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Diversify your diversifiers

by Alex Harvey, CFA

Genghis Khan is considered by many to be perhaps the greatest conqueror of all time (sorry, Guillaume de Normandie), and ruled over an empire that at its peak spanned as far west as modern-day Poland and as far east as the Russian Pacific seaboard. Mongolia today is a 'fraction' of that size but still in the world's top 20 largest countries and would knock Kazakhstan down into 10th place if you included the Mongolic autonomous region of the People's Republic of China[1]. As the least densely populated country in the world it fits the population of Wales into a land mass the size of Western Europe. It's that empty.

I was fortunate to have visited this beautiful landlocked country three years ago and journey overland through the Gobi desert and beyond. As is customary we travelled in a convoy, not because we were important (far from it!) but because if you break down out there, no one is going to find you. The lack of mobile reception was part of the 'Detox draw' but with that comes no search and rescue. That 10yr old land cruiser might have served you well in the past but it can still go wrong (and it did). In the vast empty Mongolian plains, you need a back-up plan.

The same can be said for modern portfolio design. For years investors have relied on the classic '60/40' portfolio (consisting of 60% equities and 40% bonds) which has provided investors a handsome return - and diversification - through the great 30-year bond bull market. Going forward however the maths just doesn't stack up; a 30 year annualised return of 5.2% but a yield today of sub 1%[2]. As we see increasingly these days bonds are not the antidote to a sell off in equities, they can be the cause. Recent wobbles in equity markets have followed moves higher in bond yields and some of the most sensitive names to this creep higher are the growthier tech companies whose future earnings growth feels the negative effect of a higher discount rate more acutely. With a handful of these 'FAANG'ier[3] type names driving index performance due to their size and concentration, it is unsurprising that the rate effect has become more pronounced.

Indeed, it was arguably ever lower rates that helped lift the information technology sector weight, within the US equity market, to its post 2001 TMT highs in the first place. At 0.34[5] the three-month bond – equity correlation is currently at its highest level for over five years, having only briefly been higher in the last twenty. 'Correlation does not imply causation' goes the saying but the effect is evident today. Add to this several testing liquidity episodes in the last few years for US Treasuries, the world's most liquid 'risk free' asset, and investors would be wise to hedge their diversification bets.

At Momentum we have long advocated embedding a truly multi asset exposure into client portfolios and funds. Our multi asset, multi style and multi manager approach builds in additional diversification levers that help to smooth the investment journey that we create for our clients. Credit, convertibles, inflation linked bonds, infrastructure, property, gold and alternatives are among the asset classes we use to build portfolios, whilst value, quality and growth exposure provides style diversification. Our modelling shows that over the last 20 years a broad strategic asset allocation increases the diversification benefits of a 60/40 portfolio by over 70%[4]. Some currency exposure is naturally embedded within both allocations but an explicit exposure to a perceived haven currency like the Japanese Yen could further improve the portfolio effect. The inflated returns from Developed Market sovereign bonds in recent decades may give false comfort to those banking on the same for the future. Yes, bonds are an important part of a multi asset portfolio but today arguably provide more of a 'return free risk' than a 'risk free return'. By diversifying your diversifiers you can reduce your risk of coming unstuck in the proverbial investment desert.

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[1] Source: Wikipedia ; [2] Source: JP Morgan Global Government Bond index; [3] The FAANG index refers to Facebook, Amazon, Apple, Netflix and Google. They represent 17.4% of the S&P500 index by market value today; [4] The diversification benefit for a multi asset portfolio was 2.6% compared to 1.5% for a risk equivalent global 60/40 portfolio; [5] Source: MGIM

Market Focus

» Global equities fell -1.3% last week
» The global rate of new coronavirus cases continues to decline from their peak a couple of weeks ago
» Brent crude rose 0.6% last week to $68.7 a barrel
» Gold rose 0.7% at $1843.4 per ounce

US

» US equities fell -1.4% last week
» The unemployment rate rose to 6.1% against 5.8% expected, from 6.0% in March
» The CPI reading for April came in at 0.8% on a month-on-month basis, taking the annual CPI figure to 4.2% in April from 2.6% in March and well above market forecasts of 3.6%.
» Excluding the volatile food and energy components, the core CPI rose 0.9% from March, the most since 1982.
» US producer prices rose 0.6% in April on a month-on-month basis, stronger than the 0.3% expected, sending the year-on-year number to 6.2%
» Initial jobless claims for the week fell to 473k, their lowest level since before the pandemic
» The Fed has tweaked its policy of US treasury purchases to buy more securities maturing in seven years or longer – they will now buy $20.25bn vs $17.75bn previously

UK

» UK equities fell -0.8% last week
» Restrictions in England will be eased further from 17th May with the re-opening of indoor venues and indoor mixing in groups of six or two households being allowed
» GDP contracted -1.5% in Q1, fractionally missing expectations. The monthly GDP reading for March was 2.1%, higher than the 1.5% expected

Rest of the World/Asia

» The benchmark Global Emerging Markets index returned -3.0% last week
» Japanese equities fell -2.6% over the week
» China's retail sales in April were up 17.7% year-on-year, missing expectations of a 25% increase
» Japan has expanded the state of emergency to three more prefectures and Singapore's local cases have now risen to the highest level since July

Europe

» European equities fell -0.5% last week
» The German ZEW survey, a measure of economic expectations, rose to 84.4 in May from 70.7 in April. The outcome was the highest level since 2000 and above forecasts of 71.0.
» In the Euro Area, industrial production grew by just 0.1% in March, lower than expectations of a 0.8% rise
» The Euro Area composite PMI was at 53.8 in April, its highest reading since July
» If current trends continue, Spain is on track to reach herd immunity in approximately 100 days when 70% of the population will be vaccinated

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Market Summary

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Asset Class / Region	Currency	Cumulative returns: Week ending 14 May	Month to date	YTD 2021	12 months
Developed Markets Equities					
United States	USD	-1.4%	-0.1%	11.5%	48.0%
United Kingdom	GBP	-0.8%	1.7%	11.3%	25.9%
Continental Europe	EUR	-0.5%	1.3%	11.4%	39.8%
Japan	JPY	-2.6%	-0.8%	5.3%	32.9%
Asia Pacific (ex Japan)	USD	-3.1%	-3.4%	2.1%	47.5%
Australia	AUD	-0.6%	0.2%	8.0%	35.6%
Global	USD	-1.3%	0.1%	9.9%	49.2%
Emerging Markets Equities					
Emerging Europe	USD	-0.2%	5.2%	7.7%	39.5%
Emerging Asia	USD	-3.6%	-4.4%	0.0%	46.4%
Emerging Latin America	USD	-0.6%	5.5%	3.5%	66.9%
BRICs	USD	-2.4%	-2.5%	-1.3%	39.1%
China	USD	-3.1%	-5.3%	-4.4%	30.1%
MENA countries	USD	0.6%	0.0%	15.9%	45.7%
South Africa	USD	-4.0%	0.9%	12.9%	65.6%
India	USD	-1.0%	1.3%	4.9%	67.1%
Global emerging markets	USD	-3.0%	-2.9%	1.8%	48.2%
Bonds					
US Treasuries	USD	-0.4%	-0.1%	-4.0%	-5.0%
US Treasuries (inflation protected)	USD	0.0%	1.1%	0.7%	7.1%
US Corporate (investment grade)	USD	-0.5%	0.0%	-3.6%	5.5%
US High Yield	USD	-0.3%	0.0%	2.0%	19.5%
UK Gilts	GBP	-1.3%	-0.7%	-7.5%	-8.5%
UK Corporate (investment grade)	GBP	-0.9%	-0.4%	-4.4%	4.4%
Euro Government Bonds	EUR	-0.8%	-0.9%	-4.3%	0.2%
Euro Corporate (investment grade)	EUR	-0.5%	-0.3%	-1.0%	5.6%
Euro High Yield	EUR	-0.2%	-0.2%	2.1%	17.0%
Japanese Government	JPY	0.0%	0.1%	-0.2%	-0.8%
Australian Government	AUD	-0.6%	-0.2%	-3.7%	-3.3%
Global Government Bonds	USD	-0.6%	0.0%	-4.6%	1.3%
Global Bonds	USD	-0.5%	0.0%	-3.5%	4.4%
Global Convertible Bonds	USD	-2.3%	-3.5%	-2.2%	26.2%
Emerging Market Bonds	USD	-0.3%	0.7%	-4.8%	9.0%

Source: Bloomberg Finance L.P. Past performance is not indicative of future returns.

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		Cumulative returns			
Asset Class / Region	**Currency**	**Week ending 14 May**	**Month to date**	**YTD 2021**	**12 months**
Property					
US Property Securities	USD	-1.3%	-1.8%	15.1%	48.9%
Australian Property Securities	AUD	-1.6%	-0.7%	1.1%	30.2%
Asia Property Securities	USD	-3.9%	-2.3%	4.3%	16.4%
Global Property Securities	USD	-1.8%	-1.3%	9.5%	41.2%
Currencies					
Euro	USD	-0.1%	0.9%	-0.7%	12.6%
UK Pound Sterling	USD	0.8%	1.9%	3.3%	15.6%
Japanese Yen	USD	-0.7%	-0.1%	-5.6%	-2.0%
Australian Dollar	USD	-0.9%	0.9%	1.1%	21.0%
South African Rand	USD	-0.3%	2.6%	3.8%	31.5%
Swiss Franc	USD	-0.1%	1.1%	-2.0%	8.0%
Chinese Yuan	USD	-0.1%	0.6%	1.4%	10.2%
Commodities & Alternatives					
Commodities	USD	-2.1%	1.6%	23.2%	73.4%
Agricultural Commodities	USD	-5.4%	-0.7%	19.9%	62.3%
Oil	USD	0.6%	2.2%	32.6%	120.7%
Gold	USD	0.7%	4.2%	-2.7%	6.4%
Hedge funds	USD	-0.7%	-0.7%	2.4%	13.9%

Source: Bloomberg Finance L.P. Past performance is not indicative of future returns.

For more information, please contact:

Anastasiya Volodina
Distribution Services

E: distributionservices@momentum.co.uk
T: +44 (0)207 618 1806

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