The Paradox of Diversification

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Are you an optimist or realist?
The longest bull market on record carries on

Historical look at S&P 500 cumulative return & time

Source: Strategas Research Partners, as of October 15, 2019. As represented by the S&P 500 Index.

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A Different Beta Landscape Ahead: Equities

Shiller PE and 10-year forward returns

Source: FactSet, S&P US, and Yale University Department of Economics. Monthly data as of 31 January 1928 to 30 September 2019. At the time of this analysis, the Shiller P/E was only available through August 2019. Chart is meant to illustrate the subsequent 10-year performance for the S&P 500 Price Return Index (annualized) given the starting level of the Shiller P/E.
The Importance of Starting Yield to Return

Global Agg Starting Yield vs. Rolling Subsequent 5-Year Returns

Source: Bloomberg and FactSet. Quarterly data from 31 March 1990 through 30 June 2019. Global Agg = Bloomberg Barclays Global Aggregate Index. Returns are total return and hedged in USD. The red line indicates the current yield to worst as of 27 August 2019, but not the subsequent return.

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The Curious Case Of Negative Rates

Interest rates are falling to zero and beyond


Negative yielding debt poses a challenge for investors as they search for yield

We Are 10 Years on From a Debt Crisis. Have We Learned Our Lesson? Debt Levels Have Continued to Climb...

Source: IMF Fiscal Monitor April 2018. Average is calculated using GDP at purchasing power parity. Advanced Economies - Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Hong Kong SAR, Ireland, Italy, Japan, Korea, Netherland, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, Taiwan Province of China, United Kingdom, and United States. Emerging Economies - Argentina, Brazil, Bulgaria, Chile, China, Colombia, Egypt, Hungary, India, Indonesia, Iran, Jordan, Kazakhstan, Kenya, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Romania, Russia, South Africa, Sri Lanka, Thailand, Turkey, Ukraine, Uruguay, Venezuela.

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...Whilst Measures of Quality and Liquidity Are Significantly Worse.


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How many of you have been pursuing “alternative” investments in response?
An increasingly complex puzzle

In 1989, our expectations for cash and broad U.S. fixed income were 6.80% and 9.35%, respectively. Growth assets were not required to earn a 7.5% expected return.

15 years later, an investor would have needed half of the portfolio in public equities to achieve a 7.5% expected return, nearly tripling the portfolio volatility of 1989.

Today an investor is required to include 96% in growth assets to earn a 7.5% expected return at almost 6x the volatility compared to 1989.

Source: Colin
But, Does Diversification Work When The Going Gets Tough?


“The definition of insanity is doing the same thing over and over again, but expecting different results” – Albert Einstein

“When Diversification Fails”, by Sebastien Page, CFA and Robert A. Panariello, CFA. Published in the Financial Analysts Journal Volume 74 Number 3. All data is as at June 2017.

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Dealing with increasing complexity
Why is this relevant?

...Patterns of failure:
1. Experts get fixated on a narrow solution
2. Others are intimidated by the hierarchy
3. Experts lose track of their overall goal because they are so focused on the narrow task

-From Black Box Thinking by Matthew Syed
1. What range of outcomes do you need to access?

2. What are the different ways of maximizing your chances of achieving that outcome?

- **Diversification**
  Changes the shape of the distribution

- **Active Management**
  Changes the centre and skew of the distribution

- **Options Strategies**
  Changes the range of the distribution
Active Manager Return Distributions in Bull vs Bear Markets

US Large Cap Strategy Annualized Excess Returns Against the S&P 500 Index

Summary

- Does diversification work how you want it to?
- Is it really what you need in the first place?
- Should we begin to think of skill – especially counter-cyclical skill – as a diversifying asset?