Aon's Investment Research and Insights

Why diversify now?

November 2018

Empower Results®

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About Aon's Investment Research and Insights

Aon's robust portfolio of ideas, tools and researched solutions supports trustees and sponsors to anticipate their future investment requirements.

By beginning to identify investment research and communicate ideas before they are needed we can shorten the implementation times for our clients and act in a timely way when opportunities are correctly priced.

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Summary

We believe that the need to diversify portfolios is stronger than ever.

The purpose of diversification is to spread the asset allocation across a range of investments with differing return patterns in order to minimise losses from any one asset class and generally to help reduce volatility in the portfolio. In the last few years, diversified pension schemes will have benefited from lower investment risk, but they may not have delivered as strong returns as a concentrated equity strategy, as equity markets have performed strongly.

In the current uncertain environment, we believe that diversification can both lower portfolio volatility and enhance return. Therefore in this note, we discuss why now is a good time to diversify away from traditional asset classes. We then propose some potential strategies and asset classes to help diversify portfolios.

Expensive markets

Traditional asset classes have performed well over the last ten years. This has led to markets looking expensive for some time now.

Risks

The current macro-political environment poses a number of risks to investors. The expectation is that equity and credit markets are likely to experience increased volatility with the potential for further short-lived sell-offs before a larger downturn which may occur within the next two years.

Investment options

Diversification can both lower portfolio volatility and enhance return. Asset classes or strategies with returns that are uncorrelated to traditional markets can help achieve this.

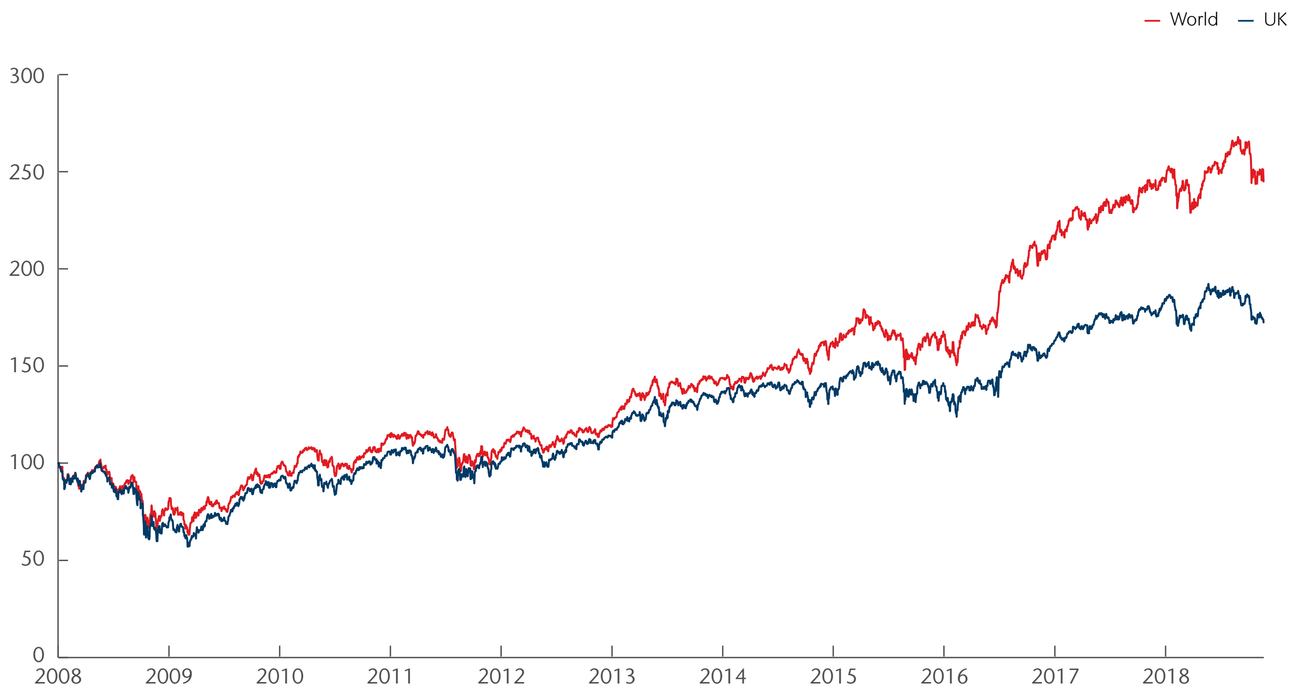
Current market environment

Risky assets have been expensive for a while but other challenges are now mounting. These include rising interest rates, geopolitical events, uncertainty over trade policy and an ageing US economic uptrend. The result has been two sharp equity market corrections in 2018. At the very least rises in market volatility look set to continue, and at worst more significant equity market downturns could be approaching.

The combination of this more challenging macro-political environment and high valuations suggests a strong dependency on a flow of good news which is far from guaranteed. Both equity and credit markets have generally performed well in the last ten years. However, we now expect that both equity and credit markets are likely to face more volatility with the potential for sharp sell-offs. The chart below shows that equity markets have continued to advance steadily higher as economic growth and earnings have driven returns throughout 2017 and into 2018. At the same time, many bond markets remain expensive as yields have fallen over many years on the back of global quantitative easing and easy monetary policy. (The exception to this is US treasuries whose yields have risen more substantially over the last two years). We should not discount the possibility that both equity and bond markets may fall together, making the need to invest in alternative return sources more important than ever.

Equity and credit markets are likely to face more volatility

Equity return indices (in GBP)



Source: Datastream. MSCI AC World Index total return in GBP; FTSE All Share Index total return. Both rebased to 1 January 2008.

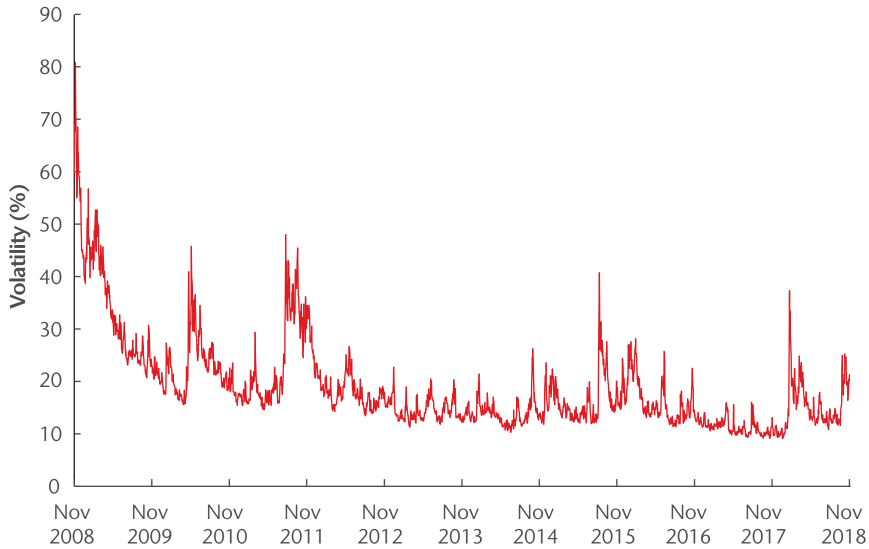
A key problem is that, with high equity valuations, particularly in the US market, it does not take much to disappoint expectations. This was seen in February and October 2018 as global equity markets fell on the back of higher inflation, higher interest rate expectations and slower global economic momentum.

Continued market sensitivity to news flow and data releases suggests further surges in market volatility would not be surprising. In recent years equities have been well supported as a result of low bond yields, so market sensitivity to an upward break in bond yields remains a risk.

Credit spreads (the higher yield from corporate bonds over government bonds) have also fallen to tight levels as a result of the favourable corporate and economic backdrop, quantitative easing and a move to ultra-low policy interest rates.

Historically, the monthly change in government bond yields and credit spreads have posted a negative correlation. Looking forward, however, we believe that current tight credit spreads may not have much ability to offset expected rising global bond yields compared to the past, given current low spread levels.

Volatility rose in February, and to a lesser extent in October 2018, after very low levels in 2017



Source: Factset. CBOE VIX index.

Investment grade credit yields and spreads are both low

Source: Factset. Bank of America Merrill Lynch Sterling Non-Gilts Index.

Potential routes to diversify

Despite this challenging time, we believe that investors should remain fully diversified. For now, exposure to growth assets should be maintained, but on the proviso that there is adequate diversification and downside protection within portfolios. A significant market downturn is expected at some point in the future and may occur within the next two years, coinciding with an economic recession, although it is difficult to time this with any precision. However, growth assets still have a greater potential for higher returns than bonds, and so there will be opportunity costs to any substantial and early de-risking.

Investors can diversify and help lower the risk of adverse market conditions to their portfolio in two ways. They can invest in:

a) a mixture of traditional return-seeking (e.g. equities) and risk-reducing assets (e.g. bonds); and

b) assets or strategies with returns which are uncorrelated with traditional assets.

In the rest of this note we focus on the latter approach. We discuss strategies that can sit alongside more traditional asset class holdings but aim to take less directional market risk or have less exposure to traditional sources of returns, as well as aiming to perform well in a variety of market environments.

We provide just a few investment examples below, covering both liquid and illiquid approaches, but please contact your Aon consultant for the full range of opportunities that we are currently discussing with our clients.

Liquid alternatives

Diversified growth funds have been a popular way of achieving diversification in a single fund. They are a wide-ranging group with a range of risk and return profiles. The more equity-focused funds have performed better than others but, in our view, do not offer the level of diversification that investors need. Hedge funds, especially strategies with returns dominated by manager added value, remain a good diversifier for traditional strategies.

However, there are a number of other approaches that exist within liquid alternative markets.

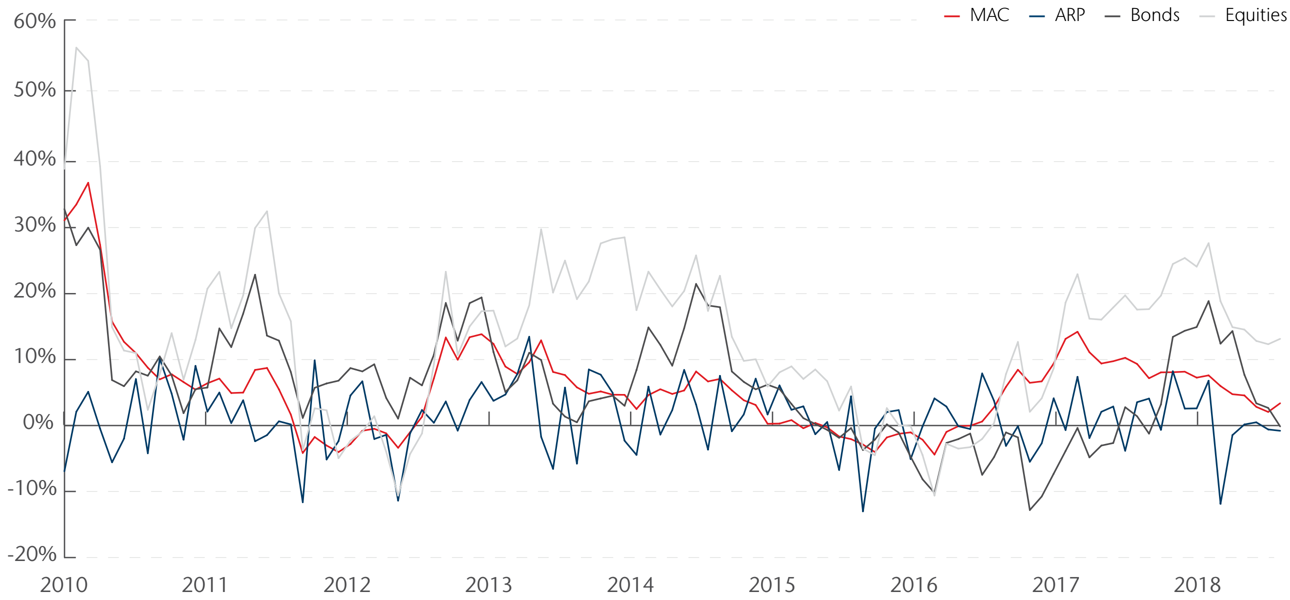
- **Alternative Risk Premia (ARP)** — A range of strategies that offer a premium for either taking risks others do not wish to bear or for exploiting market anomalies. They bring diversification and added return potential to traditional portfolios and are a viable proposition for investors looking for alternative sources of return at reasonable fee levels. See our separate paper *'Alternative Premia, Alternative Price'*[1] dated February 2018 for more detail.

- **Absolute Return Bonds (ARB) and Multi Asset Credit (MAC)** — ARB funds seek diversification from traditional asset classes by taking a wide range of active views in bond and currency markets while MAC funds offer diversification across the credit universe by quality and region. See our separate paper *'Bond Market Liquidity'*[1] dated September 2016 for more detail.

The chart on the next page illustrates that MAC and ARP strategies tend to provide a steadier return pattern regardless of equity and bond market trends.

[1] These are historical papers, based on information available at the time of publication.

MAC and ARP returns have low correlations with equities and bonds



Source: Factset; Hedge Fund Research Inc. US dollar 12 month rolling returns. MSCI World Total Return Index; HFR Bank Systematic Risk Premia Multi-Asset Index; ICE BofAML Global Corporate Index; MAC is assumed to be 3 month US deposit rate plus an equally-weighted average of excess returns of ICE BofAML Global Corporate, ICE BofAML Emerging Markets External Sovereign and ICE BofAML Global High Yield indices over US treasuries.

Illiquid alternatives

Institutional investors are increasingly showing appetite to commit to less liquid alternatives. Illiquid assets can be an attractive match for pension and insurance liabilities and investment returns tend to increase with the degree of illiquidity of the asset. The illiquidity premium refers to the additional return demanded by investors in exchange for the additional risk of locking up their capital for a specified period of time. Examples include:

- **Insurance-linked securities** — Funds that invest in a diversified portfolio of financial instruments whose values are driven by severe insurance loss events. A wide range of risk and return characteristics is available with funds generally offering quarterly or bi-annual liquidity (although some capital can become trapped beyond this). See our separate paper *'Storms, Floods and Quakes'*[1] dated March 2018 for more detail.

- **Direct lending and property debt** — Direct lending is a form of corporate lending typically made to small and medium-sized enterprises (SMEs). Loans are typically secured on company assets and investor returns primarily comprise a margin above cash and arrangement fees. See our separate paper *'Understanding European Direct Lending'*[1] dated October 2018 for more detail. Property debt is a loan secured against a property and its underlying income stream.

  In both types of loan sectors, we prefer funds that offer diversification by borrower, region and sector, and which are not concentrated in a small number of loans. These funds can provide income that can help meet benefit cashflows and can be incorporated as part of a return-seeking portfolio or a cashflow-driven investment strategy. See our separate paper *'Rethinking income'*[1] dated January 2017 for more detail. High quality managers, who can navigate around the credit cycle, are crucial.

Other ways to diversify

As well as diversification of strategies and asset classes as we have discussed, portfolio diversification may occur across geographies, sectors, styles and managers. We suggest that investors aim to achieve this full range. Typically, funds are diversified to an extent within asset classes as a result of the aim of standard benchmarks to encompass full market coverage. However, the outcome of diversification does not always occur. See our separate paper *'How Diversified is your Global Equity Portfolio?'*[1] dated September 2017 for more detail.

Active managers can help to add diversification as well as protect portfolio returns by their investment choices. For instance, by moving away from benchmark concentrations or selecting quality stocks that are more resilient in a market downturn, or by steering away from more cyclical markets. We believe that active management will be a useful weapon against the next market downturn.

[1] These are historical papers, based on information available at the time of publication.

Key considerations

There are other issues that investors should consider in assessing diversification options.

Investors need to weigh up their risk / return appetite, coupled with their investment time horizon. For pension funds, this is often driven by their long-term funding objective. Linked to this, the appetite for an illiquidity premium is also important.

Clearly there is a need to consider the asset allocation as a whole and to consider how well new ideas complement each other and the existing portfolio. Modelling and scenario stress-testing can help.

Finally, investors need to be careful not to over-diversify for the sake of diversifying, which can lead to unnecessary loss of return and/or high cost. A balance needs to be reached between the risk-reducing value of diversification and diluting returns and increasing cost — both in terms of transaction costs and governance budget.

Conclusion

We believe now is an appropriate time to add diversification to portfolios. There are a range of current opportunities that investors can consider to help diversify their investment strategy.

Suitable options will depend on individual client circumstances. Please contact your usual Aon consultant for more in-depth information and to discuss options for your portfolio.

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