QS Investors
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Beyond the "Pain" Vanilla, Reconsidering Diversification

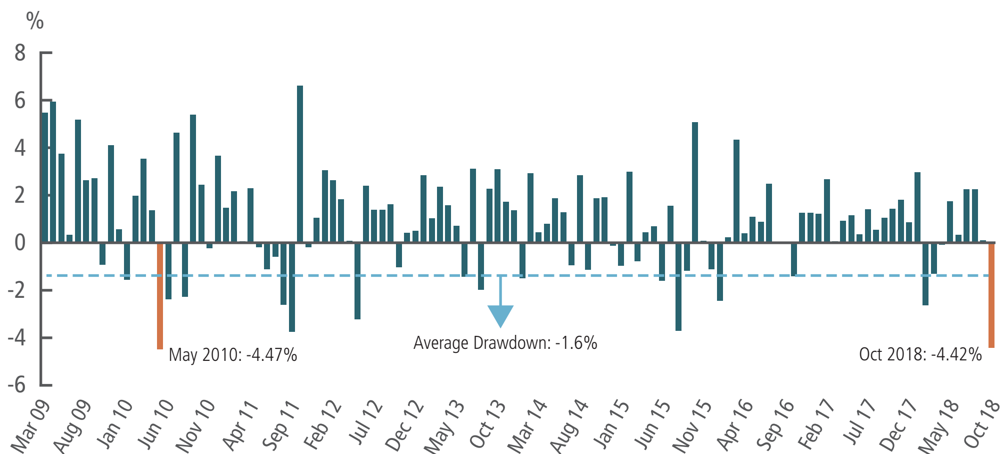
NOVEMBER 2018

October 2018 tested investors' resolve and begs investors to question whether the diversification measures they have integrated into their portfolio construction, both at the asset allocation and underlying equity level will truly hold up amidst, what are likely to be, volatile times ahead.

The traditional 60% Equity 40% Fixed Income portfolio ("60/40 portfolio") realized its worst monthly loss, down -4.42%, since May 2010 as both equities and bonds depreciated during October. In the last twenty years, the 60/40 portfolio has only suffered a worse monthly decline in 8 of the last 240 months, less than 3% of the time.

As the US begins to move from a quantitative easing to tightening interest rate environment, volatility has started to ripple through markets generating losses in both stocks and bonds and diluting potential diversification benefits.

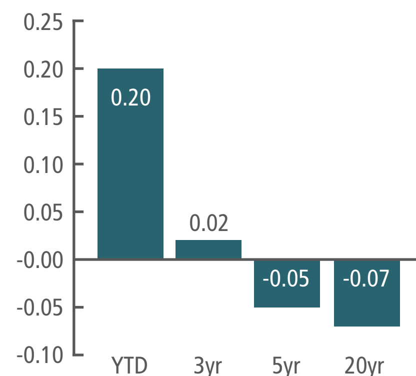
60/40 TRADITIONAL PORTFOLIO MONTHLY PERFORMANCE POST-GFC
OCTOBER MARKS WORST PERFORMANCE SINCE MAY 2010



Traditional 60/40 Portfolio assumes 60% S&P 500 Index and 40% US Barclays Aggregate Index exposure with quarterly rebalancing back to strategic asset allocation targets. Source: Standard & Poor's, Barclays Indices, eVestment.

Stocks and bonds have historically realized a negative correlation; however since the Global Financial Crisis ("GFC") correlations have gradually climbed, as both bonds and equities have risen in tandem. As the US begins to move from a quantitative easing to tightening interest rate environment, volatility has started to ripple through markets generating losses in both stocks and bonds and diluting potential diversification benefits. This leaves many to consider the portfolio implications as the long-term yin to yang of two complementary asset classes begins to fray.

RISING EQUITY-BOND CORRELATIONS
S&P 500 INDEX VS BARCLAYS US AGGREGATE INDEX



Source: Standard & Poor's, Barclays Indices, eVestment.

Furthermore, amid a trending and narrowly driven market, such as the one experienced post-GFC, many investors may find their portfolios have increased exposure to Growth/ Momentum factors and underlying consumer-facing technology companies (housed within Consumer Discretionary, Telecommunication Services and Information Technology sectors). Taking on unintended risks increase a portfolio's vulnerability to pronounced drawdowns as trends reverse. Factors such as High Dividend and Minimum Volatility and sectors such as Utilities and Consumer Staples, which have lagged since the GFC, exhibited a significantly lower beta to the market and realized a lower standard deviation versus their cyclical counterparts.

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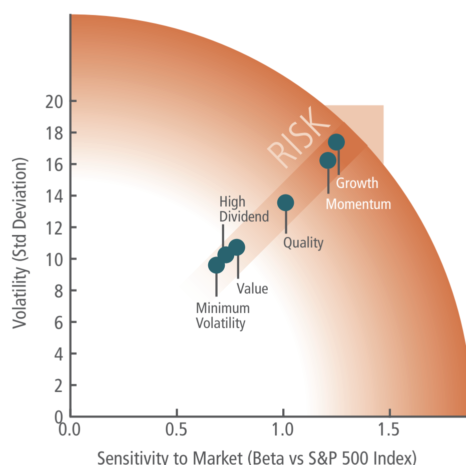
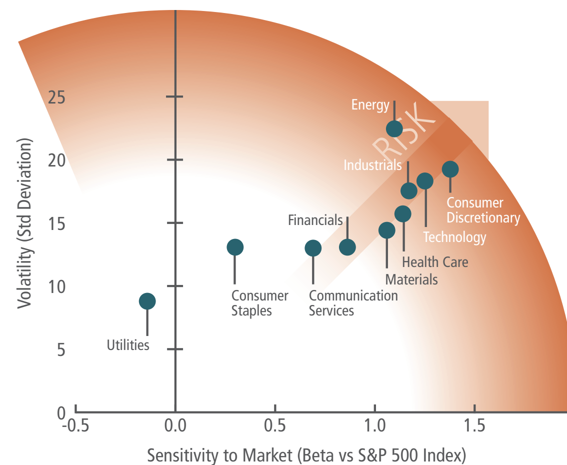
YTD FACTOR RISK



YTD SECTOR RISK



Factors represented by MSCI Indices and Sectors represented by S&P 500 Index GICs Level 1 Classification. Source: Standard & Poor's, eVestment and Bloomberg.

As a result, High Dividend and Minimum Volatility drew down roughly 60% less than Growth and Momentum Factors during October, while Utilities and Consumer Staples were the only sectors which realized positive returns for the month.

As such, many investors have begun looking beyond the traditional 60/40 portfolio, both at the asset allocation level, considering exposure to truly uncorrelated return sources found within alternatives such as an Equity Market Neutral strategy, and within the underlying equity sleeve, considering the increasing beta, and volatility associated with certain factor and sector exposures.

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