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Why Covid calls for more diversification, not less

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Joanna Ong, Investment Director at Eastspring Singapore, discusses why diversification is still investing's only free lunch and how the coronavirus has impacted the way investors think about liquidity, safe havens and income.

Q. DIVERSIFICATION IS SAID TO BE INVESTING'S ONLY FREE LUNCH. YET, DURING TIMES OF MARKET STRESS, DIVERSIFICATION DOES NOT APPEAR TO DELIVER WHAT IT PROMISES. WHAT IS YOUR VIEW?

This dichotomy is linked to time horizons. Market and asset class correlations may converge in the short term, especially during periods of extreme market stress. We saw this during the market correction in March, when the increased demand for liquidity and heightened investor fears resulted in a broad-based sell-off. Over the medium and long term however, the traditional relationships between different asset classes should re-exert themselves and reflect the benefits of diversification. For example, we still observe a negative correlation between Long-Term US Treasuries and US equities over a 1-year and 3-year rolling basis of -0.49 and -0.39 respectively[1].

Historically, the benefits of diversification can also be seen as the risk adjusted returns from a bond plus equity portfolio, tend to be higher than for an equity only portfolio as investment horizons increase. See Fig. 1. The return outcomes also typically improve as investment horizons increase.

Fig 1: Risk adjusted returns of a diversified versus an equity-only portfolio

Sharpe ratio (p.a.)	Asian High Dividend Yielding Equities	Hypothetical portfolio consisiting of 50% of Asian High Dividend Yielding Equities and 50% of US High Yield Bonds
1-year	(0.21)	(0.00)
2-year	(0.25)	0.04
3-year	(0.15)	0.08
4-year	0.22	0.39
5-year	0.14	0.36
6-year	0.09	0.30
7-year	0.25	0.44
8-year	0.31	0.52
9-year	0.22	0.48
10-year	0.32	0.59

Source: Morningstar. As of 31 July 2020. MSCI AC Asia High Dividend Yield NR USD Index. ICE BofA US High Yield TR USD.

Source: [1]Ned Davis Research, Inc. August 2020. Rolling correlation of monthly returns of the Barclays Long Term Treasury Bond Total Return Index and the S&P 500 from Dec 1927 to July 2020. Ibbotson data prior to 1973. Shaded peiods represent recessions.

Therefore, while investors often focus on asset class diversification, they also need to have at least a medium-term investment horizon in order to enjoy the "free lunch" that diversification brings! You can also see that a diversified portfolio enjoys a smoother path over the long term, compared to an all-equity portfolio. Fig. 2.

Q. DOES THE LIQUIDITY CRUNCH IN THE BOND MARKETS IN MARCH THIS YEAR MAKE IT MORE IMPORTANT TO INTEGRATE LIQUIDITY CONSIDERATIONS IN PORTFOLIO CONSTRUCTION? HOW IS THAT IMPACTING YOUR ASSET ALLOCATION DECISIONS?

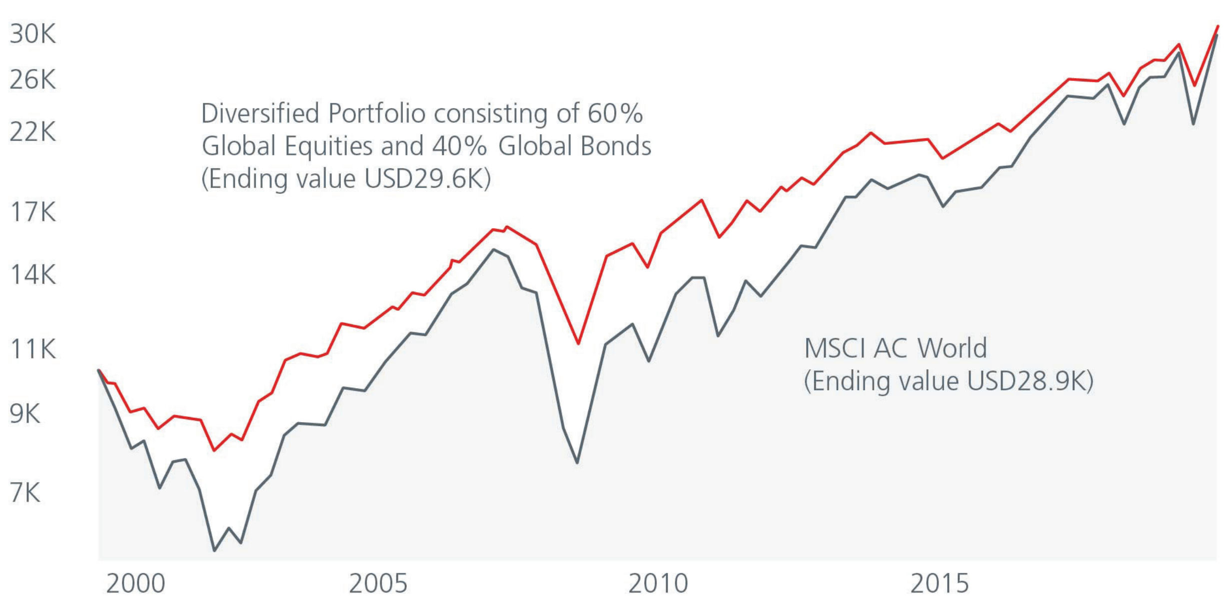
Yes, following the experience in March when even selling US Treasuries was a challenge, investors are seriously thinking about how to ensure that portfolios can be liquidated quickly when needed.

We use index instruments such as Exchange Traded Funds (ETFs) and index futures in our portfolios when permitted, and they have proved to be great liquidity tools. When the liquidity in the bond markets dissipated in March, the trading volume of ETFs surged. According to Blackrock, from February through April, the trading volume for the iShares iBoxx $ High Yield Corporate Bond ETF (HYG) was 25 times higher than the combined trading volume of their five largest bond holdings. As such, fund managers who utilise ETFs as a liquidity tool would be able to meet the redemption needs of clients without disrupting their core bond holdings.

Q. DO WE NEED TO LOOK AT TRADITIONAL SAFE HAVEN ASSETS DIFFERENTLY IN A POST-COVID WORLD? HOW CAN INVESTORS MINIMISE PORTFOLIO VOLATILITY?

The efficacy of using global government bonds as a portfolio hedge has been increasingly questioned. This is due to the rising correlation between bonds and equities following the Global Financial Crisis, where quantitative easing benefitted both asset classes. At the same time, with the US 10-year Treasury yield trending at its lowest levels in

Fig 2: Growth of USD10k investment over 20 years



Source: Morningstar Direct. September 2020. Diversified portfolio consists of 60% MSCI AC World and 40% Barclays Global Aggregate. Past performance is not a guarantee for future returns. The indices described are unmanaged and not available for direct investment.

more than 200 years, the attractiveness of using Treasuries as a portfolio hedge has also declined.

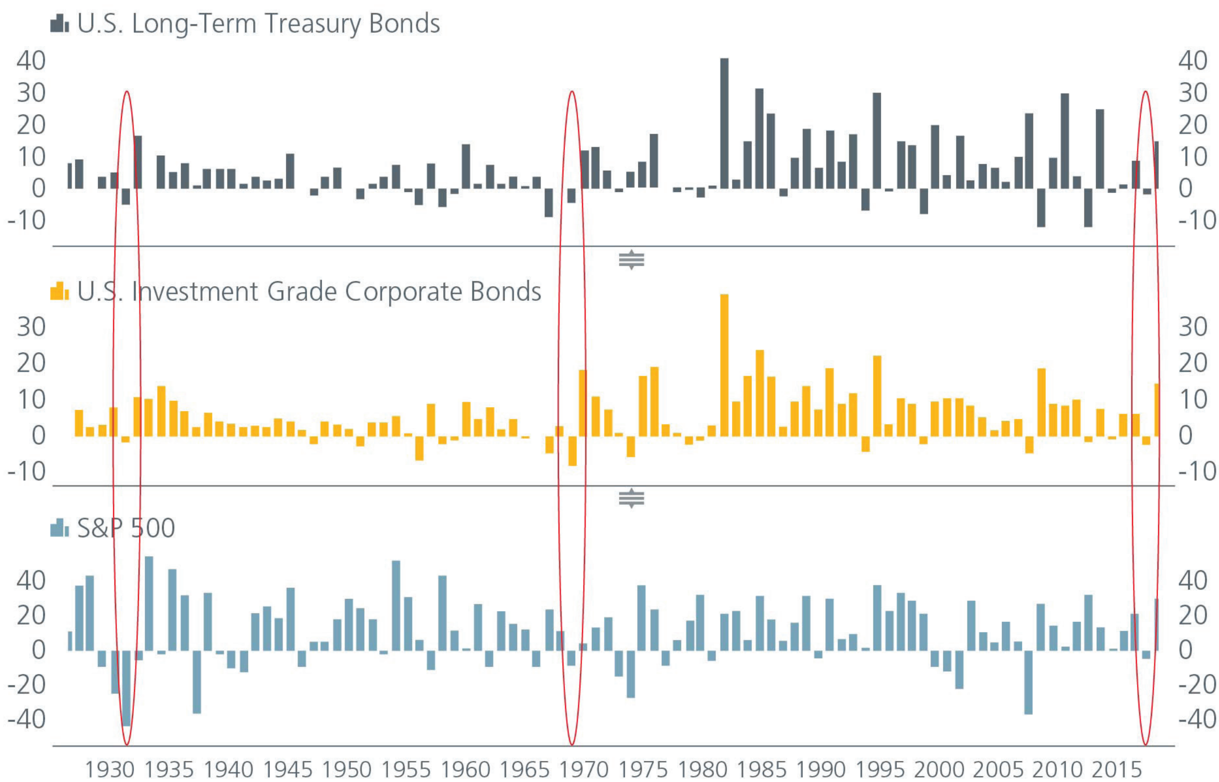
Nevertheless, both the US 10-year Treasury and gold delivered extremely strong returns in the first half of 2020, with gains of 9% and 17% respectively. This is despite losses in March where the existential threat posed by the coronavirus and the swiftness of the market correction caused indiscriminate selling.

In more normal times, we believe that US Treasuries can help buffer against equity declines that occur in slow growth or recessionary environments. Historically, it is highly unusual for both bonds and equities to decline concurrently. Since 1926, there has only been three occasions where Long Term US Treasuries, US Investment Grade Corporate Bonds and the S&P 500 posted negative returns in the same year - 1931, 1969 and 2018. See Fig. 3.

Meanwhile, although nominal yields have been flat for most of 2000, real yields have been declining on the back of rising inflation expectations. See Fig. 4. As such, the negative carry from holding gold is no longer a deterrent for investors, helping to reinforce gold's status as an inflation hedge and safe haven asset.

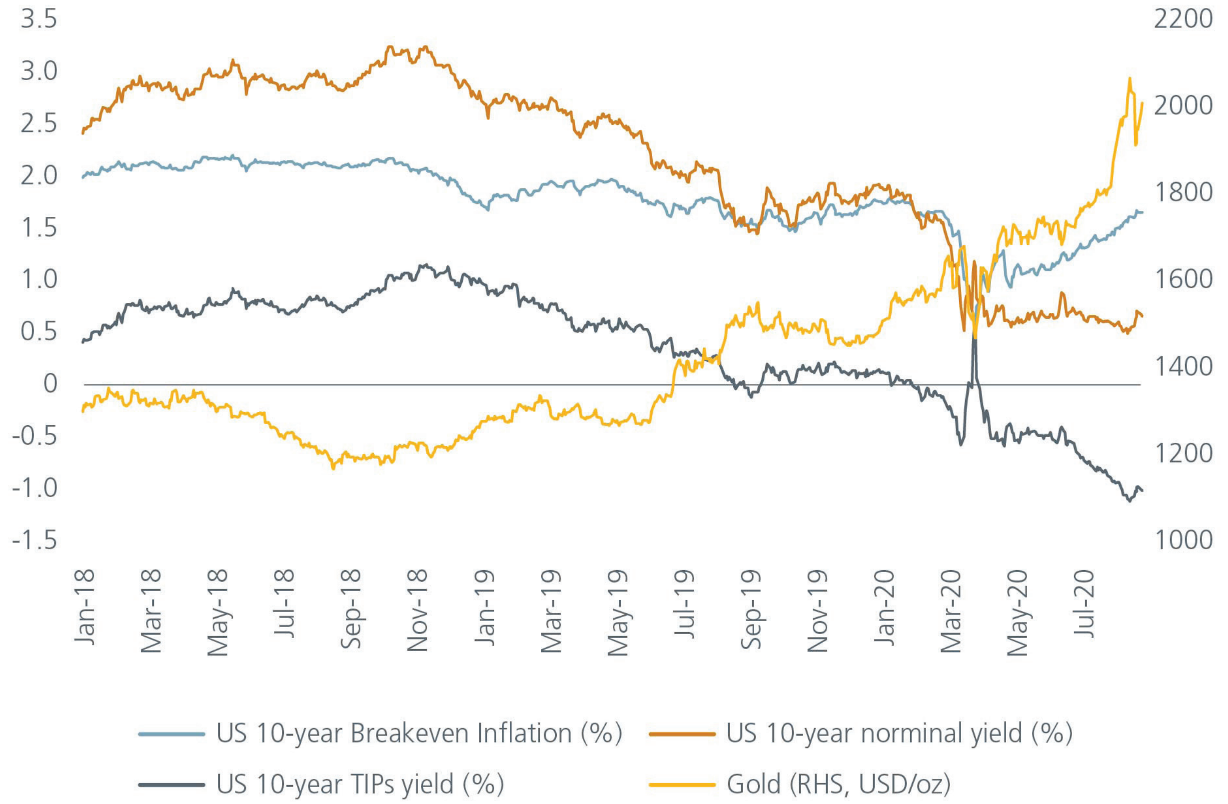
While US Treasuries and gold have different roles to play as portfolio hedges, we believe that a diversified multi-asset approach, together with a tactical overlay strategy can go a long way in dampening portfolio volatility over the medium term.

Fig 3: Annual Returns for Long Term US Treasuries, US Investment Grade Corporate Bonds and the S&P 500



Source: Ned Davis Research, Inc. Yearly data from December 1926 to December 2019.

Fig 4: US 10-year bond yield vs gold



Source: Bloomberg. August 2020.

Q. WITH THE US 10-YEAR TREASURY YIELD AT 0.7%[2] AND INTEREST RATES LIKELY TO REMAIN LOW IN MANY COUNTRIES, WHERE ARE YOU FINDING ATTRACTIVE SOURCES OF INCOME?

We like US High Yield bonds which are currently offering yields above 6% - a fairly sizable pick up above US Treasuries. In March 2020, the Federal Reserve (Fed) announced that it would expand its balance sheet indefinitely in order to support the US economy. This includes buying US Investment Grade Corporate and US High Yield bonds. Hence, US High Yields are likely to benefit from the Fed's liquidity support and be a good source of income. More recently, the Fed's willingness to tolerate higher inflation by shifting to average inflation targeting suggests a higher hurdle for future rate hikes, which is supportive of bonds. Meanwhile, the fundamental backdrop in the US appears to be improving although the pace of recovery may vary across the different states. At the point of writing, high frequency indicators such as mobility (driving) trends have exceeded pre-covid levels in the US and economic readings are also beating expectations.

However, while the second wave of new infections remains a key risk in the near term, the Fed's continued support of the US bond market over the long term poses a different kind of risk for investors. With poor quality companies potentially

Source: [2]By Bloomberg. As of 18 August 2020.

getting easy access to funding, this circumvents the creative destruction process that helps to renew the economy and capital markets. Investors would need a more active and discerning approach when investing in the US High Yield bond market going forward.

Besides US High Yields, we also find dividends an attractive source of income. Asian equities are currently offering an average dividend yield of 5%[3]. While dividend paying equities have also corrected this year as companies cut dividends to preserve capital amid a challenging operating environment, they can provide potential capital gains as covid fears dissipate. The reset in dividends may also result in more sustainable dividends going forward.

Our equity income team is actively differentiating between companies that have merely paused payouts versus those that are unlikely to restore their dividends to pre-covid levels. The pandemic has also forced a rethink of our income strategies. Given low interest rates and more restrictive regulations, the team is moving away from typical high yielders such as the Australian and Chinese banks to more consumer-oriented names. Meanwhile, the yields on property companies have risen as valuations collapsed. That said, there will be winners and losers in the aftermath of the pandemic, so stock selection remains paramount.

Q. HAS THE IMPACT OF THE CORONAVIRUS ON MARKETS AND ECONOMIES CHANGE THE WAY YOU MAKE YOUR ASSET ALLOCATION DECISIONS?

The coronavirus' impact on the global economy as well as the speed and magnitude of the resulting market sell-off has been unparalleled. While there are different triggers behind each crisis, the behaviour of cycles tend to rhyme. This common behaviour is what the Investment Solutions Team's tactical asset allocation framework seeks to capture. Our balance of indicators approach, which uses data driven signals and qualitative inputs, helps us to apply rigour and experience to our decision-making process, and enables us to navigate different cycles with objectivity and discipline. The market volatility this year has further underscored the importance of having a structured, evidence-based approach, and we are even more convinced that a nimble and active qualitative evaluation of high frequency data is needed to assess the evolving post-covid landscape.

Source: [3]Bloomberg. MSCI AC Asia Pacific ex Japan High Dividend Yield Index.

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