

# Down, but not out

Diversification may have been hit in 2008, but it's as relevant as ever



by Scott Newman

It is certainly well understood that 2008 was one of the worst years for global stock markets. To call the last 18 months "historic" would be an understatement.

But after witnessing one of the greatest stock-market downturns on record, we then saw one of the greatest stock-market rallies in history, all within a year and a half.

Practically no asset class was spared the carnage sparked by the unwinding of massive leverage in the global system.

There were few places to hide, other than what investors considered true "risk-free" and liquid asset classes such as U.S. Treasury bonds, which delivered a staggering 51% return in Canadian-dollar terms in 2008—a flight-to-quality stampede not seen in recent history.

More importantly, investors in virtually all the other asset classes were devastated by the market turmoil (see "Traditional and alternative asset returns in 2008" chart).

## Tenets of diversification

This historic downturn has prompted many investors and market watchers to suggest diversification and asset allocation are dead. They claim, "It didn't work when we needed it, so let's throw out everything we understood

about the relationship between asset classes, because those relationships didn't hold up in 2008."

But before dismissing asset allocation and diversification as the buggy whip, let's reflect on the tenets upon which they're based. Holding several different investments within a portfolio is intended to find assets that move independently of one another. You don't want to assume the risk of all holdings moving in the same direction at the same time. The idea is to combine these assets in a way that smoothes out returns at the overall portfolio level, creating less of a white-knuckle ride for the investor. It is a strategy that has proven to work well over the long term. In fact, if executed effectively, you can actually add assets into the portfolio that will increase the overall return without increasing the volatility of the portfolio. If you can add certain assets to the portfolio and increase the return in addition to actually

decreasing the risk, this results in what the U.S. economist and Nobel Prize winner Harry Markowitz dubbed "The Free Lunch."

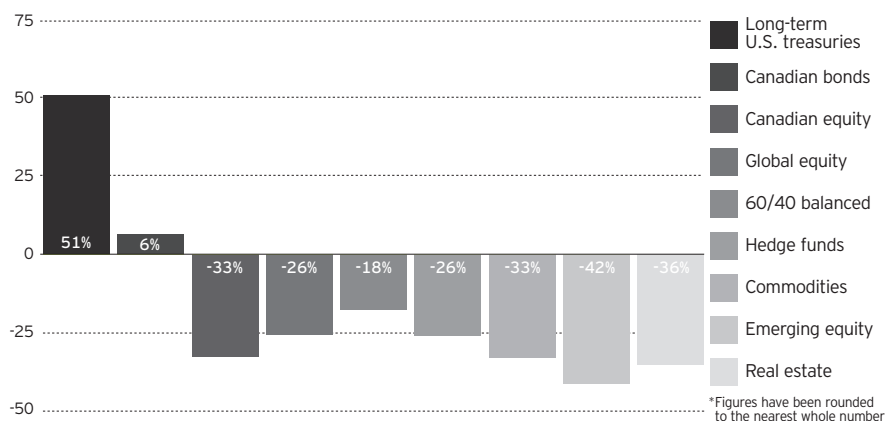
The relationship between asset classes is the key to properly diversifying the portfolio, and it is well accepted that those historical relationships broke down in 2008. Although everything fell in unison, it stemmed from liquidation and unwinding of leverage as opposed to the relationships between asset classes losing validity.

Yes, 2008 was difficult, but it was also an anomaly and should not give rise to an across-the-board dismissal or denigration of the tenets of asset allocation.

## Asset performance during different economic conditions

To build "all-weather" portfolios, it's worth thinking about diversification as a strategy to provide the right type and degree of exposure to match

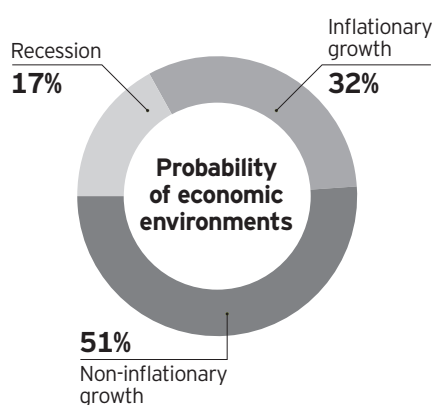
Traditional and alternative asset returns in 2008



prevailing economic conditions (see "Probability of economic environments," below). There have been three types of economic conditions over the last 45 years:

- non-inflationary growth;
- inflationary growth; and
- recession.

Different assets will perform differently during different economic conditions. Granted, that's not exactly a breakthrough concept, but looking at your portfolio through this lens may help you arrive at a better-diversified portfolio. Non-inflationary growth is certainly the dominant period wherein you have benign inflation, growing GDP, and often low or declining interest rates, all fuelling leveraged GDP growth.



In this economically favourable environment, traditional equity investing can be well rewarded. In fact, it can be a veritable tailwind for equities. You certainly want the benefit of equity exposure in your portfolio – both developed market and emerging market equities – in an environment like this.

Recession is also a reality. The flight to quality and liquidity that typifies recessionary environments often means low-risk treasury bonds provide leadership while riskier assets can – and often will – experience declines.

The other major environment – inflationary growth – is something all portfolios should be prepared to encounter. Whether or not you think inflation is a real threat, it makes sense to address tomorrow's risks today. Historically, inflation has had a negative impact on the following investable assets:

**Fixed income** has historically underperformed when interest rates rise.

**Equities** have historically underperformed as a whole during periods of rising and/or high inflation. However, some equities can do well in an inflationary environment if it coincides with a robust economy.

**Domestic currency** in an inflationary environment is usually a primary catalyst in causing inflation.

Some investable assets that may actually benefit from inflation:

- real estate;
- inflation-protected debt securities such as floating-rate loans and real-return bonds;
- hard currency like gold or other precious metals; and
- commodity prices usually rise with rising inflation as they seem to function as a natural inflation hedge.

Whatever economic environment comes next, it will provoke many opinions and questions. Are we out of recession? Is runaway inflation coming next with the decline of fiat currencies? Is a deflationary spiral coming at us? Is gold going to US\$2,000 an ounce?

The debate about whether inflation or deflation will hit the global economy next (or any other prognostication about economic and market conditions, for that matter) should not be about guessing the correct answer. Instead, it should focus on which collection of asset strategies will build a well-diversified portfolio that balances risk across assets and excels in a variety of market conditions.

So, is diversification dead? Absolutely not! The concept may have taken a hit in 2008, but it's as relevant as ever.

Scott Newman is VP of Alternative Strategies at Invesco Trimark.