‘True’ diversification: Is your portfolio overly exposed to equity risk?

RUSSELL INVESTMENT’S **DAVID VICKERS** EXPLAINS WHY MULTI-ASSET INVESTORS MUST USE A BROADER SET OF ASSET CLASSES IN ORDER TO ATTAIN ‘TRUE DIVERSIFICATION’ THAT IS ABLE TO PROPERLY NAVIGATE MARKET CHALLENGES

In an era of lower absolute returns driven by higher – and more expensive – valuations, the challenge of finding attractive potential returns within a specific risk budget continues to plague investors.

The good news is that there are many different types of multi-asset offerings that seek to achieve the types of returns investors want: from static, passive and beta-led vehicles to target return funds that are much more reliant on alpha. Despite this choice, many multi-asset portfolios remain overly reliant on the equity risk premium.

For example, a 50% allocation to equities in a diversified portfolio does not equate to 50% of the total risk the investor is taking on. In reality such an allocation is much more likely to account for upwards of 85% of a growth portfolio’s risk. As such, diversification by allocation is very often different from diversification by risk in a portfolio.

At Russell Investments, this differentiation is core to how the group looks to generate returns and manage risk profiles on behalf of its clients. The group believes that multi-asset portfolios in particular should be managed in a dynamic fashion, and asset classes above and beyond the traditional bond and equity risk premium are a much needed part of the investable toolkit.

“Against today’s investment backdrop, investors cannot rely on the same returns they have enjoyed in the past from a traditional 70:30 equity/bond portfolio,” says David Vickers, senior portfolio manager in the Russell Investments Multi-Asset Solutions team (pictured). Unlike traditional multi-asset offerings, Vickers argues Russell Investments’ strategy employs a comprehensive and long-term “strategic framework” that takes into account the full opportunity set of assets, but also employs a thoughtful dynamic asset allocation policy designed to enhance returns, or perhaps more pertinently – given where we stand today – protect the impressive returns that investors have accrued

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since the global financial crisis of 2007/2008.

He explains: “We believe that asset allocation decisions should be driven by a robust and repeatable process and we look to deploy all tools necessary in the pursuit of maximising investor returns. This approach helps us navigate the shifting sands of the investing landscape and the ever present threat that stems from behavioural bias.“

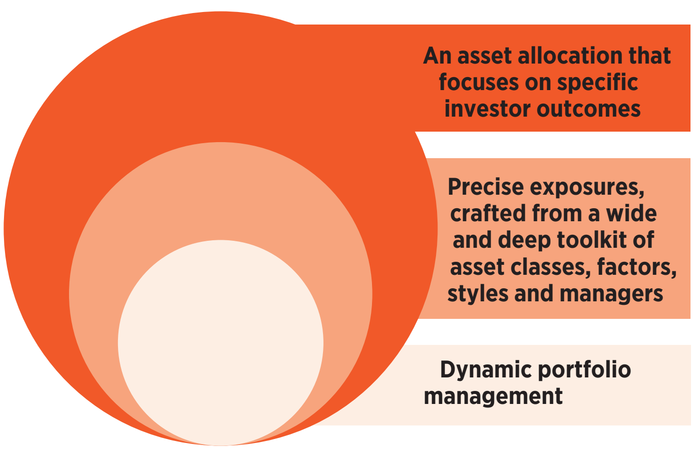
Vickers stresses “the team is not wedded to any one implementation methodology; they are supported by a large manager selection team (50-plus experts globally) and have the ability to tap into a vast array of passive and smart beta opportunities, meaning we can offer unrivalled access to the multi-asset opportunity set.”

The group constantly stress test portfolios against recurrences of previous crises and against forward-looking concerns, in a bid to manage risk on an ongoing basis.

Vickers cites the example of a ‘taper tantrum’ type event during which bonds and equities fall together. In this scenario, a repricing event in bonds could become the catalyst for a broad growth asset correction which would mean so called ‘safe haven’ asset classes such as government bonds may not exhibit their conventional diversification roles in a multi-asset portfolio.

“This sort of taper tantrum scenario is pretty bad for the traditional strategic asset allocation approach to multi-asset,” explains Vickers. “This is why we believe in utilising a broader set of asset classes to attain ‘true diversification’ and employ a dynamic approach towards asset allocation in all of our portfolios. Ultimately, we strive to design portfolios that are robust under multiple future scenarios and avoid just planning for one.”

The three characteristics of ‘true’ multi-asset investing



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