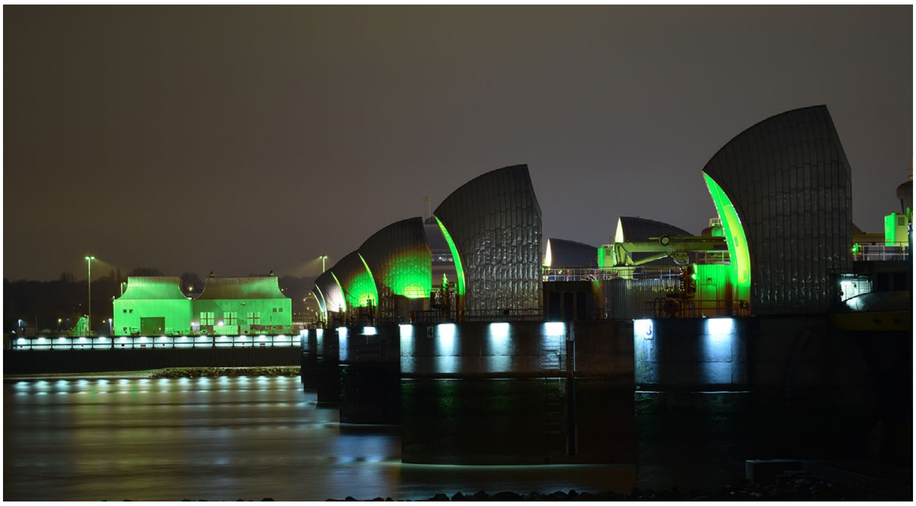
When is Defensive not Defensive?

In the aftermath of COP26 in Glasgow, and as a proud Scot and Glaswegian, it was great to see the city presented on the international stage. The issue of climate change is, quite rightly, top of the political agenda, and one hopes that the agreement reached at the conference will make a real difference in the longer term. The impact of climate change is real – as demonstrated by flooding in both London and Glasgow in recent months, where extreme volumes of rain (even for Glasgow) have overwhelmed the old drainage systems and infrastructure designed to protect residents from such events.

This idea of ageing infrastructure providing protection that is, at times, no longer suitable for changing times led me to think of the risk inherent in traditional 60/40 "balanced" portfolios, and specifically the role bonds play in these solutions.



Investment portfolios need to have protection from extreme events. Often there are different levels of protection required, which investors may need to consider, depending on the prevailing circumstances. However not every market correction is the same or extreme. In fact,

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changing your portfolio every time to insulate from the worse-case scenario when markets appear to be volatile, may be more harmful and expensive in the end.

It becomes important, therefore, to be able to determine whether a market correction is just that, or something more extreme. Once that is understood, of equal importance is to determine what type of assets to hold during a typical market correction, versus knowing which ones provide protection during extreme conditions.

In periods in which bonds have rallied, for example on the back of substantial fiscal stimulus and quantitative easing since the Global Financial Crisis in 2008, the traditional 60/40 ‘balanced’ portfolio has served investors relatively well through most market conditions. The objective of this structure is to offer investors an opportunity to participate in growth on the upside, using a 60% allocation to assets such as equities, while a 40% allocation to more defensive assets, such as fixed income, is meant to offer a degree of protection.

However, as we have seen during previous extreme market situations, if fixed income assets fall at the same time as equity assets, what’s left in the portfolio to provide protection? With bond yields and real bond yields close to being at all-time lows (and at times negative), the risk of holding fixed income in portfolios has increased. In fact, the number of times that bonds and equities have moved in the same direction has increased, as shown in Chart 1, with one good example occurring during the start of the COVID crisis in March 2020.

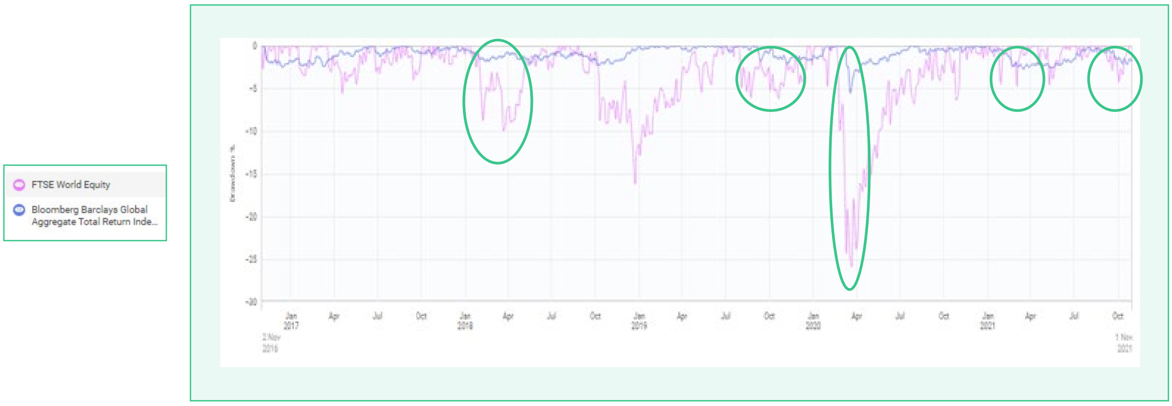

Chart 1 – FTSE World Equity/Bloomberg Barclays Global Aggregate returns. Source: Collidr/Bloomberg.

This means that the correlation between bonds and equities has increased, as demonstrated in Chart 2.

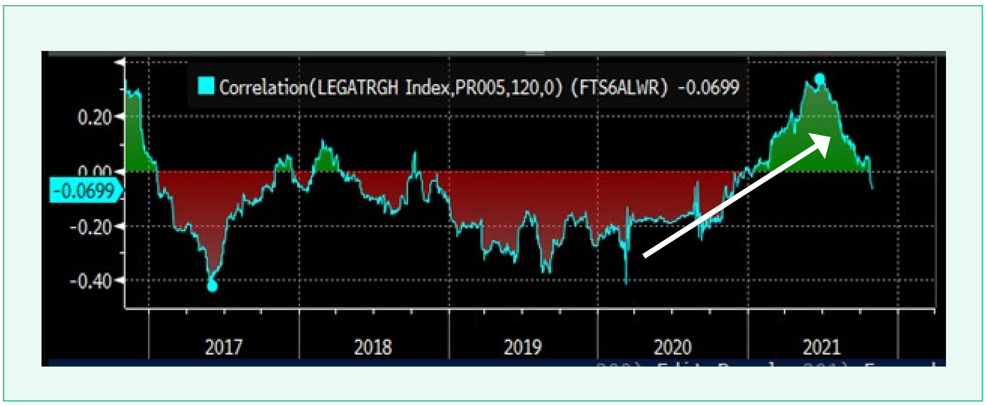

Chart 2 – increasing correlation between bonds and equities. Source: Bloomberg

When equities and fixed income move together, the traditional 60/40 portfolios, as well as other portfolios that only use those asset classes, will suffer. Looking at Chart 3, which shows the drawdown of equity markets, bond markets and a 60/40 portfolio, it is evident that in stressed periods, such as the COVID crisis in March 2020, bonds and equities can fall at the same time, resulting in typical 60/40 portfolios having substantial drawdowns.

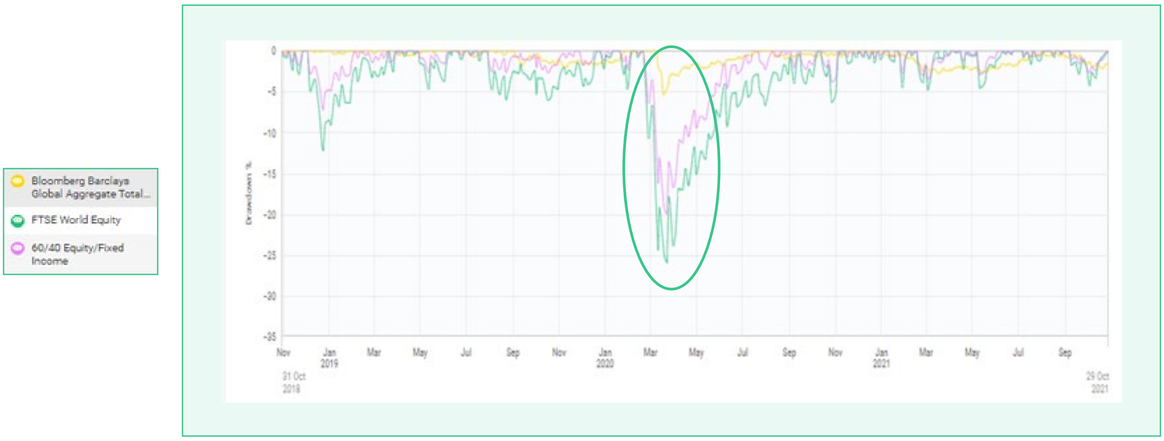

Chart 3 – bonds, equities, 60/40 portfolio drawdown over last two years. Source: Collidr/Bloomberg

When bonds fall with equities

Each market correction is different, and not all volatility is the same. There are times, like the COVID crisis, where bonds and equities fall at the same time. On other occasions, bonds can provide diversification against a falling equity market. Chart 4, showing the drawdown of bonds, equities and a 60/40 portfolio in Q1 2021, demonstrates this perfectly. During the initial drawdown at the end of January, bonds remained relatively stable when equities fell, providing some insulation for 60/40 portfolios. However, in the drawdown at the end of February, bonds fell in line with equities, pushing the drawdown for 60/40 portfolios to be closer to that of equities, and not what one might expect from a "balanced" portfolio.

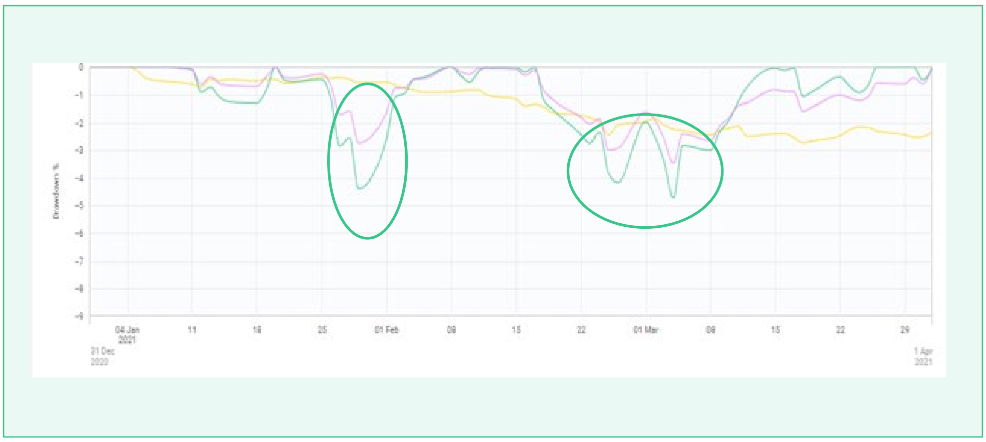

Chart 4 – bond, equity and "balanced" 60/40 portfolio drawdown in Q1 2021. Source: Collidr/Bloomberg

What this should demonstrate to investors is that there is no ideal "one-size fits all" protection for portfolios. Different market corrections require a different set of assets to help provide downside protection, but equally, not all corrections lead to a full-scale risk-off event.

For the fixed income market there are a variety of headwinds at present. In addition to interest rates being close to all-time lows, a large proportion of debt is at negative yield levels. In fact, once you take into account inflationary expectations, a substantial amount of debt is negative yielding in real terms. While bond yields could fall further (and further into negative territory), there is limited room for bonds to continue to rally. Add to this the expected unwinding of quantitative easing that has been pumped into the economy since the Global Financial Crisis in 2008, and the COVID crisis in 2020, it is clear risks in the bond space are rising.

Of these, perhaps the biggest is the increasing inflationary environment, with investors trying to determine whether the rise in inflation figures is transitory (as a result of the COVID crisis) or represent longer term inflationary pressures. Rising inflation is bad for bond investors, as inflation erodes the value of the bond upon their repayment at maturity. All these factors highlight that there may be risks ahead in the fixed income space.

Where to go for diversification?

With traditional 60/40 portfolios facing increasing risk as a result of higher correlations between equities and fixed income, what type of assets or funds might provide portfolios with a level of diversification?

One example of funds that could offer a different risk/return profile to traditional bonds are those in the liquid alternative space. These funds often use a host of different strategies, such as long/short equity or credit, which could work well at different times in a market cycle. Market neutral funds, for instance, can provide a source of non-correlated returns. However keep in mind the selection of a market neutral fund can be crucial, as each one will have a different way of investing and run a different level of market exposure. There are times when these funds can incur a drawdown concurrent with equity markets.

There are some equity-based funds which provide returns with little correlation to equity markets, for example - event driven funds. Often, these funds use merger arbitrage techniques in an attempt to generate low risk, positive returns, with little correlation to the overall market. To be effective, however, the manager has to have a full understanding of the underlying mergers and acquisitions that they are looking to exploit.

In the bond space, the use of a strategic bond fund could help diversify portfolio returns. Unlike traditional bond funds, strategic bond funds, those with good managers, can aggressively shift their allocations at different points during a market cycle. In this way, a good strategic bond manager is likely to keep the duration of the fund under control, shifting allocations to higher risk assets such as emerging market debt in positive times, and shifting to low duration, and at times even net short duration, in the sovereign bond space in a crisis. This type of fund depends on the decisions and experience of the fund manager and can help to diversify returns against equity markets if their decisions are sound.

For the more adventurous or astute investor, there are many derivatives-based funds that can also provide uncorrelated or asymmetric returns. CTA (Commodity Trading Adviser) funds, also known as Managed Futures Funds, generally run a systematic process, using a variety of futures contracts, to provide a different risk/return profile to the fixed income space. Also, there are a handful of 'tail risk' funds available. These funds often behave like insurance products, in that they typically produce negative returns in "normal" market environments (effectively incurring a cost like a premium paid for an insurance contract) but may produce substantial positive returns in a market crisis. Keep in mind these types of products are very complex and should only be used by investors who can fully understand the risks involved.

In summary, there are a variety of strategies which might help insulate a portfolio during an 'extreme' market event or correction. The key is to understand when you might need this diversification versus those times when more traditional methods work. For most investors, a good starting point is to determine what the upcoming risks might be, knowing different market conditions require different assets and strategies, and positioning their portfolio accordingly. It is important to have balance in portfolios and remain vigilant about upcoming risks.

For the most part the current drainage systems in this country can deal with normal levels of rainfall. However every so often (although increasingly due to climate change), the system gets overwhelmed, and cities are flooded as a result. Similarly, a 60/40 balanced portfolio is usually structured in a way to help investors withstand most levels of market volatility. However, not all volatility is the same, and it's important to be ready for all market environments. The next major crisis could be just around the corner.