contributions

Expected portfolio volatility 5.94%

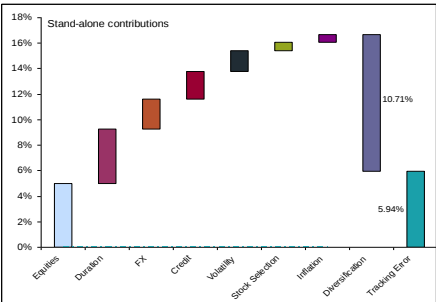


Diversification – aggregate portfolio risk

Balanced Portfolio



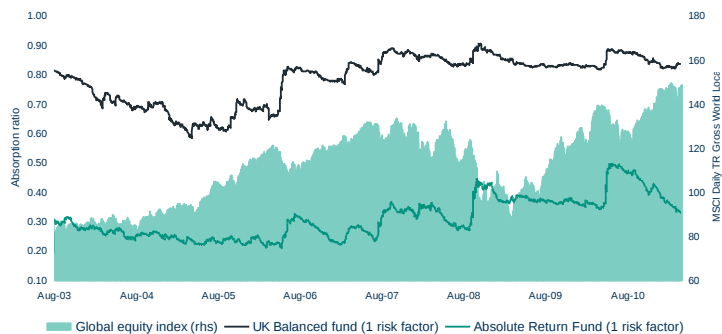
Absolute Return Portfolio



- Broadly equivalent return potential from the absolute return and balanced portfolio
- Aggregate risk less total standalone risks gives a measure of diversification
- Greater diversification in the absolute return portfolio

Source: Standard Life Investments

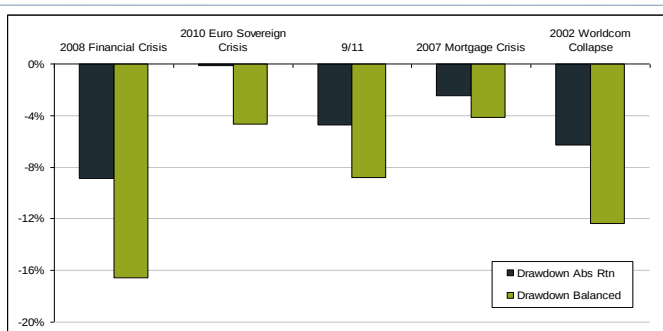
Diversification - Principal Components Analysis



- The absorption ratio is measure of how much portfolio risk can be explained by a certain number of statistical factors
- Just one factor explains most of the risk in the balanced portfolio
- This is not the case for a well constructed absolute return approach

Source: Standard Life Investments

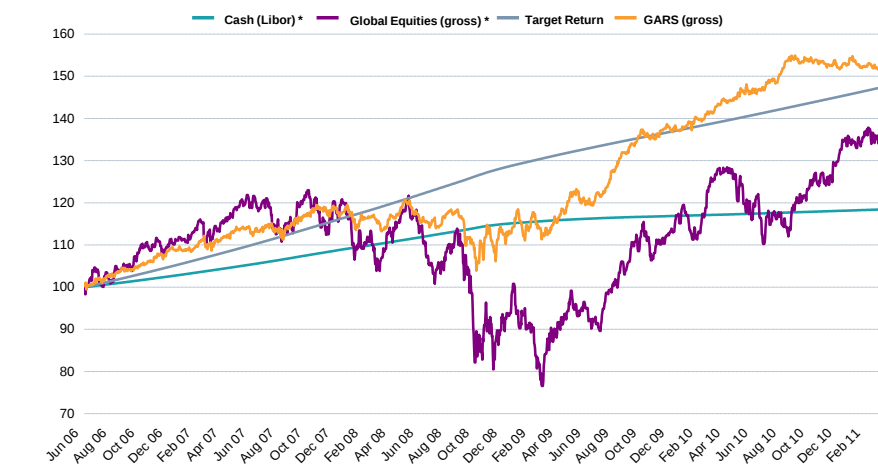
Diversification - Scenario Testing



- Economic scenario generators or Monte Carlo simulations can be used to test portfolio outcomes
- Stressing a current portfolio through historic events can be instructive
- The absolute return portfolio responds better in each stress case

Source: Standard Life Investments

We also have real life experience through troubled times



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Conclusion

- There is no doubt that many traditional portfolio styles are not well diversified
 - There is normally a high dependence on economic growth for success
 - There is frequently a specific dependence on equity performance
 - There is often little capacity for the asset manager to materially change the outcome through asset allocation
- We have tried to address these weaknesses and can certainly demonstrate superior diversification to traditional approaches
- This should make the increased dependence on manager skill less risky

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