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Go Global for Diversification, Carefully

As U.S. stocks outperformed, American investors understandably favored domestic holdings. But what are they missing, and where?

Why bother with global diversification, when different asset classes from different parts of the world seem to have become so highly correlated that they rise and fall on positive and negative news in almost perfect synchrony?

Global diversification has been a commonly accepted portfolio mantra for many advisors and clients because it traditionally promises better returns with less volatility than a domestic-only portfolio over time. Over the past few years, that premise has been challenged by less-than-satisfying results on both accounts.

First, investors remain scarred by the global financial crisis, when the correlation of all asset classes went to 1. Second, global growth has sputtered and been inconsistent, while important parts of the financial system remain fragile. One example of that fragility arises from Brexit, as the formal process of the U.K. leaving the European Union — which has already prompted more pan-European volatility — has not even begun yet.

Central banks, whose policy heavy-handedness has been one of the main challenges to global diversification and the driver of the frantic search for yield, remain active. Those central bankers are acting not just through policy measures that diverge from country to country, but as market participants themselves, purchasing assets beyond government bonds in a way that's never been seen before.

With the U.S. stock market having been the top performer worldwide, it's only normal that many investors would rather stay put domestically than look at the broader world — a world that is arguably much flatter than it's ever been. The flat world itself makes it tougher to find non-correlated investments.

But for multi-asset fund managers, ferreting out the best opportunities from around the globe and combining them for optimal portfolio performance is still as valid an endeavor as it is exciting.

“The rising correlation between asset classes has challenged” the traditional benefits of diversification, said Maya Bhandari, director of multi-asset allocation at U.K.-based Columbia Threadneedle Investments, “but we have also seen in the last few years that spreading risk across different asset classes has provided some important benefits.”

Bhandari said that some of the funds she co-manages are “free of benchmarks. We really start with a blank sheet of paper, asking ourselves ‘What asset classes do we own, and how do they fit’” into the overall portfolio?

In a highly correlated world, judging how best to combine different asset classes has become a much more nuanced process. It also requires a certain degree of willingness to go against the grain and dig deeper into the fundamentals beneath mass-market swings to find opportunities. It also calls for making portfolio decisions quickly.

“Last year, partly based on the results of monetary policy, we built up a position in European high-yield bonds,” said Bhandari. “Following that, we saw a blowup in oil prices that impacted U.S. high-yield, and with good reason,” since 18% to 20% of the high-yield bond index is energy companies. However, European high-yield “was also a casualty, the spread widening there purely a result of the contagion effect. We saw European high-yield as offering value and we built our position up to 15%” of Columbia Threadneedle's Global Multi Asset Income Fund, “which has served us well.”

Heading into the final part of this year, what are the trends advisors and investors should be looking out for, and how will they influence global diversification? Where do the opportunities for global diversification lie?

Investment Advisor spoke to some proponents of global diversification to get their take.

CONSIDER, BUT DON'T NECESSARILY FOLLOW, THE CENTRAL BANKS

In July, the Bank of England cut interest rates, while speculation is growing that the Federal Reserve will raise rates before year end (we went to press before the FOMC's September meeting; the Fed's policy-making arm meets again after the election, in December). The European Central Bank (ECB) and Bank of Japan have been buying corporate bonds, and now the Bank of England is going to do the same.

Through the years, central bank policies have supported markets in various ways and provided the kind of stability that calmed frightened investors. Central banks are such key players in the financial system and the markets — to the consternation of many investors — that for many it has become de rigeur to monitor the banks' movements and factor them into their investment approach.

But now, after so many years of central bank involvement and divergence among central banks' policies, investors like Daniel Kern, chief investment strategist at TFC Financial Management, think the wiser option would be to *not* follow every move by every central bank.
Kern believes that investors should evaluate central bank moves carefully for the effect that they are likely to have, and decide not to follow those moves if it makes greater sense for their overall portfolio.

"Expectations are an important factor to consider when deciding whether to invest following central bank intervention," he said.

ECB president Mario Draghi's "Whatever it Takes" speech in July 2012 eased concerns about a potential breakup of the eurozone, and provided policy support for a stock market rally in the zone. It was the kind of intervention that sent a positive signal for investors, and an example that supported following central bank intervention into the markets. However, "a recent example of when *not* to follow central bank intervention comes from Japan, as the Bank of Japan has repeatedly disappointed the market," Kern said. "Imposition of a negative interest rate policy hasn't achieved the desired objectives, and subsequent policy statements have fallen short of expectations."

WATCH FOR A SHIFT FROM MONETARY TO FISCAL POLICY

It may seem counterintuitive, but Paul O'Connor, co-head of the multi-asset team at Henderson Global Investors, is of the view that monetary policy may be reaching its limits globally.

In some countries, he said, central banks are running out of assets to buy, while in other countries low interest rates and therefore bond yields are beginning to have adverse impacts on pension funds, banks and insurance companies. Overall, O'Connor believes that the benefits of additional monetary easing are diminishing while the costs are rising.

"Against this backdrop, a consensus is emerging that fiscal policy will have to play a bigger role in stimulating the global economy, if that is needed," he said. "At this stage, with the global economy continuing to recover, governments are only shifting very modestly in this direction, but after five years of global fiscal tightening, 2016 looks like [it will be] the first year since 2010 in which fiscal policy will boost growth."

To that end, Japan has announced a major fiscal expansion, the U.K. government is rowing away from its previous austerity program and both candidates for the U.S. presidential election have, O'Connor said, built their campaigns around proposed fiscal expansions.

"At this stage, the collective impact of the proposed global fiscal easing is still fairly modest," according to O'Connor, but "the move away from austerity has begun, and a more decisive fiscal response is likely if growth falters."

TO LOOSEN CORRELATIONS AND BRING BACK GROWTH

"Paradoxically, the worst economic numbers gave rise to the best policy reactions, which in turn overshadowed growth," O'Connor said. "But now, as policy becomes weaker, I think growth will become a bigger factor for valuing diversification opportunities, and that will bring us back to a more normal market environment as it diminishes the frantic search for yield."

While the influence of monetary policy on financial markets appears to be peaking, both economic and political factors are beginning to reassert themselves as important factors when seeking investment opportunities. This in turn will ease the high cross-asset correlations across markets, O'Connor said, "and it should mean that multi-asset investors have more opportunities for finding diversification as assets become more influenced by idiosyncratic factors and less driven by central banks." He also argued this dynamic could create an environment in which active managers will find more opportunities to add value in both asset allocation and stock selection.

A renewed focus on such factors as growth, productivity and demographics, on transparency, governance and the rule of law, would also make sense in the context of current equity market valuations, not least with respect to the U.S. stock market, said Ben Rozin, senior analyst and portfolio manager at Manning & Napier Advisors. The U.S. market stands out as being much more expensive than the rest of the world, even as economic growth here has slowed; whereas in parts of the globe where growth is stronger and there are opportunities for more growth, valuations are cheaper and look more attractive.

The European Union, for one, is growing faster, Rozin said, supported by looser monetary policy, rising exports and increased investment. And after a slow period, growth is also picking up in emerging markets.

A PORTFOLIO WITH 60% INTERNATIONAL STOCKS?

In trying to determine the right mix of global exposure to maximize return and minimize risk, first consider that international stocks, emerging markets included, make up 60% of global market capitalization.

"That means that if you took a straight allocation based on that figure, your portfolio would be 60% international," said Bill Mann, chief investment officer at Motley Fool Asset Management.

Such an allocation would make many U.S. investors feel uncomfortable, and Mann believes they're even more uncomfortable with investing in emerging markets.

Yes, EM as an asset class did underperform for the past five years but emerging market economies are on the rebound now, he said. In the longer term, emerging markets is also the one asset class that promises to deliver the most diversification benefit.

"If diversification is important in a year of macroeconomic interconnectedness and continued monetary policy then emerging markets is the place to be, since you get economies that are growing at a much quicker rate than the developed ones," Mann said.

His top emerging market pick is Brazil, which even a few months ago everyone wanted to avoid. Today, the Brazilian stock market is a top global performer, which Mann attributes to the kind of fundamental changes that provide sustained improvement in emerging market economies.

By impeaching and subsequently stripping disgraced President Dilma Rousseff of her office, and exposing high-ranking officials embroiled in the corruption scandal surrounding state-owned oil company Petrobras, Brazil is showing itself a true democracy Mann said, one where transparency, accountability and governance are important factors.

Important long-term fundamental reforms that have been enacted in countries like India are helping make them more attractive investment destinations, too, Rozin said. He also likes the Association of Southeast Asian Nations (ASEAN) region, where the dynamics that support consumption and investment are favorable, particularly when stacked up against valuations, which compared to the U.S. are more than favorable.

Of course, the emerging markets space is huge. For TFC Financial's Kern, the countries that will prove best for diversification purposes are the ones that are more on the frontier side of the market, like Vietnam and Sri Lanka, whose manufacturing bases are more competitive because of wage increases in China but still have a long way to go before becoming closely integrated into the global economic and financial system.

"These are very different and distinct economies and, we believe, are less correlated with the rest of our portfolio," he said.

FAVOR SECTORS OVER ECONOMIES

What is it about U.S. utilities that has made that sector such a top performer this year?

According to Jeffrey Kleintop, chief global investment strategist at Charles Schwab, it's the same thing that has made the U.S. tech sector — and by extension, the U.S. stock market in general, since tech is the largest part of the index — a star performer. Ditto for health care, the second best performing sector this year so far, which by extension has made Denmark rise by 39% over the past three years, since health care is the biggest component of the Danish stock index.

Because of uncertainties in the global system — political, economic, financial — investors have tended to flock to these top-performing sectors and just stay there. But by so doing, they've become concentrated in a single country, Kleintop said, thereby missing out on opportunities in other countries and all the benefits of a truly diversified portfolio.

Rather than assessing economies at the macro level to figure out where the best global opportunities lie, Kleintop advocates a sector approach to diversification. Spreading exposure across different sectors as they gain prominence will, he said, automatically result in a globally diversified portfolio.

“The takeaway is that tech and health care won't always be outperformers,” he said. “We now see that materials and energy have really been picking up and so have financials. As different sectors pick up, so too do different countries that are also not so highly correlated with one another.”

Having a diversified sector approach to global investing enables investors to own high-performing markets even in poorly performing economies.

“Russia looks terrible as an economy, but Russian stocks are benefiting because of the rebound in the materials and energy sectors,” Kleintop said. “And in Japan, the economy is facing many problems, but financial stocks are the biggest concentration there, so there's a benefit to being in that sector.”

DIG DEEP FOR INDIVIDUAL, SPECIAL SITUATIONS

“My premise has always been that you're not forced to invest everywhere but you can invest anywhere, and for us, that is how we find the special situations that allow us to outperform,” said David Marcus, CEO of Evermore Global Advisors.

Marcus, who follows a highly active management style, pays no heed to indexes and to correlations, be they tight or loose. Instead, he looks for specific “catalysts” in individual situations across the globe — a management change at a particular company, say, or a conglomerate that is breaking up — that can add value to a portfolio.

“Most investors screen on numbers; we screen on words,” he said. “And in a world that's become that much closer, it's not difficult to search by those words, to get any information that you need.”

While European stock markets have been out of favor, and France is in the red, Marcus has made out well with Vivendi. He said the French conglomerate had been poorly managed for years, which affected profits, but under new management and after the sale of several non-core assets, Vivendi has become a stronger, more focused player. Its share price has also doubled over the past three years.

A similar rebound has been enjoyed by Marine Harvest, a mom-and-pop style enterprise that became one of the largest salmon farming companies in the world as it cleverly rode the global trend of healthy eating, in which salmon plays a huge role.

“We’ve seen everyone shifting to this passive investing style, but I do think that a couple years from now, people will be clamoring for something different because everyone will have been doing the same thing as everyone else,” Marcus said. “We’ve always been different. For example, we don't own any U.K. stocks; not because of Brexit, but because the U.K. is the first place that most American investors go to.”