Evolving Concepts of Diversification

Stockholm (HedgeNordic) – For some large institutional investors, asset allocation remains dominated by the classic 60/40 model of approximately 60% equities and 40% bonds. From a portfolio diversification perspective, this could make sense if correlations between the two are low or negative. But this assumption may be too heavily dependent on recent history. Correlations between equities and bonds have, on average, been negative for nearly 20 years since the early 2000s, but a longer lookback period of 100 or 150 years also includes extended periods when the two asset classes were positively correlated. One study, "Equity-Bond Correlation: A Historical Perspective", by Graham Capital, found that the correlation has actually been positive more often than negative, stating that: "Since the 1870s, equity-bond five-year correlation has been negative in 635 months compared to 1,063 months when it was positive".

When and why might equities and bonds both lose money? One scenario is inflation leading to higher interest rates, and therefore raising the discount rate for valuing both asset classes.

Commodities and Real Assets

Commodities are seen as one inflation hedge, which has been lowly correlated with conventional asset classes. "Diversification benefits of commodities: A stochastic dominance efficiency approach", by Daskalaki, Skiadopoulous, and Topaloglou, argues that the diversification "benefits accrue because commodities are segmented from the equity and bond markets".

In the Netherlands, some pension funds have been allocating to commodities since the 1970s. The largest Dutch fund, APG, has 4.8% in commodities as per its 2019 report. However, some investors, including the Swedish National Pension Insurance Funds (AP Funds) cannot invest into commodities. They can instead allocate to other real assets, such as real estate, infrastructure, and forestry, which may also offer some inflation protection.

Sophisticated Bond Strategies

Many pension funds are required to maintain heavy weightings in high grade fixed income, but even here there is scope to be more creative. While major bond indices could be dominated by government bonds offering little or no yield, defining bonds more broadly can open up scope for diversification through different types of fixed and floating rate corporate credit; asset-backed securities based on mortgages, credit cards, student loans or auto loans; and various types of emerging markets.

A more sophisticated portfolio management approach can also provide diversification against inflation or interest rate risk. For instance, broad bond indices may not contain inflation linked government or corporate bonds, or inflation swaps, which could hedge against inflation.

And some bond strategies, including those employed by a number of Danish managers, have shown near zero correlation to government bonds because they use derivatives to hedge out interest rate risk in order to focus on other risks such as prepayment.

Long/Short Strategies

All of the above assumes investors are constrained to long only strategies. A long/short or market neutral strategy in equities, bonds, credit or commodities can be completely uncorrelated with the long only indices for each asset class.

A long/short strategy also maximises the informational value of active management, which is partly wasted if managers cannot profit from active short positions.

However, alpha is scarce and follows its own cycles. It can be more difficult to extract alpha from security selection in markets when correlations are high, which means that investors need to keep on searching for new sources of diversification. Markets off the beaten track may offer more potential for alpha generation from informational inefficiencies.

Emerging and Frontier Markets

Nordic investors have often been the earliest movers into emerging markets and frontier markets, where equity, local currency debt, hard currency sovereign debt, corporate debt and currencies can offer not only higher yields, but also more mispricing as there is less research coverage. These markets are not always suitable for long/short strategies however, as they do not all have any or well-developed securities lending, repo and credit default swap markets. The largest developed market today, the US, was of course an emerging market in the 19th century but in a global village diversification need not be based on geographic borders.

Volatility and Correlation

Volatility and correlation are derivatives of price action, but they can also be directly traded across all asset classes. Volatility strategies are relatively new. For instance, the equity VIX volatility index future started trading in 2004, though volatility was traded earlier over the counter. A long volatility strategy can offer portfolio insurance as was the case around the Covid-19 pandemic in March 2020, though as with any insurance, it can be expensive to pay the premiums in normal market conditions. More sophisticated volatility strategies may be able to mitigate this premium cost through a variety of strategies trading both volatility instruments and other markets indirectly related to volatility.

Correlation is one example of a more exotic derivative that can itself show some correlation with volatility – since correlations tend to spike when volatility does – but also has its own dynamics. For instance, the split between “Covid winners” and “Covid losers” in equity and credit markets created new patterns of correlation in 2020. Historical assumptions that airlines effectively short of oil should hedge oil producers proved wrong since both industries suffered from lockdowns.

Exotic Markets

In the 1970s currency and commodity futures were relatively new as easily investable derivatives, and they contributed to strong CTA performance in that decade. Cryptocurrencies may be a new market to watch over the 2020s.

There has been some debate amongst regulators over whether Bitcoin should be defined as a currency or a commodity, though growing acceptance of the unit by payment processors, such as Paypal, shows that it is being used as a currency. It is also garnering wider acceptance from both hedge fund managers, and institutional investors, according to a survey from Fidelity Investments, which found that as many as 36% of institutional investors in the United States and Europe already own crypto assets, of which Bitcoin is the most popular. Bitcoin has in November 2020 regained the highs last seen in 2017.

More broadly, the science underlying Bitcoin – distributed ledger technology (DLT)- could disrupt financial and other markets. Companies in the payments space and other ecosystems could be compelling private equity or venture capital investments. Tokenisation could also democratize these illiquid asset classes, making it easier to securitise them so that more investors can access the potential diversification benefits.

*This article featured in HedgeNordic's report "**True Diversifiers**."*