

Be smart and enjoy your free lunch

Weekly Digest

12 March 2018

– Lorenzo La Posta

Anyone who has attended Finance 101 in their first year at university had one sentence imprinted on their mind: “Diversification is the only free lunch in investing”. I still remember my first day when my 40 year old, PhD in Economics, finance professor taught me the three pillars to bear in mind if you wanted to be a successful investor: diversification, diversification, diversification. Even though this is to a large extent true, this pill of wisdom could be more accurately stated as: “**Smart diversification is the only free lunch in investing**”.

According to the widely studied Modern Portfolio Theory set out by Harry Markowitz in 1952, a risk-averse investor can reduce risk in their portfolio by spreading investments across a large pool of lowly (preferably negatively) correlated assets. This is an extremely powerful yet simple principle. Whenever an asset is losing value, there is a high chance that a second asset in the portfolio - negatively correlated with the first - is offsetting this with gains, producing a less volatile return profile.

There is only one caveat: **correlation is a backward looking and purely statistical measure**. Thus, its value at any point in time is only an indication of how two securities moved together in the look-back period with little information on the underlying drivers of these movements. As a consequence, diversifying a portfolio only according to correlations works as a safety net as long as future market conditions are not too different from the past environment; this can be painfully false during short-term periods of high markets stress. In crisis periods a widespread flight to quality may add pressure to all risky assets whose returns would eventually show extremely high short-term correlation regardless of historical long-term values. In such situations

historical correlations would be less meaningful and a Markowitz-efficient portfolio would strongly underperform a “smartly diversified” portfolio where diversification takes place at a risk-driver level rather than across a correlation matrix. A significant example of this phenomenon can be observed across global stocks and government bonds, which have historically shown a negative correlation¹ (on average -42% in the five years from May 2008 to April 2013). However, in May 2013 the Federal Reserve’s chairman, Ben Bernanke, announced the FED would start tapering its asset purchase program and both asset classes sold off together for the following weeks. During the following three months their correlation topped to an unusually high value of +40% and diversification benefits faded away when most needed.

Portfolio Managers construct **robust portfolios targeting high resilience and allocation efficiency**. Each strategy that enters any of our portfolios is thoroughly analysed in all its components: experienced analysts are supported by sophisticated research tools to gain a complete understanding of each asset. Additional important factors are considered alongside the more traditional building blocks in the asset allocation process. This means embedding systemic risk checks, alternative risk factor exposures, tactical views and stress tests into the portfolio construction framework. Despite Markowitz’s idea of diversification as a simple, cost-effective shortcut towards asset allocation, only a deeper (yet real, with no over-engineering traps) and smarter asset returns decomposition would yield an efficient portfolio composition.

¹ Linear correlation of daily returns computed over a rolling window of 3 months

The Marketplace

- Global equities rebound, posting strong gains
- President Trump's chief economic advisor Gary Cohn resigns
- US imposes import tariffs on steel and aluminium
- President Trump primed to meet with Kim Jong-un

Market Focus

US

- US and North Korean leaders may meet for the first time after Kim Jong-un expressed his desire to meet President Trump as soon as possible, with Trump equally keen. This follows news stating North Korea was open to denuclearisation, providing their safety was guaranteed.
- President Trump signed an order to authorise a levy duty of 25% on imported steel and 10% on aluminium, with the tariffs taking effect within two weeks. Notably, Canada and Mexico were exempt from the tariffs while Trump stated "we're going to be very flexible".
- President Trump's chief economic advisor Gary Cohn has resigned from his post, with reports citing disputes over protectionist policies.
- In the jobs report, the US economy added 313,000 jobs in February, the largest increase since July 2016. The unemployment rate held at 4.1%. Year-on-year wage growth slowed to 2.6% in February, down from 2.9% in January and below estimates of 2.8%.
- Equities rebounded from the previous week's losses, rising 3.6%, with the NASDAQ composite closing at an all-time high on Friday.

UK

- EU Council President Donald Tusk stated that Brexit talks should resolve the Irish border issue first before reaching a transition arrangement deal.
- UK equities rose 2.3% during the week, while Gilts fell 0.6%.

Europe

- In response to President Trump's announced steel and aluminium tariffs, the European Commission compiled a list of over 100 US products that could be affected.
- The European Central Bank upgraded its Euro area GDP growth forecast to 2.4% from 2.3%.
- Continental European equities rose 3.1% in the week.

Asia

- The Japanese economy grew at a faster pace in the fourth quarter of 2017 than initially anticipated, with annualised growth at 1.6% versus a 0.5% estimate. This data confirms GDP has grown for eight consecutive quarters, the longest period of growth for almost thirty years.
- China has set its 2018 GDP growth target at 6.5%; this follows growth of 6.9% in 2017, a figure which marked the first pick-up in growth since 2010.

Asset Class/Region	Currency	Currency returns			
		Week ending 9 March 2018	Month to date	YTD 2018	12 months
Developed Market Equities					
United States	USD	3.6%	2.7%	4.5%	19.5%
United Kingdom	GBP	2.3%	0.1%	-5.2%	2.4%
Continental Europe	EUR	3.1%	-0.4%	-1.7%	5.1%
Japan	JPY	0.4%	-3.0%	-5.6%	12.7%
Asia Pacific (ex Japan)	USD	1.8%	0.6%	2.3%	29.2%
Australia	AUD	0.9%	-0.5%	-0.6%	8.4%
Global	USD	2.9%	1.5%	2.5%	19.3%
Emerging markets equities					
Emerging Europe	USD	1.6%	-0.4%	6.7%	32.9%
Emerging Asia	USD	2.0%	0.9%	3.1%	35.5%
Emerging Latin America	USD	2.1%	2.1%	11.3%	27.3%
BRICs	USD	1.7%	0.7%	6.3%	39.5%
MENA countries	USD	0.7%	0.7%	3.8%	4.3%
South Africa	USD	5.2%	2.8%	5.4%	39.2%
India	USD	-1.8%	-2.2%	-4.4%	19.1%
Global emerging markets	USD	2.2%	1.1%	4.4%	33.7%
Bonds					
US Treasuries	USD	-0.1%	0.0%	-2.3%	0.8%
US Treasuries (inflation protected)	USD	-0.2%	0.1%	-1.9%	1.7%
US Corporate (investment grade)	USD	-0.2%	-0.4%	-3.0%	3.5%
US High Yield	USD	0.3%	-0.1%	-0.4%	5.2%
UK Gilts	GBP	-0.6%	-0.2%	-2.0%	-0.6%
UK Corporate (investment grade)	GBP	-0.3%	-0.1%	-2.1%	1.3%
Euro Government Bonds	EUR	0.1%	0.2%	0.1%	2.5%
Euro Corporate (investment grade)	EUR	0.0%	-0.1%	-0.4%	2.2%
Euro High Yield	EUR	0.3%	0.2%	-0.1%	5.1%
Japanese Government	JPY	0.2%	0.1%	0.3%	1.2%
Australian Government	AUD	-0.3%	0.2%	0.0%	3.9%
Global Government Bonds	USD	-0.2%	0.4%	1.0%	8.6%
Global Bonds	USD	-0.1%	0.3%	0.4%	8.3%
Global Convertible Bonds	USD	1.3%	1.0%	3.4%	10.6%
Emerging Market Bonds	USD	0.4%	0.2%	-2.5%	3.5%

Asset Class/Region	Currency	Currency returns			
		Week ending 9 March 2018	Month to date	YTD 2018	12 months
Property					
US Property Securities	USD	2.9%	3.0%	-9.0%	-3.4%
Australian Property Securities	AUD	1.2%	1.4%	-6.0%	-2.7%
Asia Property Securities	USD	0.1%	-0.3%	-0.1%	19.5%
Global Property Securities	USD	1.9%	1.7%	-4.0%	10.6%
Currencies					
Euro	USD	0.0%	0.9%	2.5%	16.4%
UK Pound Sterling	USD	0.6%	0.5%	2.4%	13.8%
Japanese Yen	USD	-1.1%	-0.1%	5.4%	7.5%
Australian Dollar	USD	1.2%	0.7%	0.4%	4.4%
South African Rand	USD	1.0%	-0.2%	4.8%	12.7%
Swiss Franc	USD	-1.2%	-0.6%	2.5%	6.6%
Chinese Yuan	USD	0.2%	-0.1%	2.8%	9.1%
Commodities & Alternatives					
Commodities	USD	0.3%	0.1%	1.6%	9.7%
Agricultural Commodities	USD	-0.4%	-0.2%	5.3%	-1.1%
Oil	USD	1.7%	-0.4%	-2.1%	25.5%
Gold	USD	0.1%	0.2%	1.2%	9.8%
Hedge funds	USD	0.4%	0.1%	0.1%	4.7%

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