

# ALL TYPES OF PORTFOLIO DIVERSIFICATION ARE NOT EQUAL

EFFICIENT DIVERSIFICATION MEANS SO MUCH MORE THAN NOT PUTTING ALL YOUR EGGS IN THE ONE BASKET.

WORDS GLENN FREEMAN

Maintaining sufficient levels of diversification within investment portfolios is particularly important during periods of market volatility, such as those currently being experienced in Australia.

It is also critical to maintain the “efficiency” of a diversification strategy – an objective made more challenging by rich valuations across mainstream asset classes, says Ben McCaw, a portfolio manager for MLC.

“The problem is that we’re now entering a period where the opportunity to access diversification is getting more and more squeezed,” McCaw says. “Risk in the environment is growing, so it’s a very, very difficult time right now.”

Efficiency of diversification refers to the ability to obtain a good mix of non-correlated assets at a reasonable cost. Portfolio diversification can be inefficient, depending on the approach adopted by the investor – which is often heavily influenced by a financial planner.

“It depends on how you go about doing it,” McCaw says. “If you just take a naïve approach and start off by diversifying growth assets with defensive assets and maintaining that at all points in time, [then] because of the relativity of those drivers...and the relative price changes through time, sometimes bonds will be a very good diversifier for equities, and sometimes they won’t be.

“When they aren’t – or when the risk embedded in bonds is higher – there are probably other sources of diversification you can harness.”

Robert da Silva, head of research, fixed income and alternatives for SQM Research, says that

efficient diversification can be measured either by the fees the investor pays, or the price of trading in different markets.

“Fees charged by managers will vary, but even within that variance, you can still get access to some quite efficient international funds,” he says. “You want to see diversification that actually lowers your risk.”

For example, he says, holding mining stocks in two separate markets is not really diversified, because although the countries are different, the investor is still exposed to the same industry risks. He emphasises that efficient portfolio diversification is about much more than simply getting access to different markets, or to different asset classes.

“What you really want to do is get access to economies that are running at different speeds,” da Silva says.

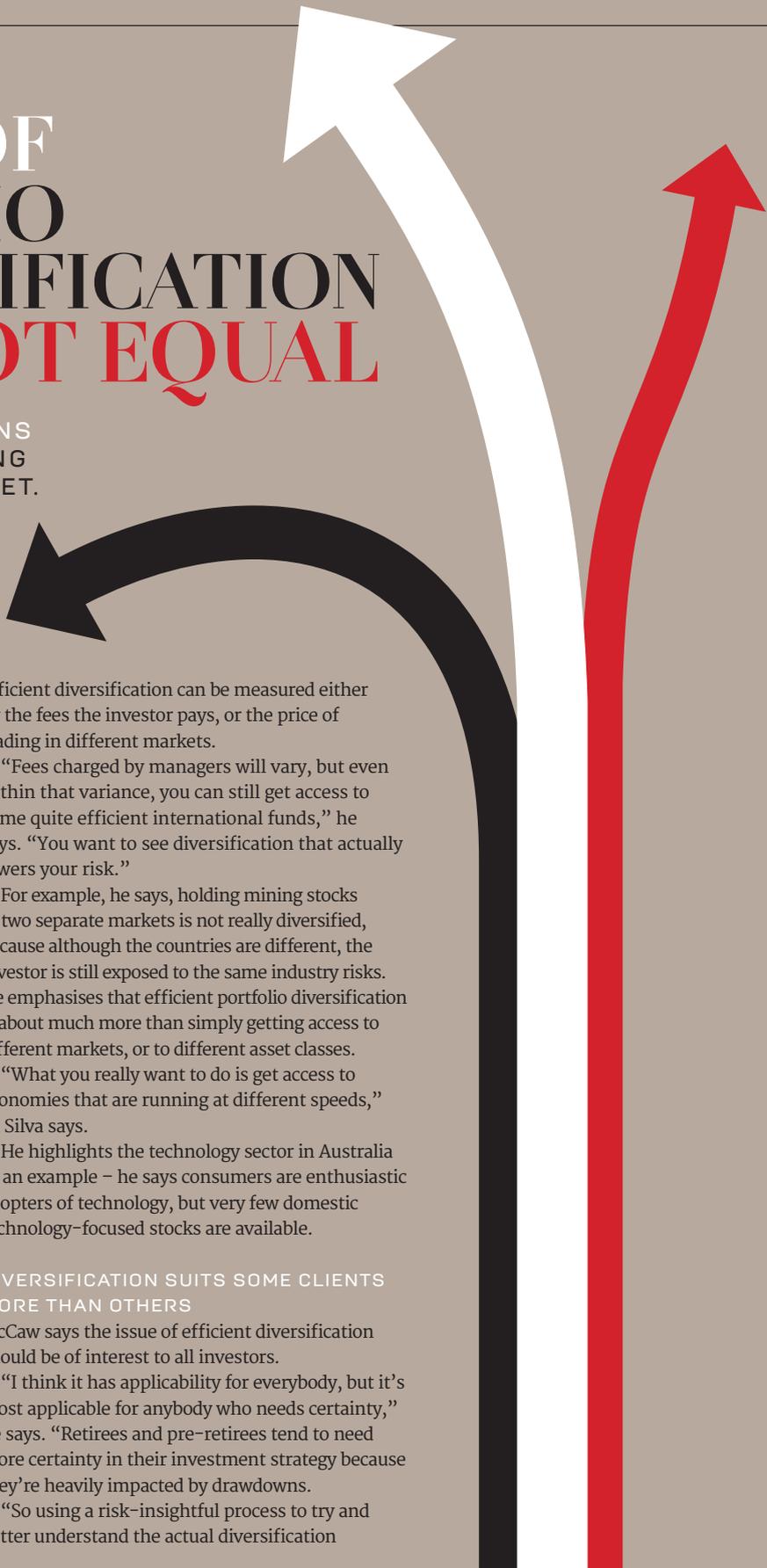
He highlights the technology sector in Australia as an example – he says consumers are enthusiastic adopters of technology, but very few domestic technology-focused stocks are available.

## DIVERSIFICATION SUITS SOME CLIENTS MORE THAN OTHERS

McCaw says the issue of efficient diversification should be of interest to all investors.

“I think it has applicability for everybody, but it’s most applicable for anybody who needs certainty,” he says. “Retirees and pre-retirees tend to need more certainty in their investment strategy because they’re heavily impacted by drawdowns.

“So using a risk-insightful process to try and better understand the actual diversification



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strategies, and still maintain as much return potential as possible, is ideally suited to retirees.”

On the other hand, clients who are younger and are in the accumulation phase are not usually subject to the same pressures, he says. McCaw also believes constraints can make it more difficult for financial planners and their clients to pursue diversification opportunities.

“A lot of the mainstream types of funds have got a mandated growth/defensive split, and whatever is classified as either of these...but in doing that you limit that ability to diversify,” he says. “You need the freedom to be able to vary the artificial growth/defensive split that encompasses most funds. And that makes more sense at the retiree end of the market.

“If you use a strategy that doesn’t have those constraints and is risk aware... at least you’re empowering the investment manager to avoid the situation where you’re going to get a drawdown because interest rates rise.”

#### RISK MINIMISATION

Inflation risk, market risk and longevity risk are three of the core risks clients face as they approach and enter retirement. McCaw says sequencing risk is addressed “just by virtue of removing the constraints over the funds, with a risk-focused process”.

“As long as the funds are managed to a real return outcome, and as long as inflation is a consideration, then it also handles inflation risk as well,” he says. “And if you minimise sequencing risk and inflation risk at the same time, then longevity risk will be reduced. But ultimately, that depends on how long [your client] lives, and their starting balance.”

Da Silva agrees that financial planners need to be particularly aware of the benefits of efficient diversification for certain demographics among their client base. However, he also makes the point that removing too much risk – and therefore, reducing potential returns – can be detrimental.

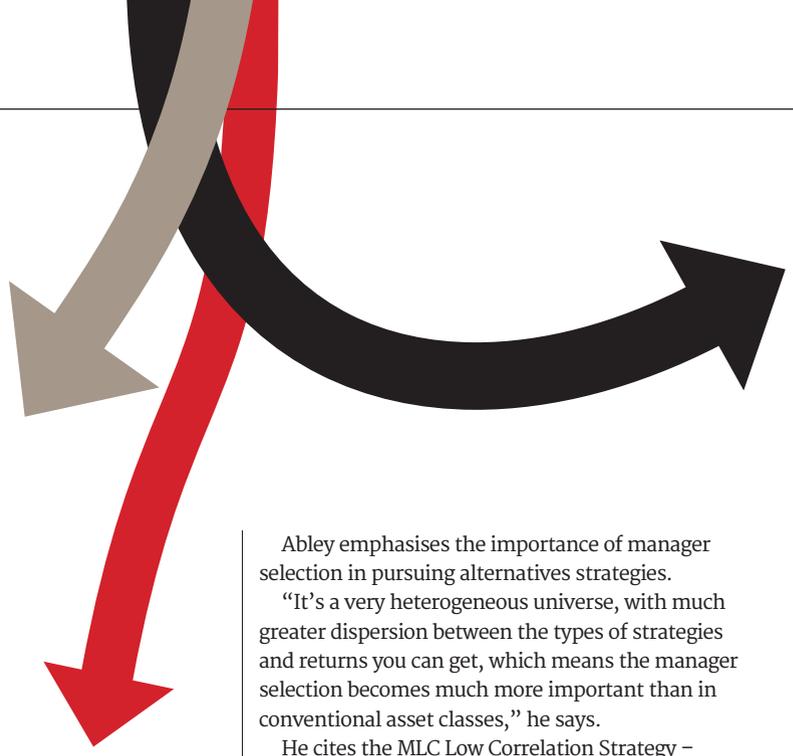
“Investors can still take some risks after retirement; otherwise it’s hard to get the retirement returns that you need,” he says. “In the days where interest rates were 12 per cent, you didn’t need to do much to get yourself returns; though this is more difficult in the current low-interest-rate environment.”

#### THE ROLE OF ALTERNATIVES

Gareth Abley, head of alternative strategies for MLC, points to the much smoother returns that alternative assets bring relative to other diversification options.

“Conventional hedge funds in particular will tend to over-promise on returns and under-deliver on both the returns and the correlation benefits,” he says. “If you look at the evidence over a long period of time, the average hedge fund is actually very correlated to equities.”

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Abley emphasises the importance of manager selection in pursuing alternatives strategies.

“It’s a very heterogeneous universe, with much greater dispersion between the types of strategies and returns you can get, which means the manager selection becomes much more important than in conventional asset classes,” he says.

He cites the MLC Low Correlation Strategy – which has delivered net returns of cash plus 5 per cent since August 2008, with a zero correlation to equities – as an example of the benefits of being very selective and focusing on the most lowly correlated hedge fund strategies.

“MLC Inflation Plus portfolios and MLC Horizon series can both be accessed broadly by the financial planning universe,” he says.

MLC Inflation Plus Assertive was launched in 2006, and MLC Inflation Plus Moderate and Conservative in 2013. These funds now have about \$1.5 billion of external capital, while the MLC Horizon series now has about \$30 billion in funds under management. The MLC Inflation Plus series in particular has a meaningful allocation to carefully selected alternatives.

“Over the last couple of years, these strategies have also added the ability to use derivatives to mitigate risk, and added more in the area of alternatives over time,” Abley says.

“Private equity is another interesting area, and there are similarities with hedge funds in that we wouldn’t invest in the average private equity manager; but if you can access the top quartile [of managers], the returns can be extremely attractive over long periods of time.”

Abley says MLC’s investments in private equity assets have outperformed the global listed market over the long term, to the obvious benefit of investors.

“This is something very hard to build directly as a planner, because you can’t access these directly. They tend to only be open to institutions, and even then they tend to be hard to access,” he says.

“It helps to have a long track record in the space, which we have, with a heritage in this space dating back to 1997, to be able to access the top managers.” ■