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NWQ CAPITAL MANAGEMENT

RE-Casting Diversification – the True Diversifiers

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The current investment landscape reminds me a lot of the Kilauea volcano – eruptions and disruptions always on the horizon.

Translate that volatile geography across to the world of finance and all too often we see the potential for the financial lava that flows from these macro events consuming traditional investment strategies.

National Geographic reports that Kilauea has been erupting almost constantly for the past 35 years … and, in the process, has been changing the physical shape of Hawaii. We now live and work in the era of the 'new normal' with its volcanic volatility changing the shape of investment practice. Add to this some more climate change factors – think Trump, think trade wars, think Brexit or, for that matter, any macro geo-political or economic event you care to choose from the smorgasbord that besets our planet.

With this changed investment climate upon us – and I think most pundits believe that the 'new normal' is most certainly the ongoing investment environment – then how do we optimise investment outcomes? Ahh, diversification I hear you say. Absolutely, but in my view, we need to re-cast the parameters of diversification in the pursuit of optimal outcomes.

In doing so, it is always prudent to take lessons from the smartest people in the business and, in this case, I am talking about the organisations that manage their funds in a fiduciary-centric way to be 'all weather.'

They embrace strategies which are true diversifiers and which complement their overall investment approach. So, let's interrogate this through the prism of two world class portfolios – our own Future Fund here in Australia and the Harvard University endowment fund in the United States.

Guidance from the $140 billion Future Fund is that for the 12 months to the end of March 2018 their return was 8.6%, which is in line with its yearly average for the past decade.

The Harvard fund (AUD 50 billion) returned 8.1% on investment in the year ended June 2017 – a year they lamented as sub-par, as the fund has generated an average of better than 10.0% per year for the past two decades.

Noting that "the successful investments of the last five decade won't necessarily be the successful investments of the next five decades," Raphael Arndt, the Future Fund's Chief Investment Officer, is focused on the role the "new generation of hedge funds (will) play in delivering uncorrelated returns and reducing risk."

The Harvard Management Company, which operates the university's endowment, is, like Dr Arndt, also wary of the past … and is currently reconstructing its investment foundations from traditional "asset allocation" towards a "risk allocation strategy." The objective is better management of risk across the fund, rather than individual asset classes.

Harvard allocates around 15% of its funds to Absolute Return, which is the same amount the Future Fund allocates to Alternative Assets – but in handing over his money Dr Arndt measures performance against the objectives of diversification, downside protection and alpha generation.

He's hit the nail right on the head. But what sort of diversification optimises alpha generation and downside protection? To my mind, diversification these days requires a lot more than a spread of asset classes and geography.

True diversification is often difficult to achieve in high volatility markets, as traditionally uncorrelated assets become highly correlated – failing the investor when most needed. Arndt says "the inclusion of uncorrelated sources of return in our portfolio allows us to invest into risk assets elsewhere in the fund."

Which brings me to the nub of my argument: the two true diversifiers in approach to investment that Australian investors need to fully embrace are equity market neutral and managed futures. Integrated into a portfolio, they enhance the high probability of returns at a targeted rate year after year and have a "smoothing" effect. This is the peace of mind all investors desire.

At NWQ we have been researching uncorrelated returns for several years, piloting a global markets fund as a next-step to our highly successful equity market neutral fund.

It is incontrovertible: managed futures work. Ineichen, a leading asset allocation researcher, concluded a well managed portfolio of managed funds "delivered a positive return in 18 out of 20 systemic events in the equity market from 1980 to 2012." Ineichen added that "in the field of investment management, there is simply nothing that comes anywhere close to this."

But, in the times which have proved that even Nobel Prize winner Harry Markowitz's Modern Portfolio Theory wasn't quite there (as we found out, all asset classes *are* affected by systemic shock such as the GFC), my conclusion is that to optimise managed futures it is necessary to have the right, diverse mix of largely uncorrelated global managers on your platform.

And that's the key to my hypothesis of an expanded definition of diversification.