"TRUE" DIVERSIFICATION IN 2022

Diversification today is not what it used to be.

So often we meet with families, and during our work together, we examine their investment portfolios. Oftentimes a portfolio considered to be diversified, upon analysis, is not. And in worse-case scenarios, a family can be unnecessarily vulnerable to major market occurrences. But why?

The definition of a diversified portfolio in 2022 has evolved and is now quite different from a diversified portfolio 40 years ago. In the past, a portfolio of equities, fixed income and cash, allocated according to a person's goals, risk tolerance and time horizon, was considered diversified. Today there are many more asset classes to consider – including private investments; alternatives such as hedge funds, more narrow slices of investable asset classes within public equities, etc. All of this provides additional alternatives to what would have been a "standard" diversified portfolio in the past.

In addition to the availability of additional asset classes, each with its own unique risk and return profile, each specific investment in a portfolio comes with its own unique set of risk drivers that should also be considered when thinking about building diversified portfolios. In fact, our view is that thinking about diversifying not just by asset class, but more importantly by "risk and return drivers" is what we feel makes for a truly diversified portfolio. Diversification of risk and return drivers should be a primary factor considered during portfolio construction.

In this commentary, we discuss the sources of uncertainty affecting markets today and why protecting against those risks may not be as simple as the traditional cash/bond/stock portfolio that was the norm in years past.

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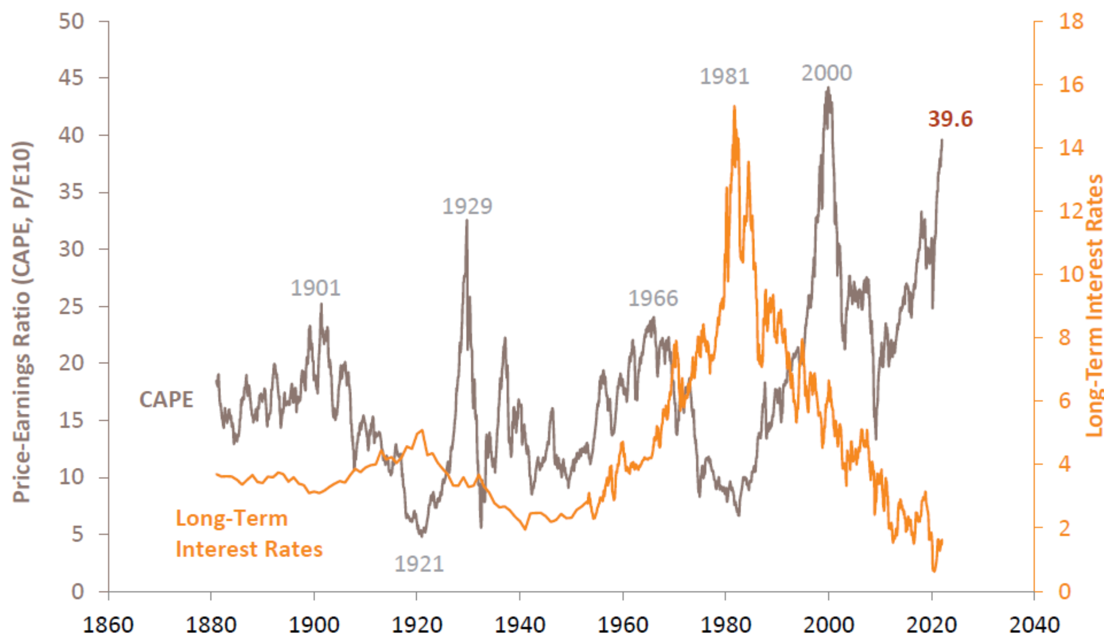
BEYOND 60/40

In the past, investors could count on the 60/40 portfolio, which did well by riding lower interest rates as inflation fell. This provided a multi-decade tailwind to a very simple two-asset class portfolio comprised of public equities (typically S&P 500) and fixed income (Barclays Aggregate Bond Index).

Today, both the 60 (equity) and 40 (core bonds) face significant challenges impeding future returns. First, equity valuations, using nearly every metric, are expensive. The chart below shows the S&P 500 at the second-highest valuation in history using the cyclically adjusted price-to-earnings ratio (CAPE), which smooths out fluctuations in corporate profits over a 10-year period. Second, interest rates are at their very low end in history, as seen in the chart below and all indications are that they will be rising for the foreseeable future:



Source: http://www.econ.yale.edu/~shiller/data.htm

MACRO SOURCES OF UNCERTAINTY AND VOLATILITY

There are several interconnected macro sources of uncertainty driving market volatility, including interest rates, inflation, and government fiscal policy. Understanding how each of these factors relate to one another – and how they relate to various asset classes – is an important starting point in building a truly diversified portfolio. We discuss each below.

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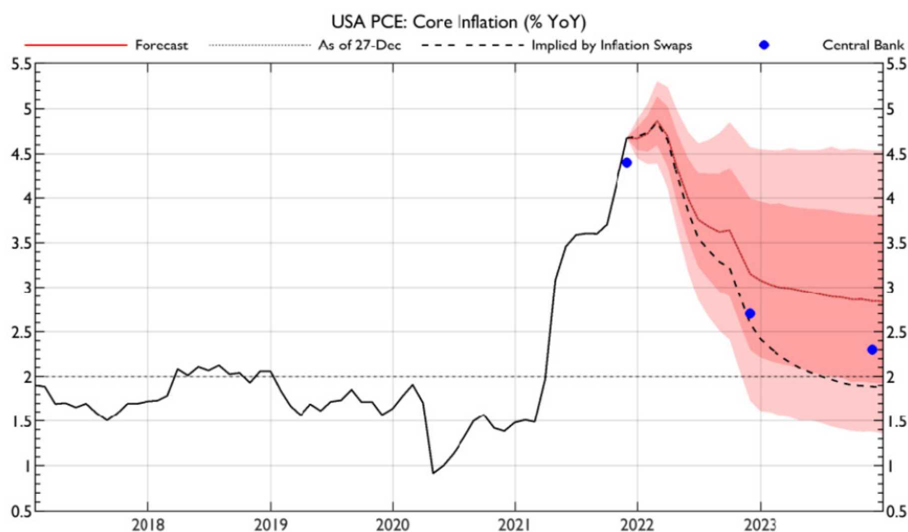
INTEREST RATES

The high valuations of both equity and bonds creates what we see as a very steep wall for markets to climb to provide returns with acceptable risks. While it is unknown if the Fed will raise interest rates significantly, even a small increase will make a significant difference after 30 years of falling rates. Given the low level of rates, rising inflation, and more hawkish monetary policy by the Federal Reserve, interest rate risk is now elevated. When constructing portfolios, it's important to know that changes in interest rates may affect asset classes differently. For instance, rising rates are bad for bonds but good for value stocks because interest rates drive stock market multiples.

INFLATION

The Bureau of Labor Statistics reported that January Headline CPI rose 7.5% year-over-year (the highest since February 1982) while Core CPI rose 6.0% (the highest since August 1982). The question we often hear in the news is whether the recent increase in inflation is transitory or permanent. It is better, in our opinion, to see sources of higher inflation over the short, medium and longer term.

COVID caused significant disruptions to supply chains and the fiscal response to it likely added to inflationary pressures in the short term. Earlier-than-expected retirements shrinking the labor force, difficulties in energy transition, and rolling back of globalization are all factors that can contribute to increasing inflation over the medium and longer terms. As a result, inflation is likely to be higher in the future than experienced in the past forty years, but the range of outcome is wide.



Source: Fulcrum Asset Management LLP

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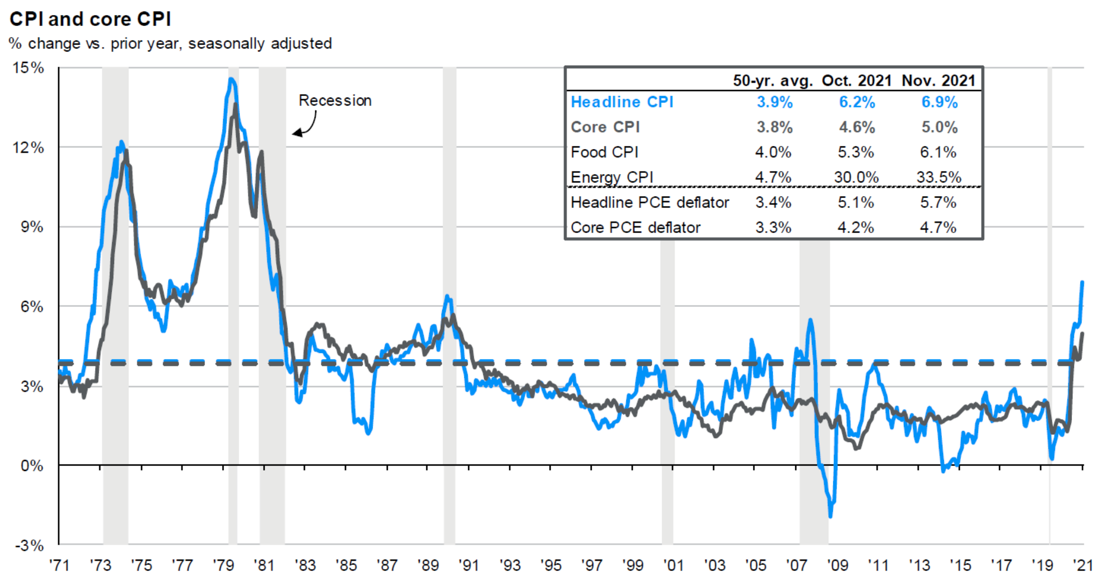
At the same time, housing cost, at 40% of CPI, has increased 18% year-over-year. Demographic trends suggest home prices aren't going to retreat any time soon. Higher rates should slow down growth, but pricing is already elevated. So, a large part of inflation seems to be longer term and structural, which eats into consumption and corporate profits, which could negatively impact the market.

GOVERNMENT POLICY

Fiscal and monetary policies can affect the environment for investing and can change the magnitude of economic and investment fundamentals. Economic growth impacts corporate earnings, which drive stock price changes. Earnings also affect the creditworthiness of bonds.

The government's response to COVID was a significant expansion of fiscal policy – and it's not over yet. Fiscal policy is expected to be more expansive going forward than in the past. This can increase earnings growth rates for stocks and can also be inflationary. Inflation was a major cause of interest rates falling over the past forty years, and it has started to turn as seen in the chart below:



Source: BLS, FactSet, J.P. Morgan Asset Management. Data are as of December 31, 2021.

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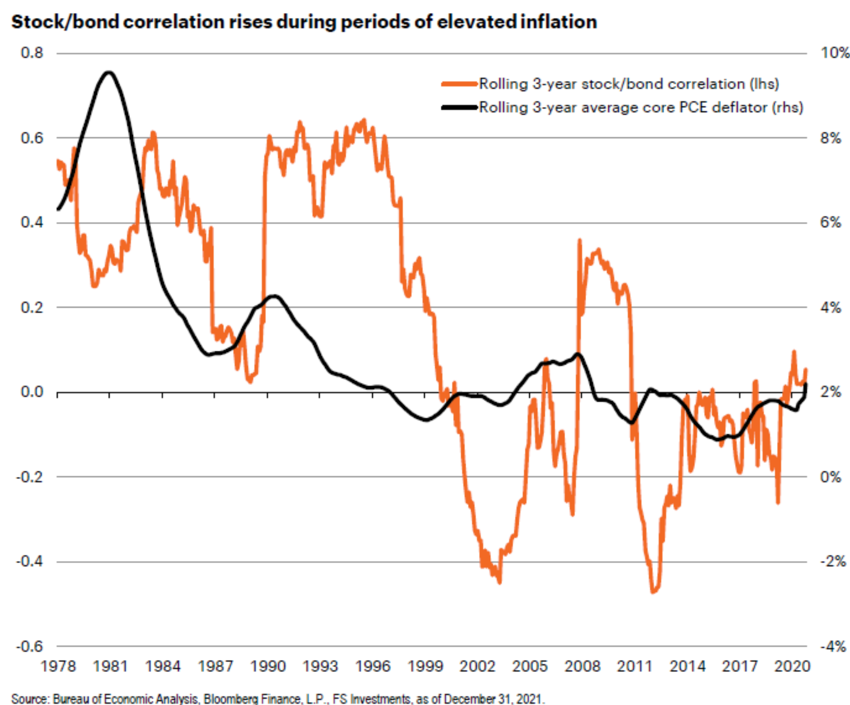
Adding to that, we have government debt/GDP at record levels and potentially a slowing economy. This is evidenced by the large number of companies missing earnings guidance in Q4, retail sales dropping below projections, etc. Therefore, increasing interest rates in a potentially slowing economy could be a challenge. Also, corporate debt/EBITDA levels are elevated because of our current cheap cost of capital, but companies' ability to service debt/refi could be a challenge going forward.

STOCK-BOND CORRELATION

Another major change affecting the blueprint for diversification is correlation between stocks and bonds. For the past 20 years it was largely negative which is a strong benefit to portfolio construction. Bonds were able to serve as a strong ballast for stocks during times of market turbulence. As a result, a simple portfolio was effective since the diversification benefit was sufficient.



What has changed is that correlation is now turning positive due to rising inflation. This has significant implications for portfolio construction. Entering a new era of higher inflation with a positive correlation between stocks and bonds, different strategies and asset classes will be needed to provide diversification.

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THE BLUEPRINT FOR DIVERSIFICATION

Because there is a wide range of outcomes, the best thing we can do is focus on being truly diversified. This means diversification across a variety of risk factors. In equity, those factors can include size, value, geography and beta. In fixed income, the risks often include interest rates and credit. Macro factors include economic growth, inflation and liquidity.

To diversify across risk factors, we look across public and private markets and within sub-asset classes. Diversifying across asset classes is beneficial because different assets react differently to adverse events. As a result, combining different asset classes can reduce a portfolio's sensitivity to market swings because they have different correlations to each other and to macro risk factors.

Additionally, adding investments with differing risk factors provides a broader number of return drivers. Having many sources of returns means that the portfolio is not dependent on just a few sectors. Instead, a well-diversified portfolio has some cylinders firing at all times. The key is finding less correlated returned streams, which can have a much larger impact due to having different reactions to different factors.

THE ROLE OF ALTERNATIVES

By reducing total risk and expanding the number of return drivers, a portfolio's overall risk/return profile can be improved. As we discussed above, current market conditions are such that the traditional 60/40 portfolio may no longer provide an adequate number of return drivers, or put another way, an inadequate number of risk diversifiers. Instead, investors are turning to alternatives to soften market volatility and provide streams of return that are uncorrelated to the broader market.

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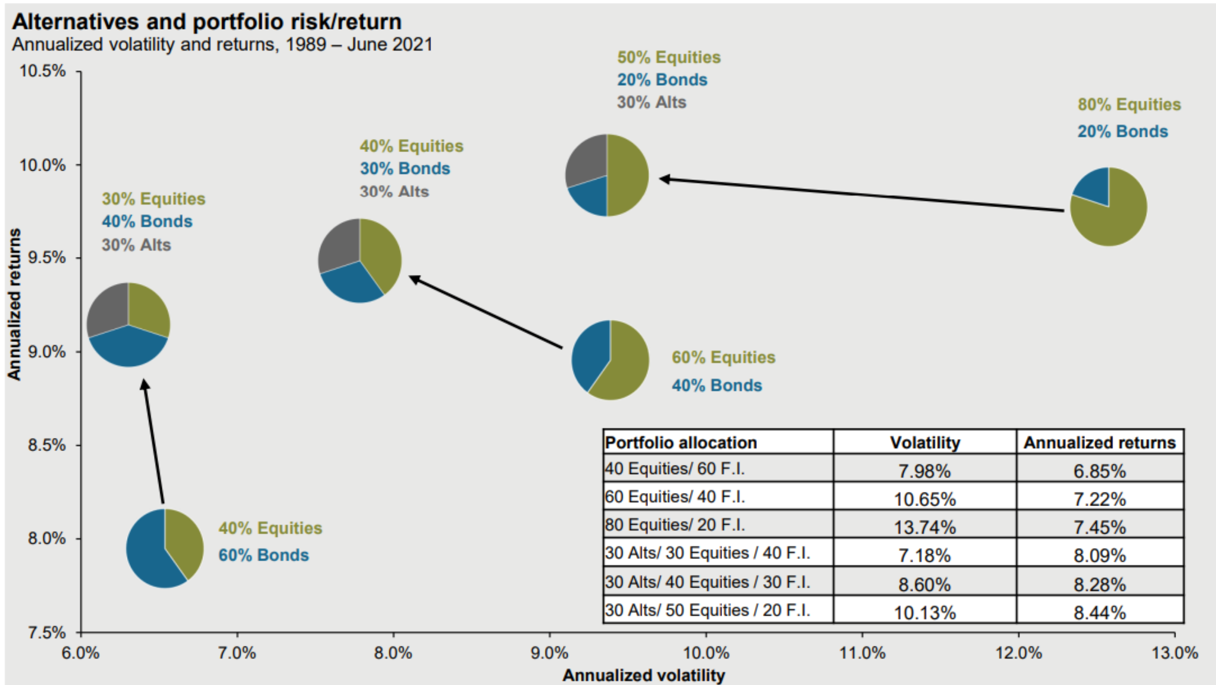

Portfolio allocation	Volatility	Annualized returns
40 Equities/ 60 F.I.	7.98%	6.85%
60 Equities/ 40 F.I.	10.65%	7.22%
80 Equities/ 20 F.I.	13.74%	7.45%
30 Alts/ 30 Equities / 40 F.I.	7.18%	8.09%
30 Alts/ 40 Equities / 30 F.I.	8.60%	8.28%
30 Alts/ 50 Equities / 20 F.I.	10.13%	8.44%

Source: Bloomberg, Burgiss, HRFI, NCREIF, Standard & Poor's, FactSet, J.P. Morgan Asset Management. Alts include hedge funds, real estate, and private equity, with each receiving an equal weight. Portfolios are rebalanced at the start of the year.
Data is based on availability as of November 30, 2021.

As investors begin to understand the importance of diversification through multiple asset classes and return streams, the natural question is, "How many asset classes do I need?" The answer is more than ever before. And it's not just asset classes, one must go underneath to look at exposures too. In our upcoming commentaries we will be looking at investments such as real estate, private equity, private credit and emerging markets. We will also discuss how these types of investments, while not traditionally used in portfolios, can be layered in to provide "true" diversification in the conditions we face today.

DISCLAIMER

All market data sourced from PGIM; US Stock-Bond Correlation, May 2021. Provided for informational purposes only, nothing herein should be considered investment advice.

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