State of Play

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First published in 1952, the Modern Portfolio Theory was developed by economist Dr Harry Markowitz, who argued that mixing different asset classes in the right proportions helps mix the appropriate trade-off between risk and return through what is known as diversification.[1] Does diversification always help in market downturns? Our Senior Investment Specialist, Simon Durling, shares his thoughts in this week's State of Play.

Review of 2022 to date

Since early January, investment markets have experienced higher levels of volatility[2] primarily driven by fears about sustained higher inflation due to expectations of central banks increasing interest rates over the next 12-18 months to tackle rising prices. Further heightened by the ongoing Ukraine conflict and the return of mass lockdowns in certain parts of China, as well as additional concerns surrounding the global economic growth outlook, and in certain forecasts, the possible threat of a recession. As State of Play has explained in recent weeks, central banks raising interest rates to tackle higher prices pushes up bond yields as they reflect future market expectations on interest rates, resulting in the corresponding capital value falling as a result. In addition, rising borrowing and manufacturing costs, forces market participants to reprice shares for those companies affected as future profits and earnings are revised downwards to compensate.

Shares

As a result of the volatility seen since the start of 2022, the reality is a story of 'red ink' across the performance of most asset classes with some experiencing higher falls than others.[2] In some respects, the numbers also support the case for diversification. Take the UK stock market for example. It has seen investors gradually fall out of love with it over the last 20 years[2] due to several factors, including sector make-up with a lack of exposure to technology companies and more recently the consequences of Brexit.

When you compare the US stock market, as represented by the broader market index, the S&P 500, over the last 20 years, has delivered investment returns including dividends of 481%, whereas a similar broader market index in the UK, the FTSE All-Share Index, has delivered only 218%, so total returns of less than half.[2] Just reflect on these figures for a moment, that is roughly (excluding compounding) double digit returns in the UK stock market over a sustained 20-year time horizon, but more than 20% per year for the US. There are two key take-aways from this, firstly the extraordinary returns that investors have received over such a long time frame was supported by low interest rates and loose monetary policy since 2008[3], and secondly, the difference in outcomes depending on where you invested in the world[2].

Yet, the perceived weaknesses of the UK in the past now appears to be an advantage since the start of 2022, as commodity prices have soared[3] and more traditional companies with strong dividends have become popular, making the UK stock market the best performing major stock market, which at the time of writing has lost just -0.8%[9]. Contrast this almost flat return with the technology dominated NASDAQ 100 index which has fallen just shy of -18%.[2] Incidentally over the last 20 years the NASDAQ index delivered 1274% - yes, this is not a typo – one thousand two hundred and seventy four percent![2] Looking at China, the combination of market concerns about central government interventions which were motivated by a return of the 'common prosperity' agenda, and more recently, the outbreak of the COVID-19 Omicron variant triggering zero tolerance restrictions, has led to the worst performance so far in 2022, falling over -18%, just beating the NASDAQ 100 for the bottom spot.[2] All other major stock markets have fallen in value since the start of the year.[2]

Bonds (also known as fixed income)

Then we come to bonds, with some of the common sub-asset classes being government bonds, corporate bonds and high yield bonds. As a reminder, bonds are loan contracts offering a 'fixed' income which is normally paid out in coupons once or twice a year. Depending on when they were first issued, the term of the loan and the credit worthiness of either the country or the company that is borrowing, they will pay varying levels of interest with the promise of your capital back at the end of the designated term (assuming the country or the company does not default or fail to repay the capital back). As inflation soars, central banks have responded eventually by raising interest rates after revising their original forecasts that inflation would be temporary, consequently sending bond yields higher.[3]

What is a yield?

A bond's yield is the amount that it pays each year in interest as a percentage of its current price. For example, if a bond is sold at £100 and pays £5 per year, its yield is 5%. When the price of a bond goes up, its yield goes down – if that same bond is now being sold for £105, its yield would be 4.76% (five divided by 105). And the same applies the other way around – if the price of that bond dropped to £95, its yield would go up to 5.26% (five divided by 95). A bond's yield (as per its current price) is, effectively, its current interest rate. This shows the corresponding consequence of a rising or falling value as the mirror opposite of the yield.

Market participants pay little attention to today or tomorrow but tend to look further ahead into the future. So, let's take UK Government bonds (also known as gilts) as an example. The 10-year government bond yield started 2022 at just shy of 1% but was as low as 0.8% on 1 November last year.[3] At midday on Monday (9 May) the yield breached 2% for the first time since mid-2015, falling back at the time of writing to 1.85%.[3] Year-to-date, as at close of business on 9 May, the total investment return for FTSE All UK Gilts index is a fall of 11%.[4] It is a similar story for US government bonds. 10-year treasury yields started 2022 at 1.5% before doubling to 3% (as at 9 May) causing the equivalent US government bond index to fall 10% and others, including corporate and high yield bonds, delivering a similar double digit negative total return with US corporate bonds falling in value just shy of 15%.[4]

Modern Portfolio Theory

American economist Harry Markowitz pioneered a theory which was published in 1952, titled 'Portfolio Selection', arguing that assets should not be viewed in isolation, but within an overall portfolio. Modern Portfolio Theory is a method for selecting different investments within a portfolio to maximise returns for an agreed level of risk.[1] Many aspects of this theory are still integral in how investment solutions are designed and managed by investment companies. Often, these solutions will be recommended by a professional adviser, who will firstly evaluate a client's attitude to investment risk, assess their circumstances alongside their long-term goals, and then recommend the appropriate investment solution which best matches all these factors and aims to achieve their objectives.

If you look back over history, different asset classes like shares, bonds and property at times behave very differently and this is measured using correlation.[2] If assets are negatively correlated, when one asset class rises in value, the other will fall and vice versa. If they are positively correlated, then they will rise and fall at the same time. The degree to which they change in price in relation to one another is also measured. Clearly, this correlation, or relationship between asset classes is not constant and is always changing. However, these differences allow for an assessment of what proportion of different assets should be included in the original asset allocation depending on the objectives, strategy, time horizon and risk profile of the investment solution matched to the investment needs and risk appetite of an investor, with the intent to deliver a smoother investment journey. This principle is called diversification.

Why has diversification been less effective this year?

In practice, diversification sees investment managers using different asset classes in varying proportions at different stages throughout an investment journey, changing the shape and allocations depending on market conditions and short-term outlook. When an investment solution is recommended, it should align to an investor's objectives, time frame and attitude to risk. Once the client invests into the recommended solution the investment managers task is to manage the solution in line with the fund's long term investment objectives and risk profile. The rules and boundaries set to help stay within this agreed risk level restrict how much investment managers can make changes to investment portfolios. So, when in the rare circumstances asset classes are very positively correlated for a sustained period and, like now, shares and bonds are all falling in value at the same time[2], the options available to avoid or mitigate these falls can be very limited. This can mean most investors, regardless of how comfortable they are with risk, are experiencing similar falling investment values at the same time.

My explanation to try and simplify this concept is to think of your investment as a long-haul flight to a faraway destination with your fund manager as your pilot and the other passengers as fellow investors in the same fund or portfolio. Ideally the pilot would look ahead at the impending weather, the direction and strength of the winds at different altitudes and navigate the most efficient route to help achieve the smoothest and most comfortable journey for the passengers (the investors) reaching their desired destination.

Clearly, depending on how unpredictable the weather systems or large the storms are along the way, regardless of what changes in coordinates the pilot chooses to make, at times they may not be able to avoid all of the turbulence, especially when the conditions are so changeable on the route. In reality, especially for passengers who dislike flying, at times this can feel very scary. Given what has happened so far this year and how different asset classes have fallen in value at the same time[2], at present many investors are likely to feel much like someone who is scared of flying, sitting in their seat as the aeroplane is bumped about by severe turbulence, and tending to think the worst. Whilst the first reaction is to expect the pilot to mitigate the turbulence or fly around it, sometimes this just isn't possible.

Sticking to a long-term plan

Investing can be a very emotional journey which tests individual investors to varying degrees depending on their knowledge, understanding, attitude to risk and previous experience. History shows that when markets fall sharply in value many investors tend to panic simply encashing their investments and accepting their losses.[2] Recently, in early 2020 when the COVID-19 pandemic began, shares on stock markets fell sharply in value from late February until late March.[2] At this point governments and central banks around the world stepped in to provide financial stability and support.[5] Stock markets rebounded almost as sharply as they had fallen, with many, like the NASDAQ 100, surging beyond their previous highs only a few months after.[2] If an investor had stuck to their long-term plan and remained invested through this period, they would have likely benefitted from this recovery.

Cleary, depending on when you may need to access some, or all, of your investment the timing of this withdrawal in many respects is down to luck. However, sticking the course has many benefits, even if at times it can be daunting. Some investors choose a very simple tactic to avoid the build-up of fear by only checking the value of their portfolio very occasionally. For others, regardless of how it makes them feel they check every day without fail. It doesn't matter what type of investor you are, the help of your professional adviser to guide you, reassure you, keep you informed and to act as your unemotional third party may stand you in good stead during your investment journey.

Regardless of whether diversification has been unable to help mitigate the market volatility since the start of this year, it remains an important principle used in investment management so that investment portfolios and solutions are able to be adapted to align to the appropriate risk comfort level and provide access to investment returns for all types of investors. In addition, it is crucial to navigating changing market conditions as we travel through the various stages and cycles of economic change.

Learn more!

Investing can feel complex and overwhelming, but our educational insights can help you cut through the noise. Learn more about the Principles of Investing **here**.

Note: Data as at 10 May 2022.

[1] Investopedia, 10 May 2022
[2] FE Fund Info, 10 May 2022
[3] Investing.com, 10 May 2022
[4] Refinitiv Datastream, 10 May 2022
[5] Financial Times, 14 March 2022

Important Information