



What is the history of portfolio diversification?

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What is the history of portfolio diversification?

We are all aware of the integral concept of a diversified portfolio, we all know that investment portfolios have a diversified approach to the management of money in the 21st century. But how long ago was the concept of diversification understood and used? When did the concept of diversification when investing become important?

It may come as a surprise to realise that the great playwright William Shakespeare referred to the diversification of investments back in the 16th century. Everyone is familiar with the saying, "Don't put all your eggs in one basket." In Shakespeare's play, "The Merchant of Venice," written more than 400 years ago, the character Antonio demonstrates his understanding of the concept when he says: "I thank my fortune for it — my ventures are not in one bottom trusted, nor to one place, nor is my whole estate upon the fortune of this present year."



In the 20th century, we need to look back at the work of Nobel Laureate and pioneer of investment theory Harry Markowitz. In 1952 he wrote a paper entitled "Investment Selection", which established the foundations for what is known today as Modern Portfolio Theory.

His analysis provided the mathematical underpinnings for the concept of portfolio optimisation. The key contribution of Markowitz was the quantification of portfolio risk, which was measured by the variation in investment returns, known as standard deviation.

Harry Markowitz's research highlighted the benefits of a diversified approach to investing with an "optimal portfolio". This was a framework in which both risk and returns are considered. The Optimal portfolio offers a maximum expected return for a defined level of risk. Markowitz's work highlighted the benefits of diversification, which reduces risk, without sacrificing long term returns. He regarded the concept of diversification as "the only free lunch in finance".

Modern Portfolio Theory led to the establishment of the 60:40 portfolio, a mix of



Long term investors are now being compensated for being exposed to a range of different risks, versus a focus on the traditional asset mix of past years.



60% shares and 40% fixed income securities. This mix dominated portfolio management practice for many years and was very much domestically biased. The concept of international investing was not widely adopted in the 1960's or even into the 1980's.

The practice of incorporating an increase in offshore investments occurred in the late 1980's and 1990's due to significant changes in the global environment at that time. The deregulation of financial markets, the rapid growth in emerging markets, financial innovation with the growing availability of new financial products and services, and several academic "discoveries" had an impact on the traditional mix of investments in portfolios.

In addition, the ending of fixed currency exchange rates around the world, and the relaxation of capital controls between countries led to a dramatic increase in the level of international investment activity.

Over time, other academic discoveries have led to what is known as "style investing" where the investment manager will adopt a position with value investing or growth, along with a rise into investing into smaller companies which typically add value and serve to increase diversification. Style investing has now been superseded by factor investing which is covered later in this article.

There have been many periods in the intervening years where events such as the Tech Bubble crash of 2000, and the global markets meltdown of the Global Financial Crisis generated much academic research, and specific learnings have now changed the approach to portfolio construction, and risk management.

The severity of the Global Financial Crisis in 2008 tested all investment portfolios. Because of the dislocation of financial markets at the time, this had the effect of muting the benefits of diversification and resulted in many academics and investment professionals questioning the actual level of useful diversification within portfolios.

In 2009, as a result of the effects of the GFC on their funds, the Norwegian Government Pension Fund commissioned a study to investigate their

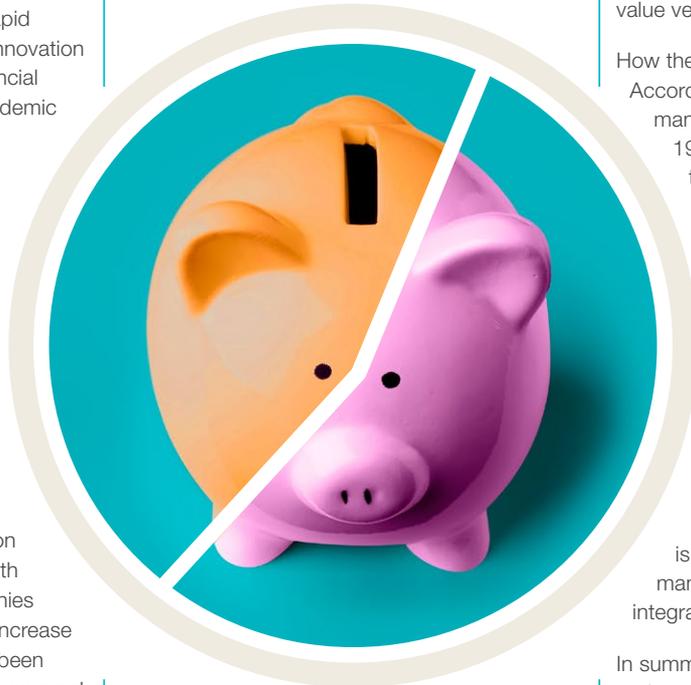
investment returns during that period. This study was undertaken by three prominent professors, Andrew Ang from the Columbia University School of Business, William Goetzmann from Yale University, and Stephen Schaefer from the London Business School of Economics. The results of this study have gone on to influence portfolio diversification practices, and the concept of factor investing in recent times.

gains of diversification are lost if the chosen securities move in lockstep with the broader market, as happened in the GFC when certain market conditions arose. The good news is factor investing can offset potential risks by targeting broad, persistent, and long recognized drivers of returns from all asset classes. True portfolio diversification is achieved instead by investing in different risk factors that drive the asset classes, for example, duration, economic growth cycles, levels of volatility, and value versus growth investing.

How then, does this approach relate to the Accordia Portfolios? Are our client portfolios managed based on the structures of the 1980's and 90's? Absolutely not. Are the Accordia portfolios including and adopting the key outcomes of the academic learnings of the 21st century? Most certainly, yes. Not only that, but the research team at Caliber, the investment manager of the Accordia Portfolios, are continually evaluating new and future trends in global portfolio management. We have long held the view that understanding and managing risk is a pivotal component in portfolio management. Risk budgeting is also an essential element of portfolio management, and risk factor analysis is an integral feature of portfolio construction.

In summary, the advancements in technology, and academic study has assisted investors to understand and appreciate the different dimensions of risk better, and to move away from the old portfolio models of 40 years ago. There is no doubting that if done well, diversification can lead to much improved long term returns but delivered in a much smoother fashion over time. This approach ties in with the fact that for our clients, the failure to meet long term realistic investment objectives is the greatest investment risk of all.

Perhaps it is worth reflecting upon, that although the benefits of diversification are without question hugely beneficial, Modern Portfolio Theory of the 1950's cannot now be considered Modern in the context of the global dynamic in which we now live.



How has the concept of factor investing changed portfolio management? As discussed, the findings of the Norwegian study post GFC, found that portfolio diversification alone does not come from investing in more and more asset classes. This can diminish benefits of diversification. For example, adding global listed property shares or listed infrastructure investments to a multi asset portfolio that already includes a significant holding of global shares.

Now, true portfolio diversification is achieved by investing in different risk factors that drive the asset classes. What then, is risk factor investing? Factor investing, from a theoretical standpoint, is designed to enhance diversification, generate above-market returns and most importantly, manage risk. Portfolio diversification has long been a popular safety tactic, but the

The outlook for interest rates in New Zealand.

After many indications that the Reserve Bank would cut interest rates further before the end of 2019, the bank at the Monetary Policy Committee meeting on the 13th of November decided that the official cash rate (OCR) would remain unchanged at 1%. This decision surprised many commentators, who had expected a further 0.25% reduction before the end of the year.

However, Reserve Bank policymakers stated that current economic developments did not justify a further cut in what is seen as a very stimulatory policy setting at this stage in the economic cycle. This situation will continue to be closely monitored and the bank will be prepared to act if conditions require it.

The Committee further stated that it is anticipated that interest rates will need to remain at low levels for a “prolonged period” to see any meaningful changes to the inflation target, and to provide opportunities for the maintenance of low unemployment statistics.

The OCR has been lowered from 1.75% to its current level this year after being on hold for over two years.

The following observations were made by the Monetary Policy Committee regarding the outlook for the rest of 2019, and into 2020.

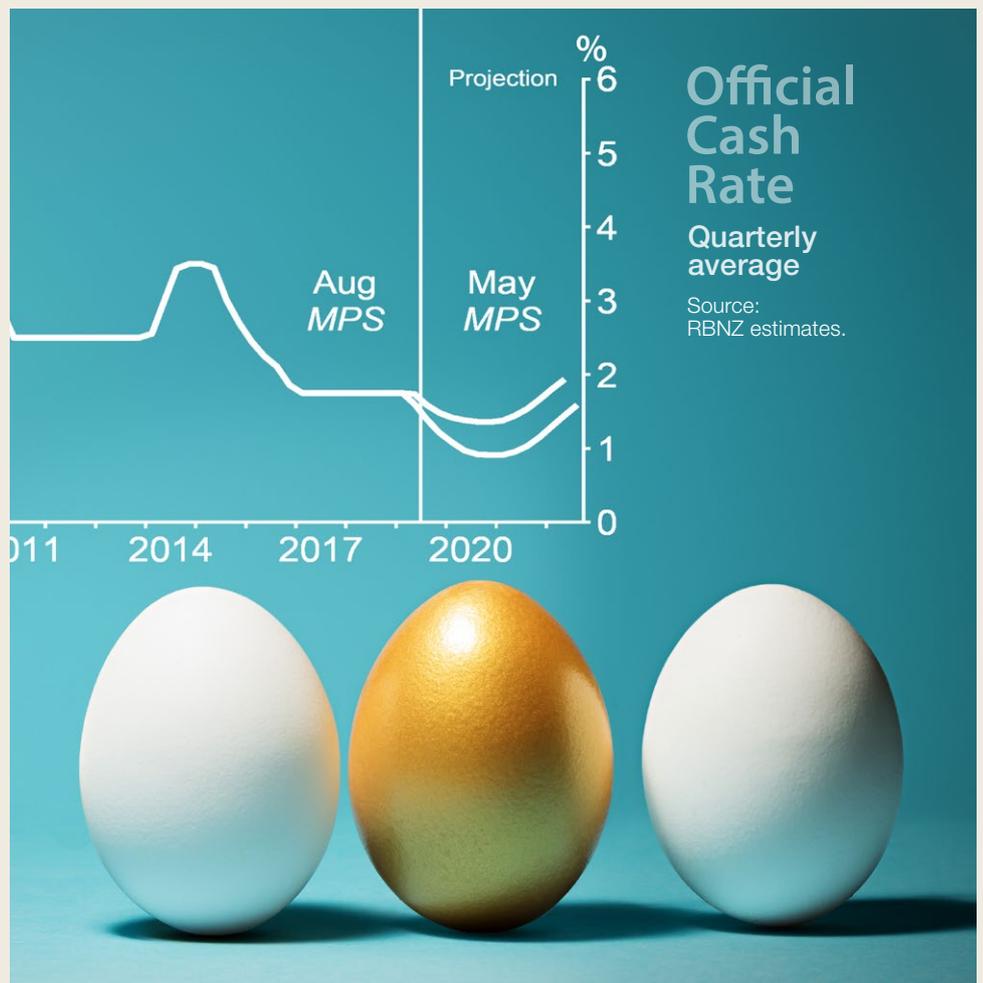
It noted that Economic growth has continued to slow in mid-2019 reflecting weak business investment and sentiment, along with much softer household spending. The bank expects economic growth to remain subdued for the rest of 2019.

The bank also noted that New Zealand is vulnerable to a softening in the growth of our trading partners. It commented that Growth in global trade and manufacturing is weak, and uncertainty remains high, dampening global business investment. However, New Zealand’s export commodity prices have been robust, underpinning a positive terms of trade environment for the country. An additional benefit to exporters has been the lower New Zealand dollar exchange rate during 2019, which has provided some useful offset to the weaker global economic climate.

Domestic economic activity is expected to increase during 2020 supported by low interest rates, and higher wage growth. It is also expected that increased government spending and investment will contribute to the overall economic performance in New Zealand. One of the effects of the low level of the OCR has flowed through to lower lending rates more generally, which support spending and investment. Rising capacity pressures are projected to promote a pick-up in business investment in the coming year.

The committee members noted that employment remains close to its maximum sustainable level while consumer price inflation remains below the 2 percent target mid-point but within the 1 to 3 percent target range.

What are the implications for retail bank term deposits? There is no doubt that the outlook for interest rates will remain very low for some considerable time. The yield curve which indicates the returns offered over various maturities is flat. In other words, there is currently no extra reward for locking in terms longer than 18 months to 2 years. This has had a major effect for people who have had two, three- and five-year term deposits mature, and have faced the daunting prospect of big reductions in interest rates on offer from all banks. This further underpins the need for a diversified approach to investment. Unfortunately for term depositors, having “all eggs” in the term deposit basket in recent years has proven to be a costly exercise in terms of lost opportunity, and for many, the prospect of running out of capital to finance lifestyle options in later years.



The global hunt for yield. The link between risk and return.

What is the relationship between return and risk? Most of us are aware that the greater the return offered on any given investment, the greater the risk. They are inextricably linked, and underscores the old maxim, “if the return sounds too good to be true, then it probably is”. While this may sound cynical, and perhaps could be argued that this philosophy could discourage making a decision that could be advantageous, for many it is a very real consideration.

However, in the context of the current global financial market environment, there is widespread concern among investment commentators and investment professionals that too many investors are ignoring or downplaying risk, instead focussing on returns in their hunt for yield in an environment where yields are low, and likely to remain so for some considerable time.

It goes without saying that when managing money for the long term, the absence of a well thought out investment portfolio risk budget can be a recipe for disaster.

In many situations, commentators have pointed out the problems associated with the purchase of a single, or very limited number of “high yield” offers that quote or imply returns significantly higher than returns on offer from the banks. For many, the focus on yield is the predominant driver behind their investment decisions, and other critical factors are not considered. What, you may ask, are these factors?

1. Liquidity Risk

The lack of liquidity could mean that if cash is required for an emergency, the investment may not be able to be sold or redeemed. In many cases, there may be no secondary market structure available to sell it.

2. Default Risk

Is the investment truly offering a return that is commensurate with the risk? In a low yield environment, a return that may offer a pre tax return of two to three times the rate available from the bank may sound very attractive. However, what is the likelihood of the investment failing entirely? What could be recoverable, if any in such an event?

3. Underlying Costs and Expenses.

A careful analysis of the fine print for such an offer may provide some insight as to who is really making a good return for the risk involved. Will it be the investor, or the issuer of the investment offer? Are the expenses understood relative to what is being offered?

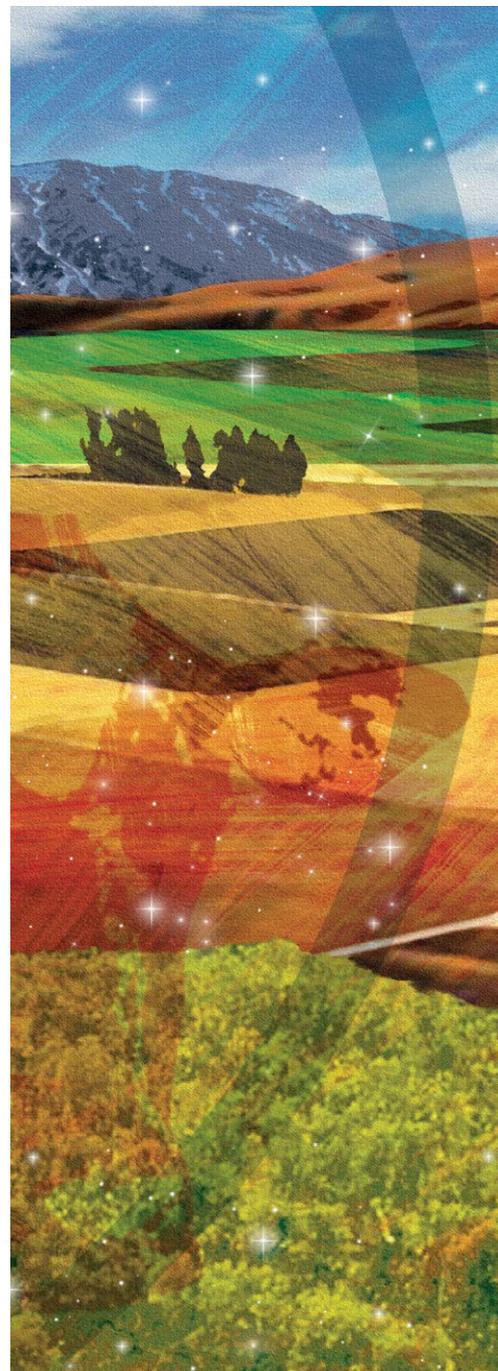
4. Risk Specific to the Underlying Security

What is the actual asset that is being invested in? It is a financial instrument such as a bond, or a property syndicate, perhaps a specialist investment that could be made up of a mix of leveraged assets? Knowledge of what the underlying assets are, and an understanding of the characteristics of these need to be clearly understood. For example, what are the drivers of return and value, how will they be valued, how are they managed, and by whom are some of the many questions that should be understood, but in many cases, are not. The promise of yield is the key driver for many people.

Unfortunately, for many who have been tempted by such offers, the above considerations will not necessarily have been accounted for and will inevitably result in some financial stress if things go wrong.

At Accordia, we remind clients that after working hard for many years, and in most cases taking considerable risks to achieve financial stability and prosperity, it is not our job to take greater risks with invested money than it took to generate it in the first place.

At this critical point in our clients lives, never has it been more important to work closely with them to determine what is an appropriate risk budget for them, and to advise on an appropriate well-structured investment solution for their personal circumstances. By adopting this approach, we can be certain that we will be able to substantially increase the likelihood of achieving a long-term portfolio framework that will serve them well for a very long time.



Christmas hours.

We will be closing the office for the year on Friday December 20th, reopening on Monday the 13th of January 2020.

We would like to take this opportunity to wish all our clients and readers a very merry Christmas, and our best wishes to you all for a great 2020.