CREDO
WEALTH

Against the Gods

Lessons from the first 5 years of Multi-Asset Portfolios - Part III

Ainsley To, Head of Multi-Asset - 27 September 2019

Part 3 - Dare to be dull

"I know you've said you don't do forecasts but what is your view on the market right now?"
Every other person after they find out you work in asset management.

A problem for evidence-based investors is that in investing, *what is interesting is rarely what is useful, and what is useful is rarely interesting for the layperson*. And whilst quantitative strategies are enjoying a renaissance in investment circles (see Part II), they are still a conversation killer at the dinner table. Individual investors much prefer hearing macro predictions (such as how Brexit will play out) than the pros and cons of portfolio optimisation. This pressure is unique for those in the investment profession – thanks to the financial media, modern society now conflates an ability to predict the future with having credible investment ideas. As one who doesn't believe in forecasts, I have one of two options when asked for a prediction… sacrifice my integrity and tell the audience what they want to hear, or lose credibility and say "I don't know" (the most underused phrase in investing). After grappling with this choice on many occasions, I have found it useful to ask myself which choice I would prefer a different professional to take in my shoes: If I naively asked my doctor something he couldn't possibly know, such as, "what is your prediction for the exact date and time of my death?"…I would much rather he told me that he didn't know than guess an arbitrary date, which I might then take literally and go on to plan the rest of my life around. Thus the preferred path is to explain the importance of time in the market, not timing the market.

In my experience, this is often something investors need to figure out for themselves. Even the great John Maynard Keynes, one of the greatest macro thinkers in history, took his own time to admit to himself he couldn't make money from forecasting the direction of the economy. Jumping from headline to headline gives you some great narrative to woo clients but unless you're smarter than Keynes, it doesn't qualify as a repeatable investment edge (if you aren't convinced, try watching CNBC pundits' forecasts from 12 months ago and see if you find anything useful).

To conduct an orchestra, you have to turn your back on the audience

The alternative to taking "cocktail party risk" is to focus on portfolio improvements that don't require macro forecasts and that are backed by robust evidence which won't change on a daily basis – e.g. spend time on what actually works. An example of this has been the increased emphasis on diversification in the Multi-Asset Portfolios (MAP). A nice thing about diversification as a concept is that it is objectively the only free lunch in investing and combining diversifying assets will always give you a greater risk/reward than the sum of the parts.

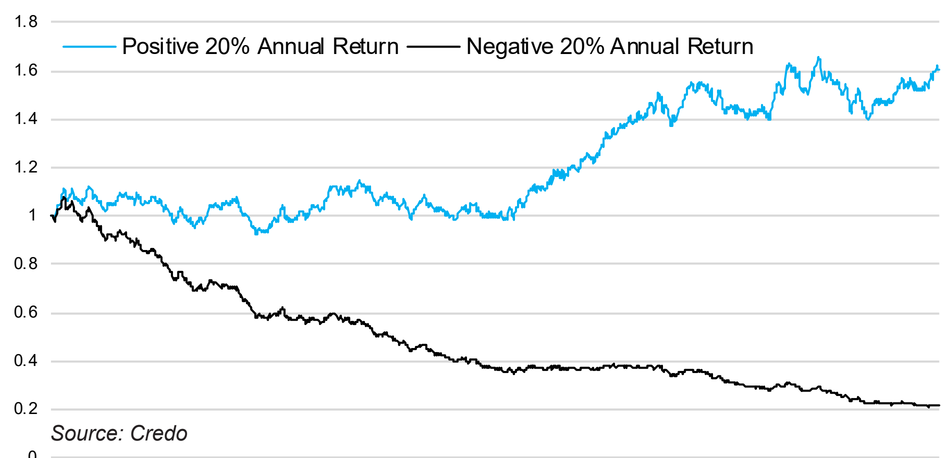
In the traditional Modern Portfolio Theory (MPT) sense, you increase diversification by holding assets in your portfolio which have low correlation with each other. I'm guessing when Harry Markowitz published on MPT he would never have believed that practitioners would still be referring to it as "modern" over 60 years later. The main problem with the theory is that it does not work well in practice. As touched on in Part I: estimates of returns and risk (including correlation) are uncertain - small errors in your predictions can lead to terrible outcomes if used naively in portfolio optimisation.

Another more subtle problem with over-reliance on a correlation number is hidden in its mathematical formula (I did warn you at the start that this was going to be boring!). Correlation is the degree to which two assets co-move *around their averages*. Chart 1 shows the prices of two hypothetical investments which are perfectly correlated but have different average returns. This (admittedly extreme) case helps illustrate how little practical use a single correlation number can be. Correlations can also vary over time and look different over various time horizons. In MAP, we combine statistical measures of diversification with fundamental intuition of why a strategy has different long-term return drivers to the rest of our portfolios – without an economic rationale, an investor runs the risk of relying on purely statistical relationships which may turn out to be spurious.

Whilst important, there are benefits to diversification beyond the relationships between the assets in your portfolio. A more holistic view needs to pay homage to the old adage that you "don't put all your eggs in one basket". The concept of diversification is in our nature as a species and biodiversity is embedded in the workings of the natural world. When a concept is so universal and has aided survival for millennia, one would be foolish to ignore it.

A more concrete illustration of how more underlying securities can improve investor outcomes is to consider the positive skew of individual stock returns: the vast majority of individual stocks underperform cash, and the tiny fraction that remains are responsible for driving all the returns of the overall market. A sufficiently diversified portfolio and increased breadth of

Chart 1: Two hypothetical investments with a correlation of 1



Source: Credo

opportunity set will reduce the risk of missing out on all the opportunities that capitalism has to offer. If you ever hear a money manager use the phrase "Diworsification" then you are in the presence of a charlatan - make sure your wallet is still in your pocket, then walk swiftly away.

Over the years, MAP has been increasingly cognisant of providing exposure to a wide breadth of underlying securities across asset classes – Table 1 provides a summary of how the MAP portfolios have a larger number of underlying securities as well as a smaller weight concentration in the Top 10 and Top 100 compared to when the portfolios began.

A conscious focus on diversification can be difficult when investors often masochistically obsess over short term performance, particularly since investors are often overly concerned about underperformance of specific line items - *the problem with diversification (if done correctly) is that you will always be apologising for something in the short term!*

This brings us to a third boring but important dimension for improving diversification – diversifying across time. Every risky asset or strategy produces a return with the passage of time. But with each time step comes some associated noise or volatility which could have been driven by some unpredictable news or exogenous event that occurred during that specific period. However, as time goes by, the noise is diversified away (in the same way the volatility of two uncorrelated assets is reduced when combined into a portfolio) leaving the risk premium for the investor to capture. For example, investing $1 in equities on Tuesday and $1 in equities on Wednesday, will (on average) give a better outcome than investing the entire $2 in equities on Thursday – combining two independent bets is better that the sum of the parts. Waiting around is difficult for individual investors who have to contend with action bias, but it is key to capturing returns in the low signal-to-noise world of financial markets. MAP is committed to a long-term investment horizon and to focusing on strategies which are compatible with capturing the benefits of time diversification.

Table 1	2014			2019		
MAP	**Underlying securities (#)**	**Top 10 Weight**	**Top 100 Weight**	**Underlying securities (#)**	**Top 10 Weight**	**Top 100 Weight**
2080	1,708	40.1%	83.2%	11,022	4.0%	17.8%
4555	2,964	22.4%	56.6%	11,022	4.7%	19.2%
6040	2,962	18.8%	49.1%	11,022	5.3%	22.8%
7030	2,962	14.8%	41.6%	11,022	5.8%	25.7%

Conclusion

Bold macro forecasts and making big market timing bets are a much sexier way to invest and much more interesting to sell to investors than an approach of humble diversification and long-time horizons. "High Conviction" and "Contrarian" sound like wonderful virtues in marketing material but can be impossible in practice – they make the implicit assumption that the investor is able to survive the idiosyncratic volatility along the journey.

There is no amount of data I can show you that will prepare you for the feeling of losing money that you used to have.

MAP continues to implement a forecast-lite approach that focuses on diversifying across three dimensions: correlations, securities, and time. By definition, this will never achieve the best possible return in hindsight (which would require a crystal ball). And whilst we do utilise elements of market timing (we reserve the right to innovate and "sin a little", which we cover in Part IV), a diversified and long-term approach will give the majority of investors the best chance of achieving their goals. ■