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 ...
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

Absolute Return Portfolio – stand alone contributions

Expected portfolio volatility 5.94%

Expected Portfolio volatility 10.43%

Diversification – aggregate portfolio risk

Balanced Portfolio

Absolute Return Portfolio

Stand-alone contributions

• 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
The absorption ratio is a 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.

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.
We also have real life experience through troubled times

Source: Standard Life Investments, gross performance from 12/6/2006 to 31/03/2011
Portfolio performance is based on the £ institutional pooled pension portfolio
* Source: Thomson Datastream

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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