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The Truth About Diversification

Diversification means not putting all your eggs in one basket. But do you own too many eggs?

We learn in finance theory that diversification simply means not putting all your eggs in one basket. Simple as this idea is, most investors do not hold portfolios that are even close to being truly diversified.

There are two reasons that make this sensible objective difficult to achieve. Firstly, most investors are not disciplined enough to implement diversification. To illustrate the point, pause and check whether you are willing to reduce equities when the trailing 12-month return on stocks is 20+ percentage points higher than bonds?

Second, but not less importantly, most investors do not actually diversify their equity risk with their investment decisions; they are still exposed to one common significant shock. Returning to the initial analogy, many portfolios resemble a truck with several baskets of eggs loaded on it. Clearly, investors' eggs are vulnerable to the truck tipping over.

So why is it so important to get your risk assessments correct before making asset allocation decisions?

Source of True Diversification

Many investors who aren't in finance view owning Richemont, SABMiller, and a few more hot stocks in their portfolios as providing sufficient diversification. Luckily, many also own real estate and put money into savings accounts. So, to a degree, they are more diversified than they intend to be.

More sophisticated investors own a portfolio with multiple asset classes including equities, bonds, commodities, etc. And within each category, they diversify across geographical or economic regions. For example, they hold both established and emerging market sovereign bonds. This group is better diversified than my less sophisticated friends, but they are probably not as diversified as they want to be.

The truth is, static diversification across multiple asset classes is not sufficient. An adequately diversified portfolio should also be diversified over time and over different economic regimes. This is the tactical element in your allocation!

In standard finance applications, asset class volatilities and correlations are usually assumed to be constant over time for simplicity. While this assumption reduces the complexity of the models and their calculations, it can lead to sub-optimal portfolios and risk management solutions. If equity market volatility varies over time and is negatively correlated with equity market returns, ignoring this counter-cyclicality could lead to excess allocation in stocks when forward-looking risk for stocks is high. Furthermore, if equity market volatility is positively correlated with the volatilities of other asset classes, ignoring this correlation would again lead to an overall over-concentration in risky assets.

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Macro Factor Influence

To demonstrate that common macro factors indeed drive the movements in financial assets, Table 1 illustrates volatilities for 16 asset classes in expansionary and recessionary environments over the period 1997–2012. As Table 1 shows, equities tend to experience a sharp spike in volatility when an economy is in a recessionary period compared to an expansionary period.

Table 1. Volatilities of Asset Classes, March 1997-June 2012

	Overall	Expansion	Recession
Commodities	17.26%	13.16%	24.49%
Bank Loans	7.03%	4.14%	14.20%
High Yield	10.04%	6.43%	19.39%
TIPS	5.84%	4.95%	9.49%
Convertibles	13.89%	10.27%	16.91%
REITs	21.20%	13.53%	32.58%
Local Currency EM	8.02%	6.99%	10.13%
Small-Cap U.S. Equities	21.49%	18.32%	27.75%
Emerging Markets Equities	25.89%	21.98%	35.51%
Developed ex U.S. Equities	18.13%	15.33%	24.08%
Large-Cap U.S. Equities	16.49%	13.52%	20.79%
Emerging Markets Bonds	13.48%	14.23%	14.38%
Short-Term Bonds	1.52%	1.75%	1.96%
Long Credit	9.22%	7.81%	15.66%
Core Fixed Income	3.54%	4.64%	9.50%
Long Treasury	10.31%	9.57%	14.39%
Average Volatilities	12.71%	10.41%	18.20%
Average Corr across All	0.36	0.28	0.50
Average Corr with S&P500	0.48	0.39	0.62

Source: Research Affiliates, based on monthly data from Morningstar Encorr.

This sharp increase in equity market volatility often goes together with rising volatilities in other pro-cyclical asset classes such as commodities, high yield, and long credit.

The results in Table 1 suggest that shocks to equity valuation often spill over to other markets, and that liquidity-driven selling and the reduction in liquidity provision in the capital market are often systemic across various asset classes. This observation is confirmed by the correlation data. For this data set, the average of correlations across all 16 asset classes nearly doubles to 0.50 in recessionary stages from 0.28 in expansionary periods. Their correlations with the S&P 500 Index average 0.62 in economic downturns in contrast to 0.39 in expansions.

The evidence presented illustrates two points: (1) the second moments (i.e., volatilities and correlations) of asset classes' returns change drastically during different business cycle phases; and (2) true diversification is harder to achieve in recessions than in expansions.

To address the cyclicality issue, many people introduce correlation timing techniques such as regime-switching models and recession forecasting models into the asset allocation process. We can illustrate the advantage of introducing the time-varying variance–covariance matrix vividly by using a forecasting model with 100% hindsight. If we can predict NBER recession dates with 100% precision, the optimal portfolio of the 16 asset classes will give us an annualized return of 10.96% and a volatility of 10.05%, versus a return of 10.37% and volatility of

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12.6% for the portfolio utilizing the long-term average covariance for optimization.

Let's say we cannot achieve 100% accuracy on when the economic regime shifts. Even when our dates are three months earlier or later than the actual regime switching dates, the portfolio still provides a Sharpe ratio much higher than the static model. In fact, when the business cycle (here we use NBER cycle definition) forecast model predicts a bit earlier than the actual switching dates, the Sharpe ratio of the portfolio is slightly better than the optimal one with perfect precision.

The picture in Table 2 is pretty clear—once you get the second moments estimates right, your asset allocation practice can be a lot more effective!

Table 2. Performance of an Mean-Variance-Optimal Portfolio, March 1997–June 2012

	Return	Volatility	Sharpe Ratio
Full Period	10.37%	12.60%	0.61
Two Stage	10.96%	10.05%	0.82
Two Stage 3 Month Lag	10.59%	9.99%	0.79
Two Stage 3 Month Lead	11.15%	10.19%	0.83

Source: Research Affiliates, based on monthly data from Morningstar Encorr.

Is This Time Different?

Since the Global Financial Crisis, we have seen a shift in the cross-asset classes' correlations. Asset classes seem to be more correlated than they used to. The trailing 10-year average pair-wise correlations among the 16 asset classes have jumped to 0.44 today from the level of 0.28 prior to the Lehman's debacle in September 2008. Not surprisingly, people are asking whether this shift is a permanent structure break or just a cyclical peak. Honestly, it's too early to tell. After three and a half years, the short- to medium-term correlations based on 1-year or 3-year time periods have come down, but the 5-year and 10-year numbers continue to drift higher. So, is this time really different? Probably not.

Conclusion

Diversification remains one of the most important considerations as investors design their portfolios. Asset classes have distinct volatility, correlation, and risk premium characteristics in both recessionary and expansionary periods. Employing long-term historical relationships across asset classes could lead to substantial underperformance when regime shifts happen because volatilities for various risky asset classes tend to be low in equity bull markets and high in equity bear markets.

Investors should pay attention to how they achieve diversification in their portfolios. In recessionary periods, correlations between asset classes rise. Investors need to ensure they shift their asset allocation as regimes change. Capturing this time-varying characteristic is important for obtaining mean-variance portfolio optimization. When the road is smooth and straight, investors can carry as many baskets of eggs as they want to. But when it is bumpy and twisted, investors need to diversify the goods they are bringing to market — adding carrots, corn, and potatoes, for example, in the event that their vehicle drives off the road.

By Feifei Li, Analyst, Research Affiliates.

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Marketing Tips: Marketing Insurance

Great marketing is a long-term endeavour and it pays off over the medium to long-term. There's no quick-fix panacea (though there are short-term strategies that give results) that generates sustained returns. Remember that marketing is about identifying a need and filling it, over and over again.

Marketing Insurance.

Instead of always trying to figure out on the fly which marketing strategies will work for you – why not carry Marketing Insurance?

What if you paid a premium each month for this so-called Marketing Insurance that would protect you from making mistakes in your marketing? You would certainly make sure you were implementing a lot more marketing, right?

Marketing Insurance, of course, isn't something you buy, but it IS something you can have. In fact, sometimes it's actually free! But paying attention to it really is the key.

Your Marketing Insurance comes in 3 parts:

Determine where your best new clients will most likely originate. Will they come from referrals, a seminar, strategic alliances, speaking engagements?

Create a simple action plan for defining the handful of activities required to consistently implement these strategies that will produce your next clients. Consistent implementation is critical. Assign someone, even yourself, to be responsible for getting these tasks done every week, month and quarter.

Look at your plan every week and make sure you are moving activities forward. Even if for just five minutes – review the plan and make sure implementation is happening.

Okay, it may seem pretty simple, but if you know where clients could come from, you have a simple plan to consistently reach out, and you are on top of this every week, you have just bought yourself some marketing insurance. The plan is the premium you pay. And, I have yet to see a firm that has consistently implemented a sound plan that has gone backwards in new business acquisition. The insurance works!

Maribeth Kuzmeski
Red Zone Marketing

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Market Update

Amid hopes that the US would avoid the fiscal crisis after the US President, Barack Obama, expressed confidence of winning the Congress support for a deal, South African and UK markets ended in the green on Monday. These hopes, together with positive US existing home sales data, saw the US markets also ending in positive territory. Markets in Asia were trading mostly higher on Tuesday morning, after the upbeat US housing data helped offset France's credit rating downgrade by Moody's Investors Service. South African and US markets were lead higher on Tuesday by the US housing data and Greek bailout hopes. UK markets received a boost from the approval of Glencore and Xstrata merger. On Wednesday Asian markets were trading in mixed territory as European officials failed to reach a decision on Greece. South African markets ended in the green on Wednesday, with UK markets following suit, as investor sentiment was lifted following positive comments from the German Chancellor and Finance Minister that the Greek aid issue would be solved in the next meeting. US markets finished in positive territory, amid easing concerns about the Middle East turmoil. Markets in Asia traded mostly higher on Thursday morning, on the back of upbeat Chinese manufacturing data. The positive data lead commodity sector stocks and the South African and UK markets in general to end in positive territory on Thursday. US markets were closed on account of Thanksgiving Day. Markets in Asia traded higher on Friday morning, amid signs of an improvement in global manufacturing activity. In Japan, markets were closed on account of a public holiday. South African markets ended marginally higher on Friday. UK stocks also ended higher on Friday, as a rebound in business confidence in Germany and France, lifted investor sentiment. Whilst markets in the US ended firmer, following better-than-expected German economic data.

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Economic Update

The headline household finance index in the UK rose to a reading of 39.30 in November, compared to a reading of 39.00 reported in October.

On a seasonally adjusted month-on-month basis, construction output in the eurozone decreased 1.4% in September, following a revised 0.6% growth recorded in August.

On a seasonally adjusted basis, existing home sales in the US rose 2.1% to an annual rate of 4.79mn in October, compared to a downwardly revised 4.69mn recorded in September.

Japan's leading economic index declined to a reading of 91.60 in September from an initial estimate of 91.70, and as compared to a reading of 93.20 in August.

The Bank of Japan (BoJ) has maintained its benchmark interest rate in the range of 0.0% to 0.1%. The BoJ has also kept the size of its asset-purchase program unchanged.

On an annual basis, Foreign Direct Investment (FDI) in China has dropped 3.5% for the first ten months of 2012 to $91.70bn.

The RMB/BER business confidence index in South Africa dropped to a reading of 46.00 in the fourth quarter of 2012, compared to a reading of 47.00 reported in the third quarter of 2012.

On a year-on-year basis, overall mortgage lending in the UK increased 4.0% to GBP12.90bn in October, marking the highest level since November 2011 and compared to a sharp drop recorded in September when lending fell to GBP11.40bn.

On a monthly basis, the Producer Price Index in Germany remained flat in October, compared to a 0.3% increase recorded in September.

On a seasonally adjusted basis, the trade surplus in Switzerland rose to CHF2.82bn in October compared to a revised surplus of CHF1.93bn recorded in September.

On a month-on-month basis, all industry activity in Japan dropped 0.3% in September, compared to a flat reading recorded in August.

The Conference Board's leading economic index for China has advanced to a reading of 245.50 in October following a reading of 241.80 posted in September.

On an annual basis, South Africa's consumer price index (CPI) rose 5.6% in October, the highest in five months and compared to a 5.5% increase reported in September. On a monthly basis, CPI grew 0.6% in October, compared to a 0.9% rise reported in the previous month.

For the week ended 17 November 2012, initial jobless claims in the US fell to 410,000, in line with the market expectations and compared to the previous week's revised figure of 451,000.

The Bank of Japan (BoJ), in its latest monthly report indicated that Japan's exports and industrial production would likely continue to decrease for the time being, while the overall economic activity is expected to remain relatively weak, mainly due to slowdown in overseas economies.

The South African Reserve Bank kept its benchmark interest rate unchanged at 5.0%, in line with market expectations. It cut its 2012 economic growth forecast for South Africa to 2.5% from a previous forecast of a 2.6% growth. Additionally, growth in 2013 is expected to be 2.9% compared to a previous estimate of 3.4%, while the growth forecast for 2014 has been revised down to 3.6% from 3.8%.

On a seasonally adjusted quarterly basis, the Gross Domestic Product (GDP) in Germany rose 0.2% 3Q12, in line with the preliminary estimate and compared to a 0.3% growth recorded in 2Q12. On an annual basis, the GDP rose 0.4% in 3Q12, compared to a 0.5% increase recorded in the previous quarter.

Germany's exports rose 1.4% in 3Q12, following an upwardly revised 3.3% recorded in 2Q12.

Government spending in Germany increased 0.4% in 3Q12, compared to a downwardly revised 0.2% decline recorded in the previous quarter. Meanwhile, private consumption rose 0.3% in 3Q12, following a downwardly revised 0.1% increase recorded in 2Q12.

Standard and Poor's affirmed France's "AA+" rating, citing the government's commitment to budgetary and structural reforms which would improve the country's growth potential. The rating agency confirmed its long-and short-term sovereign credit ratings on France at "AA+/A-1+". It also

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Economic Update

maintained its long-term outlook at "Negative" and stated that there is at least a one-in-three chance that the ratings could be lowered in 2013.

The European Central Bank (ECB) President, Mario Draghi stated that there are signs of a relative return of confidence in the Euro area due to decisions taken by the European leaders as well as the central bank. Speaking at the 22nd Frankfurt European Banking Congress, Draghi noted that the decision by the European leaders to form a "financial union" by creating a single bank supervisor around the ECB and the proposal that European banks would receive direct capital support from the European Stability Mechanism, helped to calm markets.

Corporate Update

South Africa

Netcare: The hospital promotion and management company, in its FY12 results, indicated that its revenue stood at R25.17bn, an 11.5% increase compared to the corresponding period of the prior year. However, headline EPS declined 18.5% to 95.30c posted a year earlier, after the company wrote down the value of its UK business.

Barloworld: In its results for FY12, the company reported that its revenue climbed 17.5% annually to R58.55bn. it reported that basic headline EPS rose to R6.80 from R4.65 posted in the previous year, on the back of buoyant demand from southern Africa and Russia.

Telkom SA: The telecommunication company, in its results for 1H13, stated that total revenue was 1.5% lower at R16.45bn compared to last year. Headline EPS dropped sharply to R0.37 from R1.78 reported a year earlier, hurt by the impact of the provision for the penalty handed down by the Competition Tribunal.

African Bank Investments: The bank holding company, in its results for FY12, announced that interest income on advances increased 35.7% annually to R9.92bn. Headline EPS stood at R3.43, a 17.7% rise from a year earlier.

Eskom profits, electricity demand falls: Releasing its interim results in Johannesburg, Eskom posted electricity sales of 110,766 Gigawatt Hours (Gwh) for 1H13. For the same period a year ago, sale of electricity was recorded at 114,043Gwh.

FirstRand delays dollar bond sale: FirstRand Ltd., South Africa's second-biggest financial services company, delayed plans to sell dollar bonds to boost its capital in line with new requirements after failing to attract enough potential buyers.

ArcelorMittal warns unions of bleak 2013: ArcelorMittal, the world's largest steelmaker, has told labour unions there is little hope for improvement in results next year, citing the likelihood that European demand for steel will fall further, according to French media reports.

Tiger Brands: In its results for FY12, the company stated that its revenue came in at R22.68bn, an 11.0% increase compared to the previous year. Headline EPS climbed 7.3% annually to R16.89. The company also announced plans to increase its interest in Dangote Flour Mills to 70.0%, after it brought a 63.4% stake in Dangote Flour Mills earlier in the year.

Massmart Holdings: The company stated that for 20 weeks ended 11 November 2012, its total sales climbed 16.2%, while comparable sales grew 7.3%.

Nampak: The diversified packaging manufacturing group, in its results for FY12, indicated that its revenue increased 11.5% annually to R17.64bn. Headline EPS came in at R2.01, a 16.5% rise from a year ago, boosted by robust performance in fast-growing economies outside its mainstay South African market.

Cipla Medpro South Africa: The pharmaceutical company reported that Indian company, Cipla Limited, has offered to acquire approximately 51.0% of the issued share capital of the company for a price of R8.55/share, excluding its final dividend.

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Corporate Update contd..

PPC to build $200.00mn factory in Zimbabwe: South Africa's Pretoria Portland Cement (PPC) plans to build a $200.00mn cement factory in Zimbabwe, Business Day reported, citing the Zimbabwe head of Africa's biggest cement maker.

Don Group sells remaining five hotels for R120.50mn: The Don Group announced the sale of its remaining five hotels as it looks to turn itself into a property management company. It has spent more than R30.00mn converting some of its hotels into residential units.

SABMiller: The beverage company, in its 1H13 results, stated that its revenue came in at $11.37bn, a 7.9% rise compared to the corresponding period last year. Basic EPS increased 14.5% annually to $1.00, boosted by the acquisition of Foster's and robust growth in Latin America and Asia Pacific.

Redefine Properties International: The property investment and development company announced that its 71.0% held subsidiary, Redefine Hotel Holdings, has completed the acquisition of 60.0% of the issued shares in BNRI Earls Court from Camden Lock and Earls Court LLP for a consideration of GBP8.70mn.

Transnet plans new coal export terminal: South African logistics group, Transnet, plans to build its own coal terminal at Richards Bay to break the export stranglehold of major miners and open up capacity for new market entrants.

Afrox to invest $83.40mn on new plant: Africa's biggest gases and welding group, African Oxygen, plans to invest R750.00mn ($83.40mn) in a new site with a filling capacity of 5,000 cylinders daily and a new air separation unit, it said.

Anglo American: The miner along with Lafarge SA announced that they have appointed Cyrille Ragoucy as the Chief Executive Officer for the UK joint venture they agreed to last year. The companies have also appointed Jamie Pike as the Non-Executive Chairman and Guy Young as the Chief Financial Officer of the joint venture.

AFGRI: The company stated that it its wholly owned subsidiary, AFGRI Operations and Fox Business Trust, have agreed to sell their respective 46.0% and 30.0% shareholding as well as the related intellectual property in Deposita to G4S.

Kloppers faces axe as BHP seeks replacement: Marius Kloppers, once viewed as the boy wonder of the world's mining industry, now seems set to get the axe as BHP Billiton boss. A BHP Billiton spokesman confirmed that the company was on the lookout for a replacement for Mr Kloppers after the Financial Times reported that "the company was actively seeking to replace Mr Kloppers within a year to two years".

Curro acquires independent school in Polokwane: Listed private schooling company, Curro Holdings, said that its 65.0% subsidiary Business Venture Investments No 1606 would acquire the Northern Academy Independent School in Polokwane for R157.00mn.

UK & US

JPMorgan Chase: The bank reported that Marianne Lake has been promoted to Chief Financial Officer effective early next year, succeeding Dough Braunstein who would become a Vice Chairman of the company.

Cisco Systems: The technology company indicated that it has agreed to acquire Meraki Inc in a deal worth $1.20bn.

Old Mutual: The financial services provider stated that it has bought a large interest in Uruguay's AIVA Business Platforms for an undisclosed sum to boost sales in Latin America.

Hewlett-Packard: The technology company, in its results for FY12, stated that its revenue fell 5.4% annually to $120.36bn. It reported a loss of $6.41/share compared to an EPS of $3.38, hurt by a massive write-down tied to its acquisition of Autonomy Corporation last year. The company expects 1Q13 EPS to be between $0.68 and $0.71, lower-than-market consensus of $0.85/share.

HJ Heinz: The food company, in its results for 2Q13, indicated that revenue rose marginally to $2.83bn compared to the corresponding period a year ago. EPS came in better-than-expected at $0.90, boosted by growth in emerging markets and a favourable tax rate.

News Corporation: The media company announced that it has agreed to acquire a 49.0% stake in the Yankees Entertainment and Sports Network.

EasyJet: The airline, in its FY12 results, indicated that its revenue came in at GBP3.85bn, an 11.6% rise compared to last year. Diluted EPS rose 18.7% annually to 61.70p, helped by a surge in late summer demand.

Deere & Company: The company, in its FY12 results, announced that its revenue came in at $33.50bn, a 13.7% increase from last year. EPS rose to $7.63 from $6.63 reported in the previous year.

General Motors: The company announced that it has acquired the European, Latin American and Chinese operations of Ally Financial Inc. in a deal worth $4.20bn.

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