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The Strange Paradox of Diversification

February 2019

Sitting through the most tedious Super Bowl in recent memory did at least give me the opportunity to connect it with my theme for this quarter's letter, the strange paradox of diversification in good times. It's been tempting to see the success of the New England Patriots as down almost entirely to their legendary quarterback, Tom Brady (and maybe a little bit to Gronk...). This year, when Brady's prowess was seemingly blunted (and Gronk barely figured), they still emerged victorious, due to an outstanding defensive performance that no one expected, coupled with a game winning receiving performance from a historically underappreciated Julian Edelman.

The paradox arises because for many years, money spent on the defense (and perhaps even Edelman) would have been viewed as a complete waste (along the lines of "why do we need (defense) when we have Brady..."). Then finally in a match where offensive points were hard to come by, the value of the defense came to the fore. (Although space limits my ability to fully develop the analogy, just in case anyone thinks I have gone totally native, you can make the same observation around the strategy and team development within "true football" i.e. soccer, for example, with Lionel Messi at Barcelona.)

There's a strong parallel with diversification in investments. In some market conditions, it can go completely unrewarded. Indeed, in the short term, making the right choice – building a robust total portfolio – can often actually seem to cost both returns and money. If the obvious single asset performs the best, then in pure results terms, diversifying from that asset leaves us worse off in the short term, even if the actual portfolio chosen a priori had been a much more robust design.

I am prompted in these thoughts because, while 2018 was a relatively traumatic year for both equities and bonds, it came after one of the most benign periods for these assets that we have ever seen. In the case of equities, commentators mark the start of the latest bull market from the troughs around the end of Q1 2009, and indeed the returns have been stellar. Of course, what is rarely mentioned is that, at the time, it felt like there was a 50% probability of the end of capitalism, and prices reflected that (or the attendant fear if you prefer). Unsurprisingly, once you take that risk off the table, equity prices were rebased in a major way. In the case of bonds, the environment has been even more favorable if that were possible: a 30-year bull market initially triggered by a long cycle of disinflation in part driven by a one-time globalization of the world economy, then followed over the last decade by a hunt for yield that has spread right across the capital spectrum and seen more than $2 trillion deployed into the asset class.

On top of those benign fundamentals, the party was for many years further invigorated by a global wave of quantitative easing (QE) that's now coming to an end (and already has here in the US). We probably still need more distance from QE to diagnose its effects fully, but a reasonably well held view (that I share) is that it helped perpetuate both equity and bond bull markets – probably not a surprise when central banks are pumping money into the capital markets on top of normal demand! What we don't know is what happens as they withdraw that same money – but it's hardly unreasonable to imagine some opposite effects.

But to return to my theme, this has meant that diversification in the last decade (before 2018) has been truly a game of "offense only". With hindsight, the best thing anyone could have done was simply to run an old-fashioned balanced 60-40 portfolio. However, I think 2018 provides a much better sense of the next decade than the years that preceded it: not meaning negative returns necessarily, but certainly more normal levels of volatility for equities, and bond markets that can go down as well as up! In that context, I would argue every client should at least cast a critical eye over their portfolio construction to ensure it's ready for the return of volatility. The challenge in so doing is that for exactly the reasons above, you cannot use recent returns to do that analysis since they are not representative of anything other than a very benign period that seems to have come to an end. Rather it forces us to instead try and use investment first principles.

Before I come to what that sort of thinking might entail, let me offer a historic example. Does anyone remember the EMMA mandates – "emerging market multi-asset"? These were quite fashionable earlier this decade when both emerging market equities and bonds were going gangbusters, and the sales geniuses in our industry decided that by packaging the two together, they could narrow the competitive field. The only problem with this logic (and I well remember a golf outing at the time being somewhat marred as I argued exactly this point with one of the said geniuses) was that irrespective of how they had performed in the recent past, you were yoking together two assets that had more in common then everything else in the portfolio (the dependence on emerging market currencies and politics if relevant), and reducing your ability to diversify for no obvious positive utility. (The only counterargument I heard was that a single mandate would allow the manager to go across the capital spectrum, but which manager has ever been able to do that reliably or even try credibly!)

So what might a first principles analysis of your diversification entail? I can't do justice to it fully in what's left of this letter, but the place I would start is to truly understand in forensic detail the embedded directionality in each of your portfolio components i.e. despite what the label says, how is the price likely to behave in response to rises or falls in equity markets, bond markets and, I would argue, credit spreads. This can be amplified by analyzing the actual performance in the relatively rare episodes of adverse markets. Let me offer a couple of examples as food for thought:

- Absolute return bond funds. It's a lovely idea: I can invest in this vehicle which has shown great historic returns, and yet will be protected should yields rise or spreads widen. I'm not saying it can't be done, but it's remarkably difficult to build a portfolio that's truly neutral to interest rate moves and spreads, and harder still to actually then leave scope for positive returns. You should really dig in to identify embedded directionality.

- All weather diversified growth funds (very popular in the UK). Again, the core concept is very appealing, but it's important to assess in a very scientific way what you are getting by way of market return. For all the talk of individual ideas or themes, equity beta can often be the dominant return driver.

Of course, the counterargument that often comes back is timing. "We know when to be in and out" may come the refrain. Again, I am not saying that timing skill is impossible or doesn't exist, but it is a very precious commodity and should be evaluated with great care. However, at least in portfolio construction terms, that is also turning the argument into its correct form: recognizing that this asset will only diversify if the manager has market timing skills, and evaluating on that basis.

None of us knows with certainty what the markets will bring in the next few years. However, we can recognize that the years prior to 2018 have been exceptionally benign. This has meant that diversification – constructing more robust total portfolios – has been both unrecognized and unrewarded. If we are entering a period of more volatile markets, the rules of the game are already changing and diversification is coming back into fashion. Now is the time for clients to look at the robustness of their portfolio construction through fresh eyes, focusing on the underlying exposures that will drive the outcome. In the same way as the Patriots ultimately needed a game plan that was more than just reliance on Brady, make sure that the success of your overall portfolio is not dependent on just one or two elements however they may have performed in the last few years!

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QMA-20190222-86