

# Market Insights – The Diversification Challenge

July 2017

*“Wide diversification is only required when investors do not understand what they are doing.”* **Warren Buffett**

**Julian Howard, Head of Multi-Asset Solutions**

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# The Diversification Challenge

## Key themes for investors

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### **Equity case begins to be tested**

- Fundamentals appear to support the asset class
- Nothing to suggest a recession is round the corner
- But doubling of US growth now looks like fantasy
- Waning Chinese credit impulse could hit global GDP
- TINA compressed amid bond selloff
- And rich valuations do matter for future equity returns

### **Testing assumptions**

- Few asset classes genuinely thrive during drawdowns
- In markets, rock-solid relationships can suddenly break
- Death of the 60:40 portfolio imminent
- Structural demand for bonds has invalidated their diversification qualities
- Risk parity – not necessarily the answer
- Hedge funds a smaller part of the solution now

### **What might actually work**

- Tactically, VIX futures appear compelling
- Regional equity calls will become important
- Example 1: Europe overweight amid earnings optimism
- Example 2: UK underweight as Brexit phoney war ends
- But time horizon is the best equity diversifier of all
- Alt-bonds can produce steady on-going returns

### **Positioning and Q&A**

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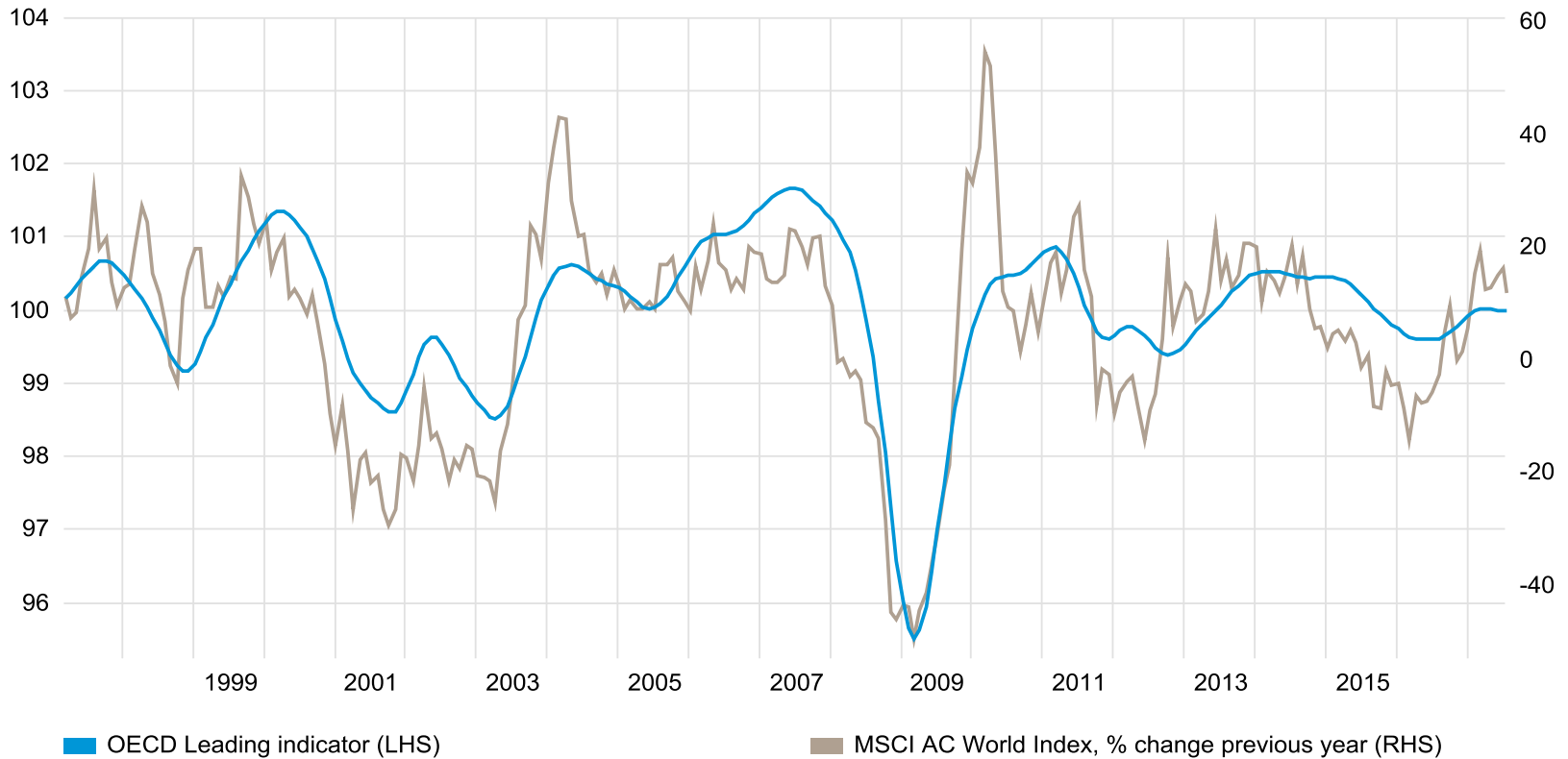
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**EQUITY CASE**  
**BEGINS TO BE**  
**TESTED**

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# Fundamentals appear to support the asset class

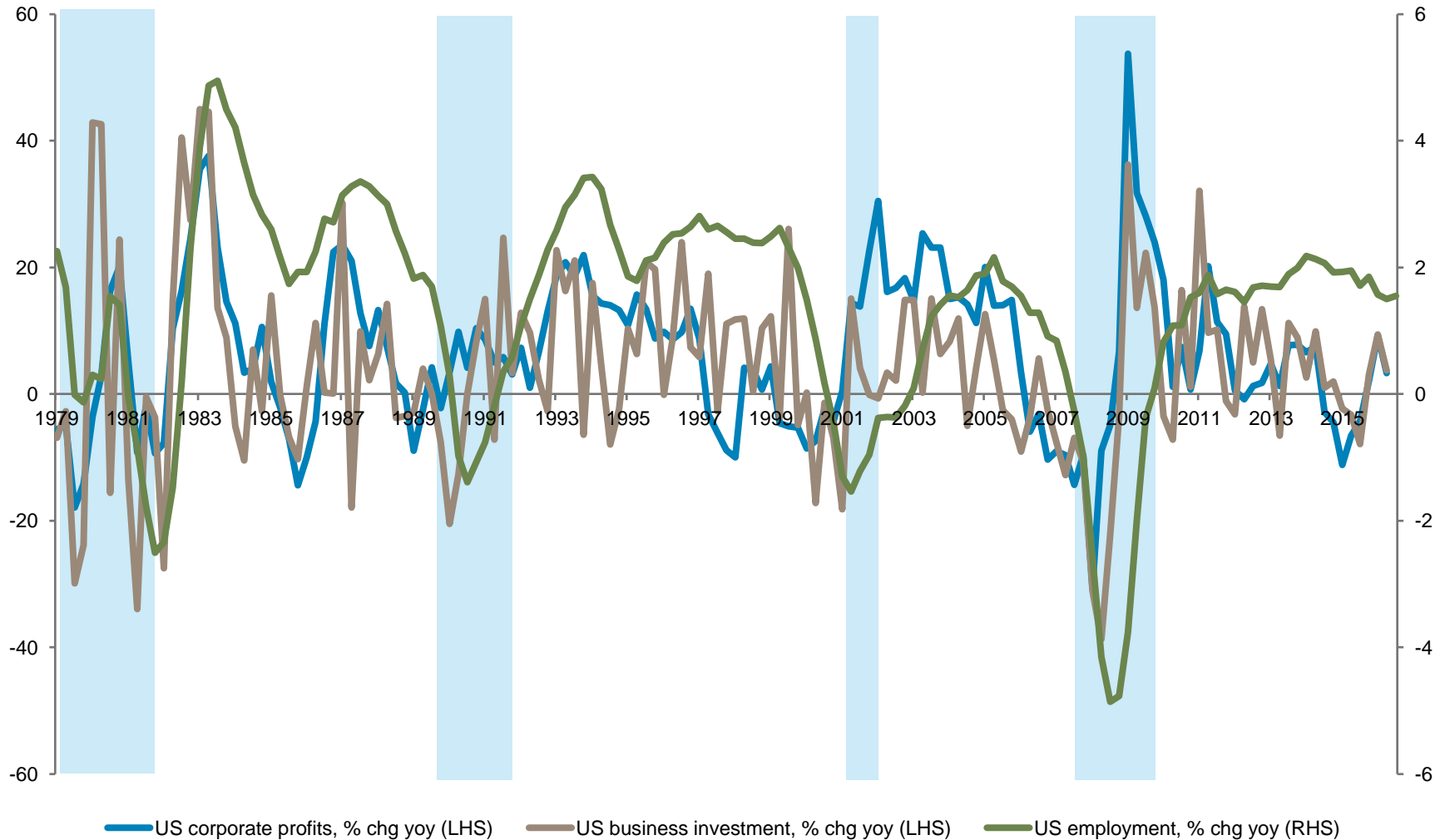
From 28 Feb 1997 to 11 Jul 2017



Past performance is not indicative of future performance.

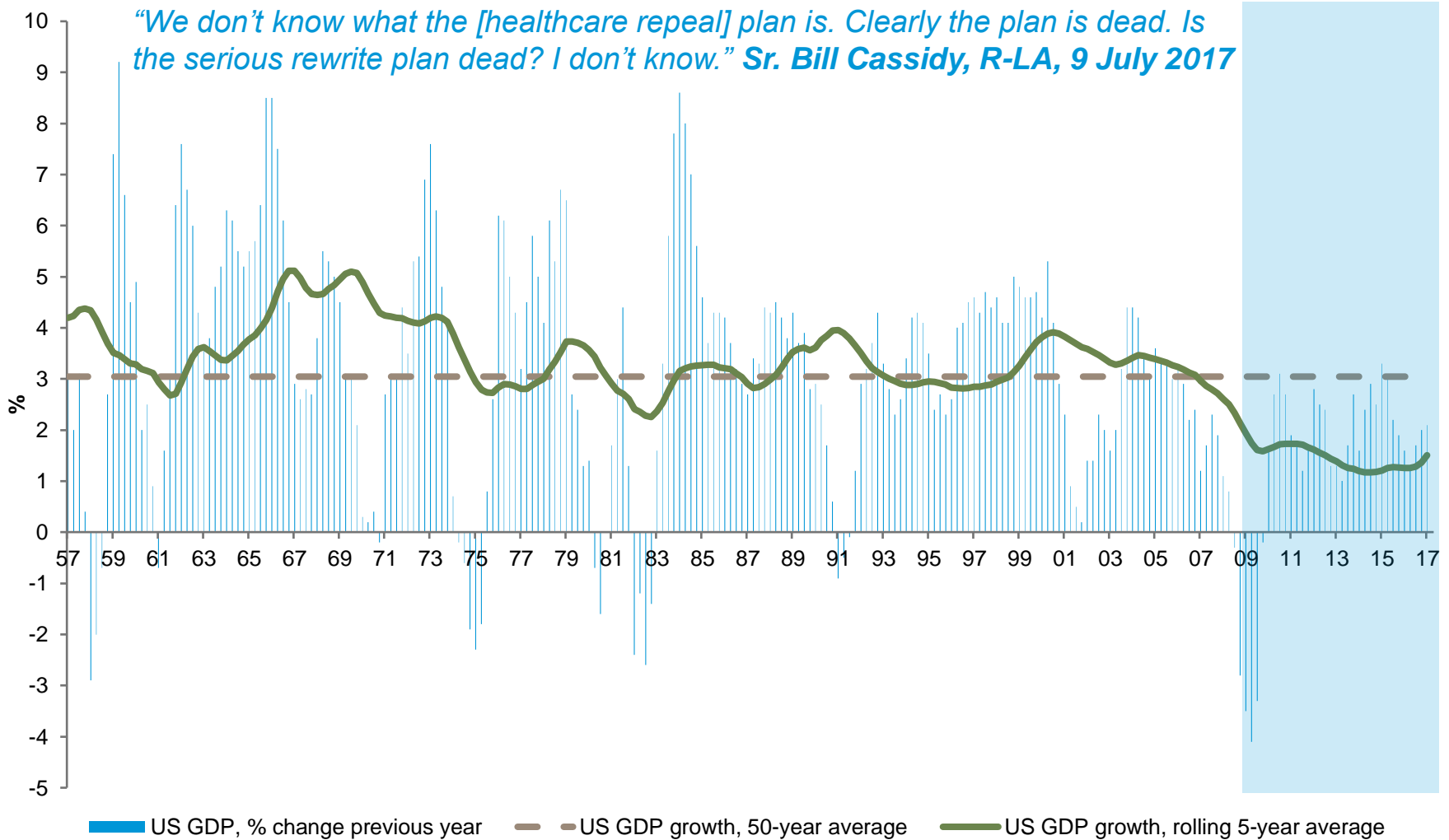
# Nothing to suggest a recession is around the corner

Data from 31 Dec 1979 to 30 Jun 2017



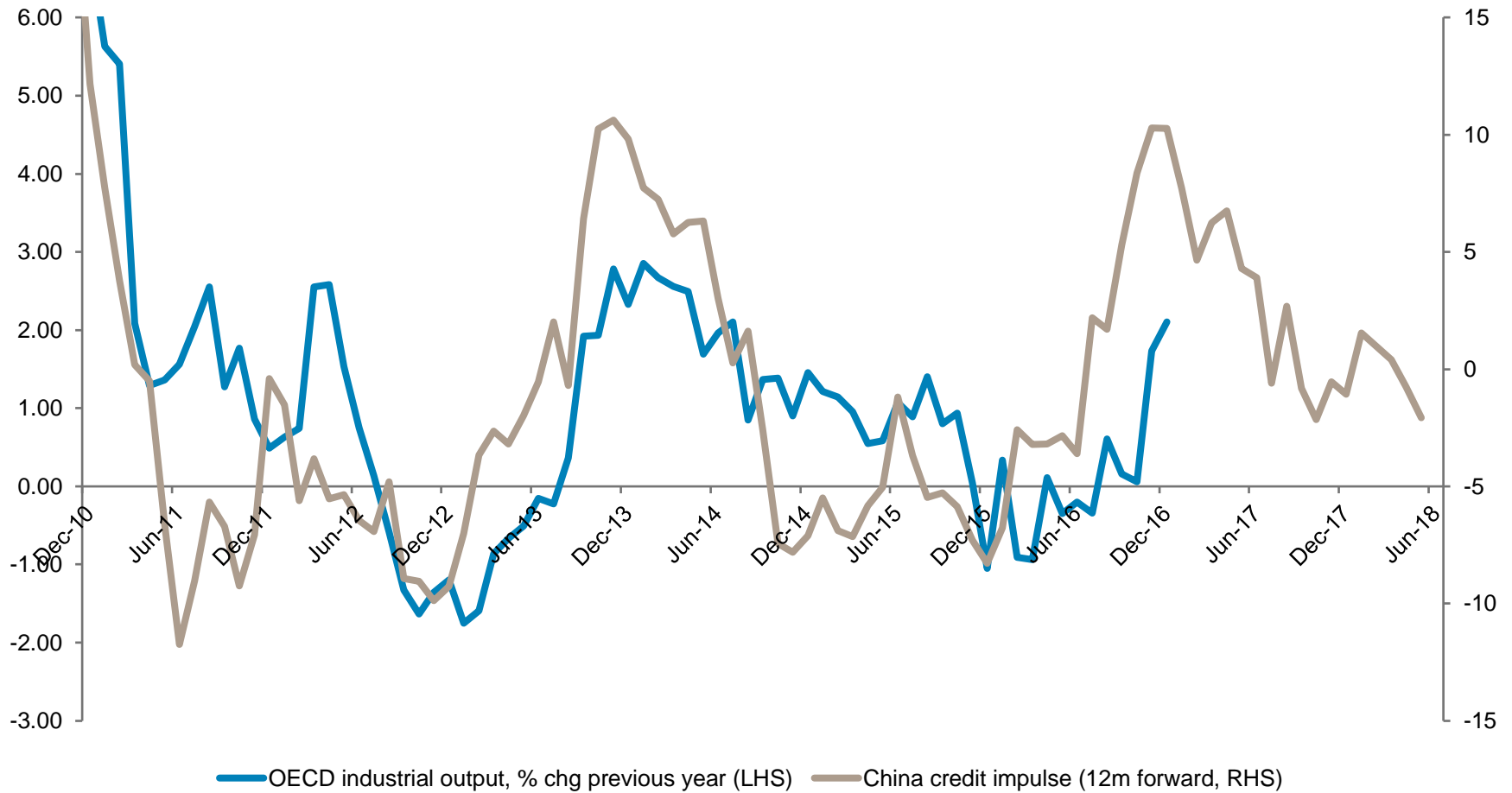
# But doubling of US growth now looks like fantasy

Data from 31 Mar 1957 to 31 Mar 2017



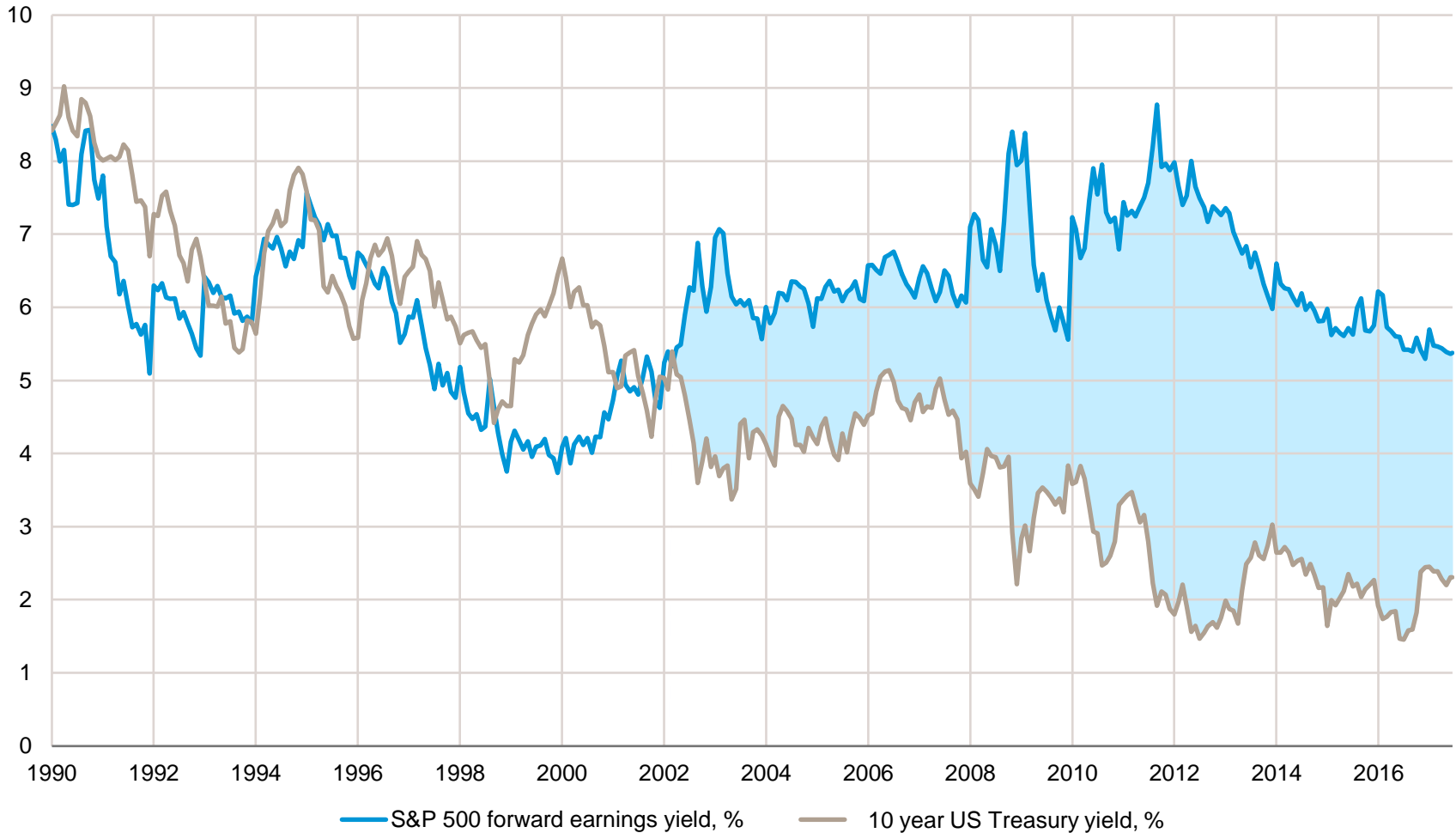
# Waning Chinese credit impulse could hit global GDP

Data from 31 Dec 2010 to 31 May 2018



# TINA compressed amid bond sell-off

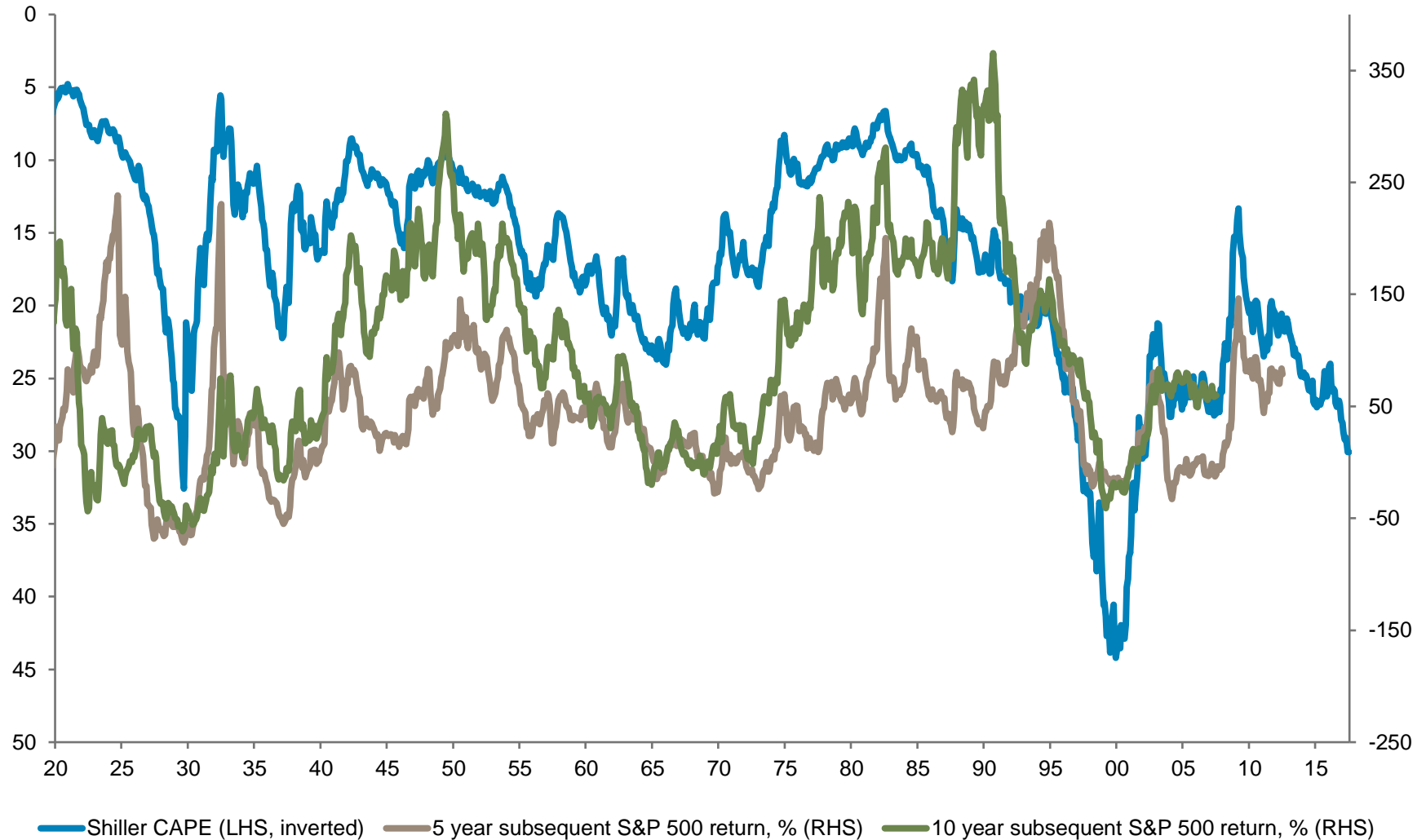
From 31 Jan 1990 to 12 Jul 2017





# And rich valuations do matter for future equity returns

Data from 30 Jun 1917 to 3 Jul 2017



# Our latest 12m scenario analysis (for AR strategies)



Data as at 13 Jul 2017

Probability: %	Crisis: 10%	Slowdown: 25%	Sideways: 50%	Acceleration: 15%
	<ul style="list-style-type: none"> <li>Global GDP &lt;0%</li> <li>DM slows, EM follows</li> <li>Geopol./systemic crisis</li> <li>Profits relapse</li> <li>Market correction</li> </ul>	<ul style="list-style-type: none"> <li>Global GDP 1%-2%</li> <li>Reflation stalls, EM lags</li> <li>Geopolitical tensions</li> <li>Profits growth deteriorates</li> <li>Markets soften</li> </ul>	<ul style="list-style-type: none"> <li>Global GDP 2%-3%</li> <li>Moderate DM, EM growth</li> <li>Geopolitics contained</li> <li>Profit recovery stalls</li> <li>Modest market progress</li> </ul>	<ul style="list-style-type: none"> <li>Global GDP &gt;3%</li> <li>DM thrives, EM takeoff</li> <li>Geopolitics benign</li> <li>Profits beat forecasts</li> <li>Markets accelerate</li> </ul>
<b>Equities</b>	<b>-20 to -10%</b>	<b>-10 to 0%</b>	<b>2 to 5%</b>	<b>5 to 10%</b>
Allocation	10%	15%	30%	50%
Implied contribution	-1.5%	-0.8%	1.1%	3.8%
<b>Fixed Income &amp; Credit</b>	<b>2 to 5%</b>	<b>1 to 4%</b>	<b>1 to 3%</b>	<b>-2 to 2%</b>
Allocation	55%	50%	40%	25%
Implied contribution	1.9%	1.3%	0.8%	0.0%
<b>Alternatives</b>	<b>-2 to 5%</b>	<b>-1 to 5%</b>	<b>-1 to 5%</b>	<b>-2 to 5%</b>
Allocation	20%	25%	25%	20%
Implied contribution	0.3%	0.5%	0.5%	0.3%
<b>Liquidity</b>	<b>0% to 0.5%</b>	<b>0% to 1%</b>	<b>0.5% to 1.5%</b>	<b>2% to 3%</b>
Allocation	15%	10%	5%	5%
Implied contribution	0.0%	0.1%	0.1%	0.1%
<b>Expected return</b>	<b>0.8%</b>	<b>1.1%</b>	<b>2.4%</b>	<b>4.2%</b>
<b>Including alpha</b>	<b>1.6%</b>	<b>2.0%</b>	<b>3.4%</b>	<b>5.1%</b>

**Probability-weighted expected return including assumed alpha = 3.1%**

Source: GAM. For reference, OECD full year 2017 forecast for world GDP growth is 3.3%.

Allocations, asset class ranges and holdings are subject to change. The views expressed are those of the manager at the time and are subject to change. There is no guarantee that forecasts of strategies or objectives will be achieved.

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# TESTING ASSUMPTIONS

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# Few asset classes genuinely thrive during drawdowns



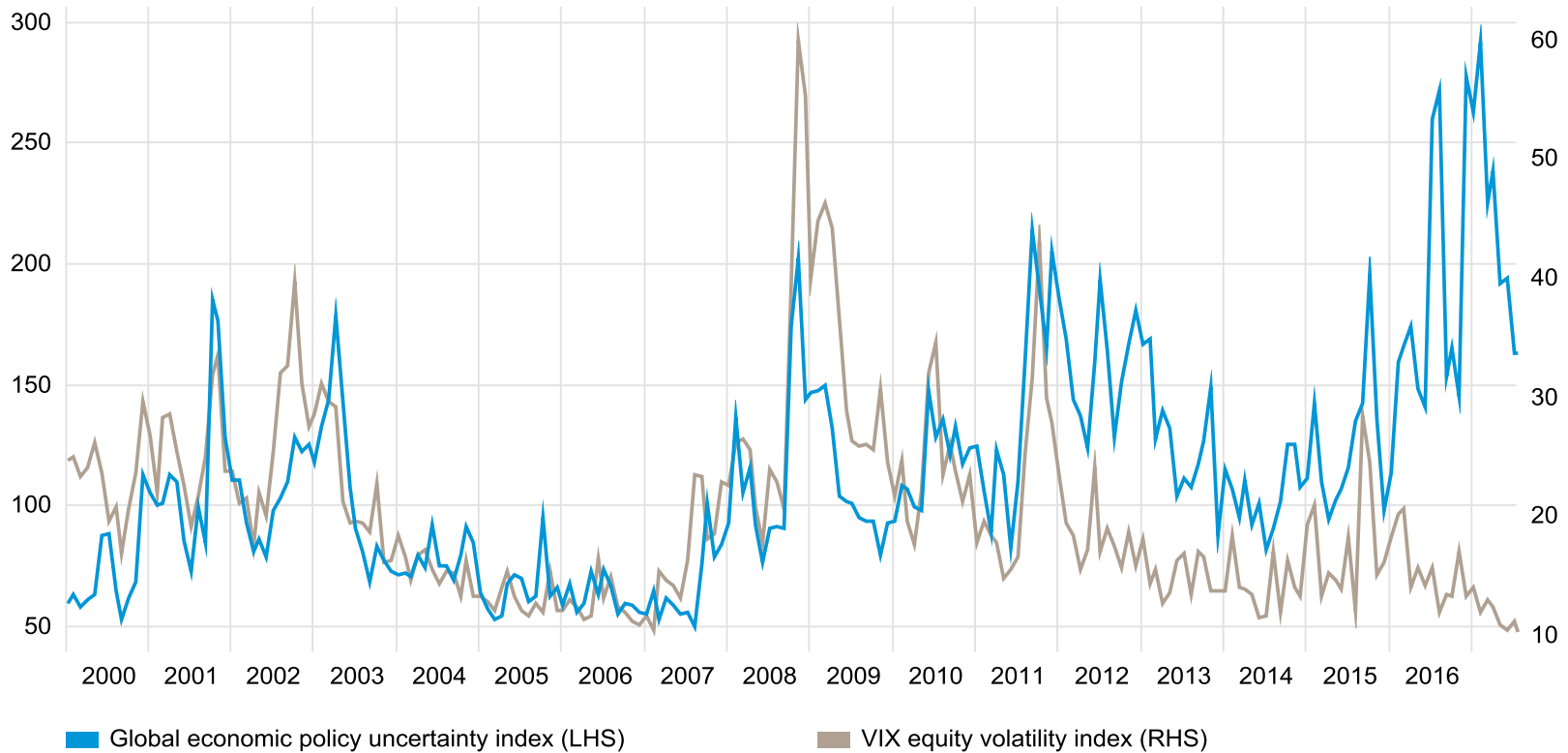
10-year correlation of weekly returns from 30 June 2007 to 30 June 2017

Security	S&P 500	Russell 2000	US 10 year Government Bond	IBOXX Liquid Investment Grade	BofAML US High Yield Master	Gold	Crude Oil	Swiss Re Cat Bond TR	HFRX Macro/ CTA	HFRX/ HFRX Global Hedge Fund
S&P 500	1.00	0.93	-0.38	-0.07	0.63	-0.03	0.35	0.09	-0.07	0.66
Russell 2000	0.93	1.00	-0.39	-0.11	0.59	0.01	0.33	0.05	-0.06	0.62
US 10 year Government Bond	-0.38	-0.39	1.00	0.61	-0.17	0.18	-0.29	0.06	0.17	-0.21
IBOXX Liquid Investment Grade	-0.07	-0.11	0.61	1.00	0.34	0.04	-0.18	0.19	0.15	0.13
BofAML US High Yield Master	0.63	0.59	-0.17	0.34	1.00	-0.01	0.33	0.21	0.01	0.68
Gold	-0.03	0.01	0.18	0.04	-0.01	1.00	0.26	0.04	0.18	0.06
Crude Oil	0.35	0.33	-0.28	-0.18	0.33	0.26	1.00	0.06	0.02	0.37
Swiss Re Cat Bond TR	0.09	0.05	0.06	0.19	0.21	0.04	0.06	1.00	0.01	0.17
HFRX Macro/ CTA	-0.07	-0.06	0.17	0.15	0.01	0.18	0.02	0.01	1.00	0.42
HFRX/ HFRX Global Hedge Fund	0.66	0.62	-0.21	0.13	0.68	0.06	0.37	0.17	0.42	1.00

# In markets, rock-solid relationships can suddenly break

From 31 Dec 1999 to 12 Jul 2017

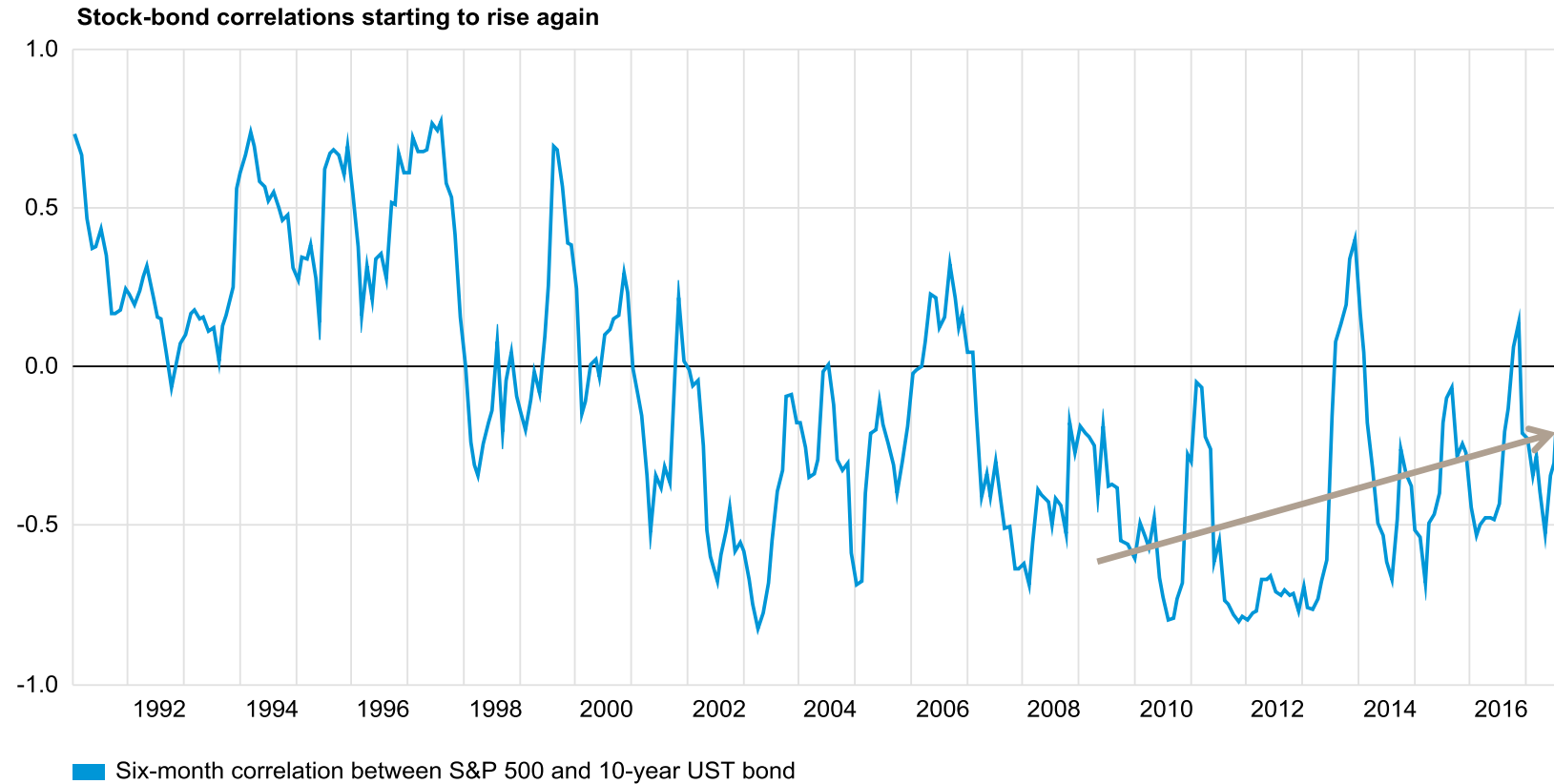
Inverse relationship between political risk and market performance suddenly broke in early 2016



Past performance is not indicative of future performance.

# Death of the 60:40 portfolio imminent

From 29 Dec 1990 to 8 Jul 2017



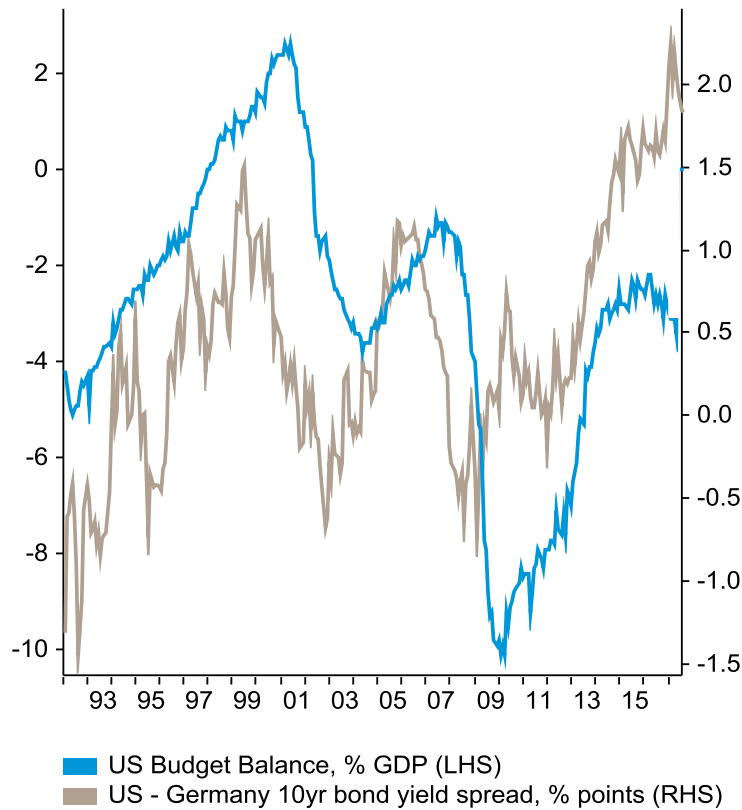
*“Global yields lowest in 500 years of recorded history. \$10 trillion of negative rate bonds. This is a supernova that will explode one day.”* **Bill Gross, June 2016**

Past performance is not indicative of future performance.

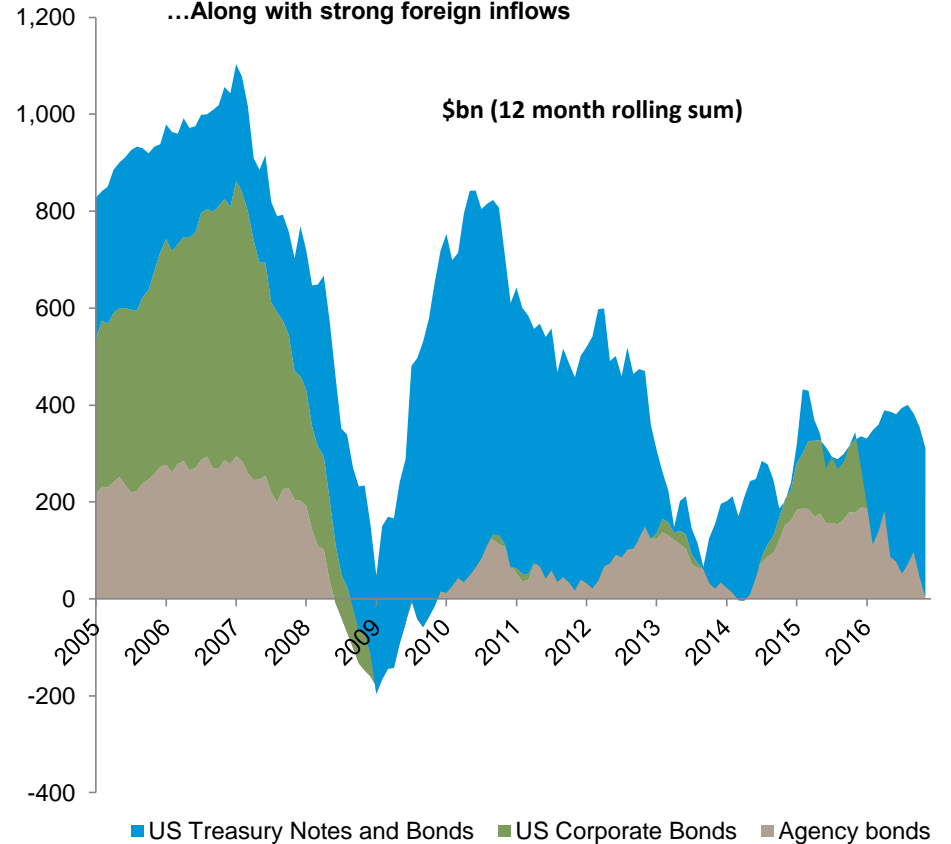
# Technical factors have driven this

From 31 Dec 1991 to 10 Jul 2017

Attractive carry and short supply...



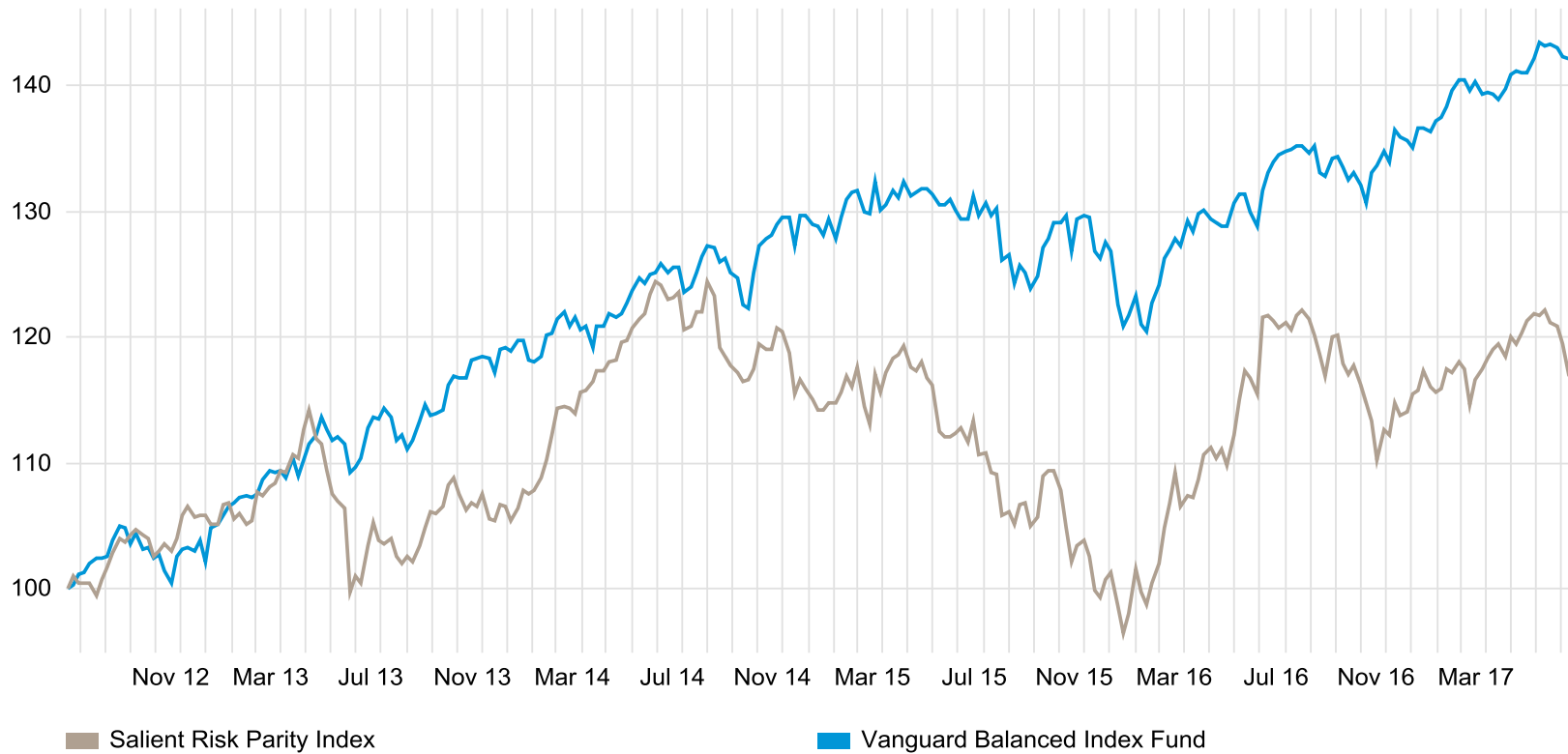
...Along with strong foreign inflows



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# Risk parity - not necessarily the answer

From 13 Jul 2012 to 10 Jul 2017

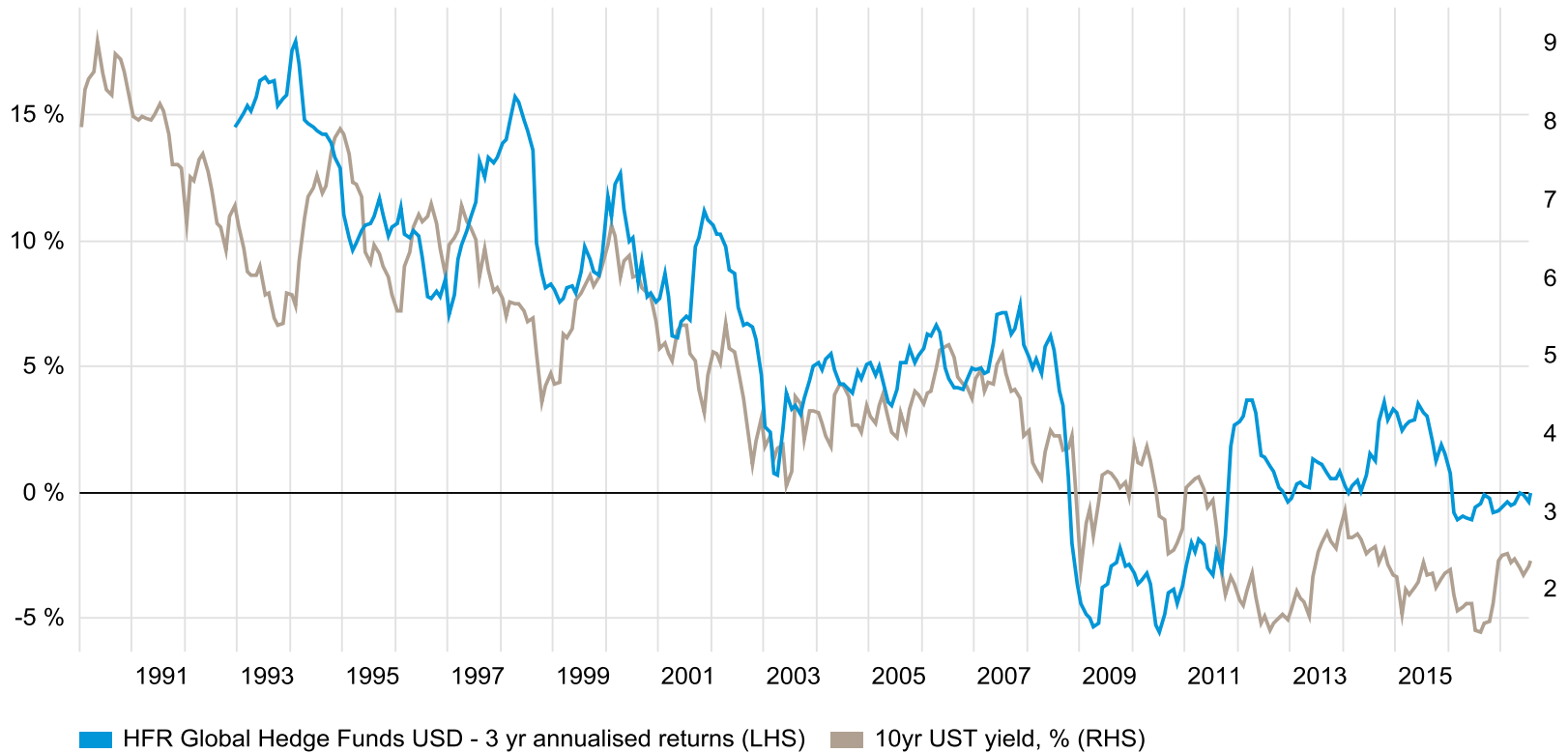


Past performance is not indicative of future performance.



# Hedge funds a smaller part of the solution now

3 years rolling annualised returns from 29 Dec 1989 to 10 Jul 2017



Past performance is not indicative of future performance.

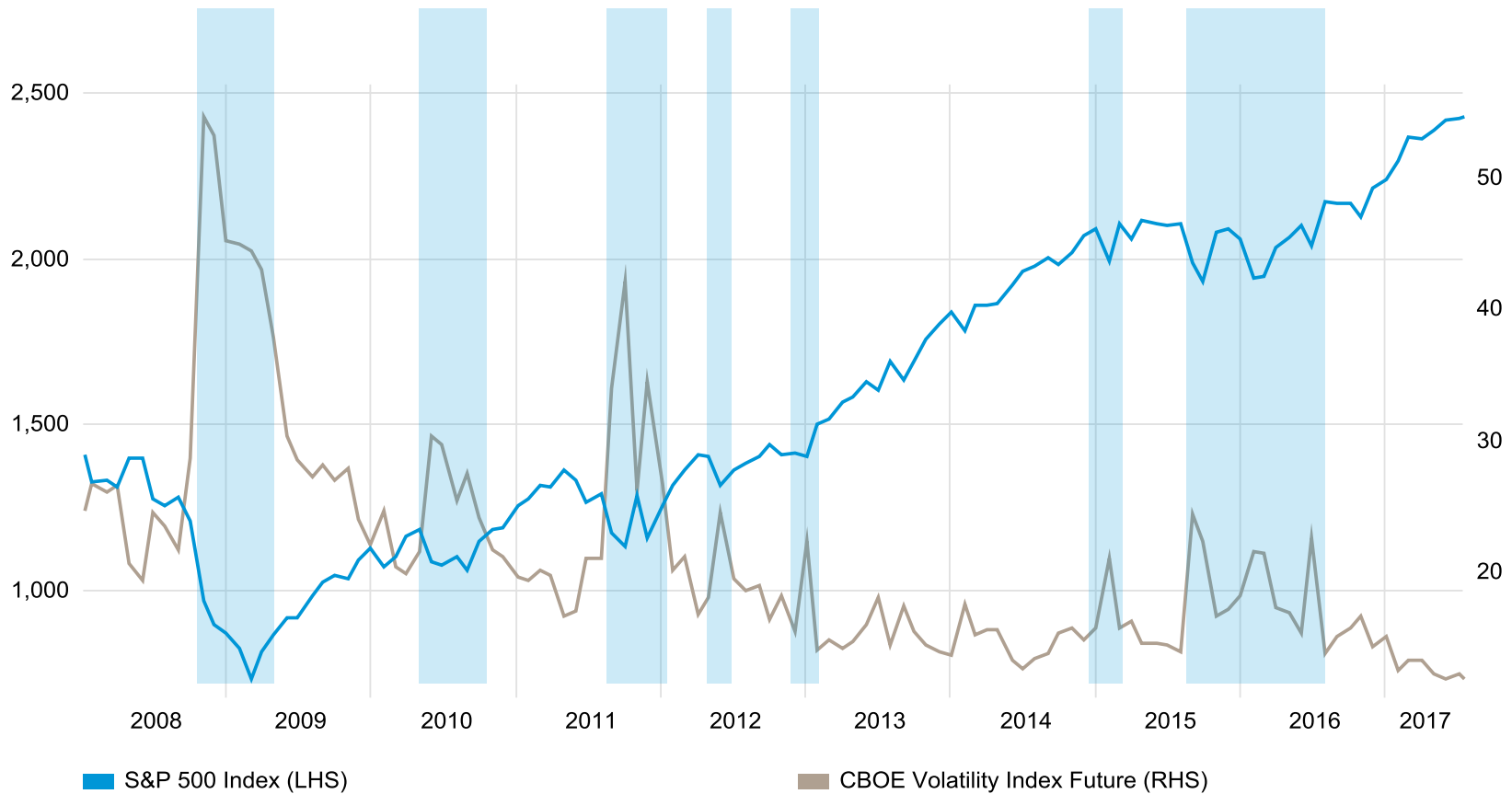
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**WHAT MIGHT**  
ACTUALLY WORK

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# Tactically, VIX futures appear compelling

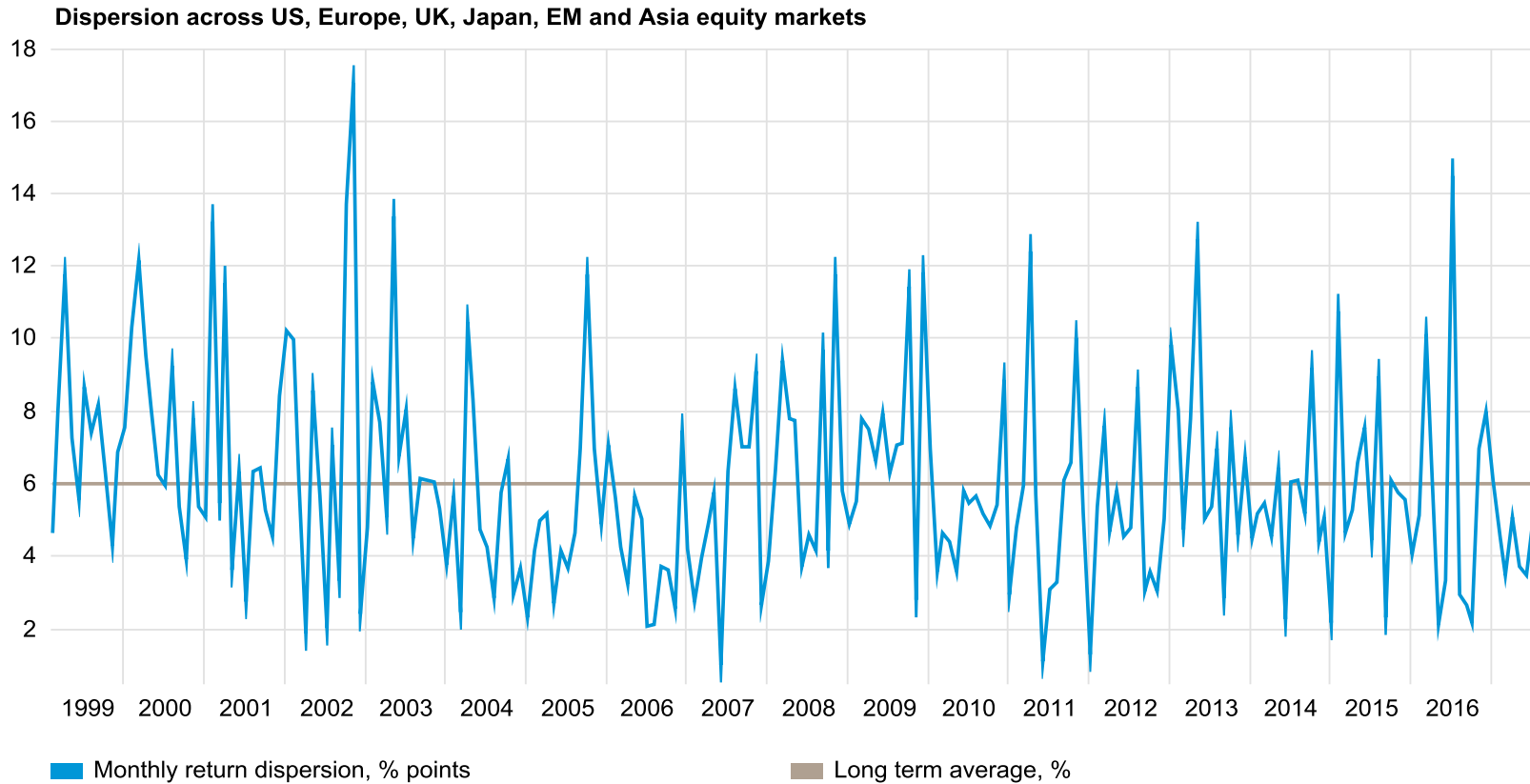
From 4 Jan 2008 to 12 Jul 2017



Past performance is not indicative of future performance.

# Regional equity calls should also provide diversification

From 31 Jan 1999 to 30 Jun 2017

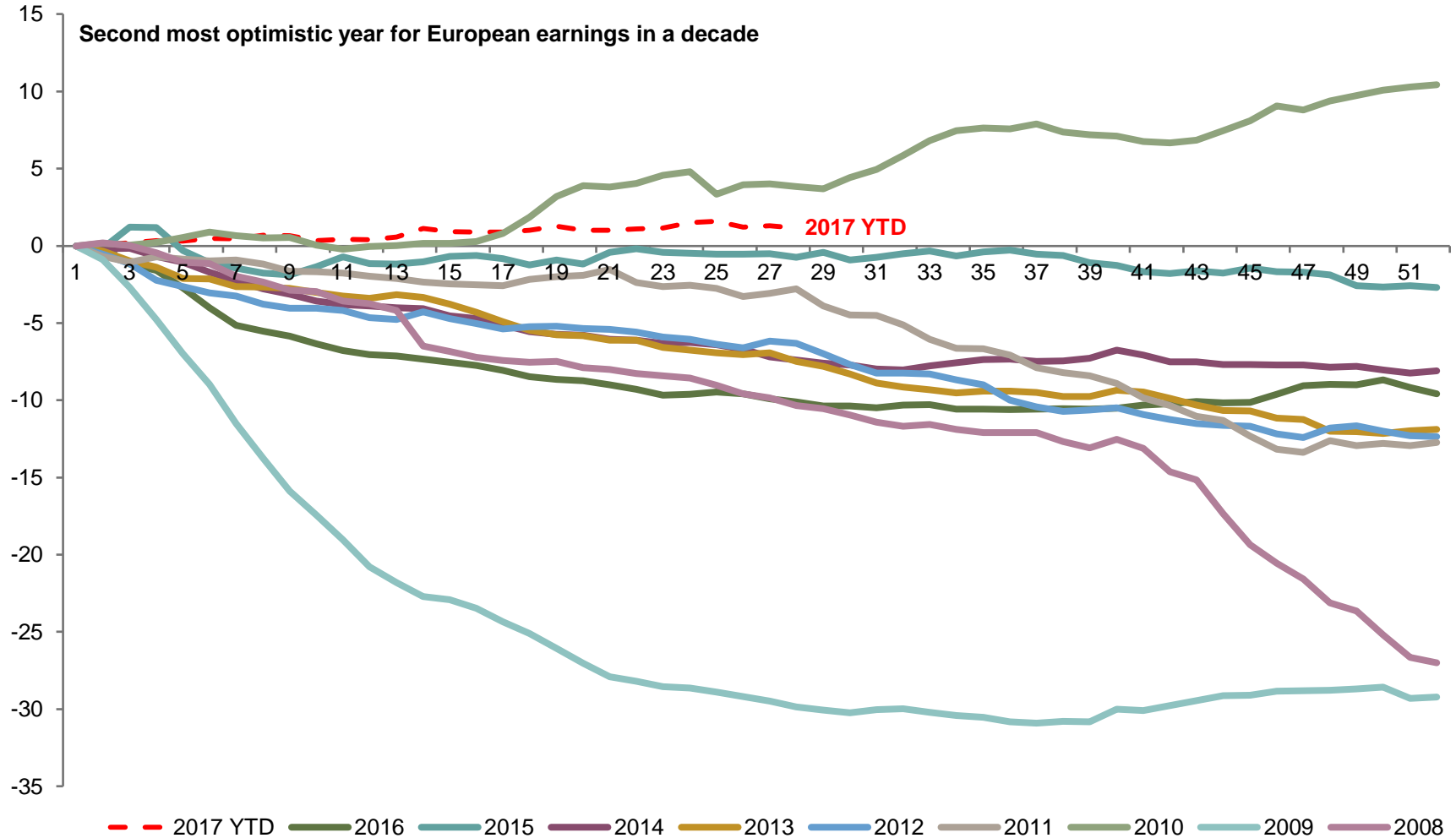


Dispersion defined as % point difference between highest – lowest regional equity market monthly return. Past performance is not indicative of future performance.

# Example 1: Europe overweight amid earnings optimism

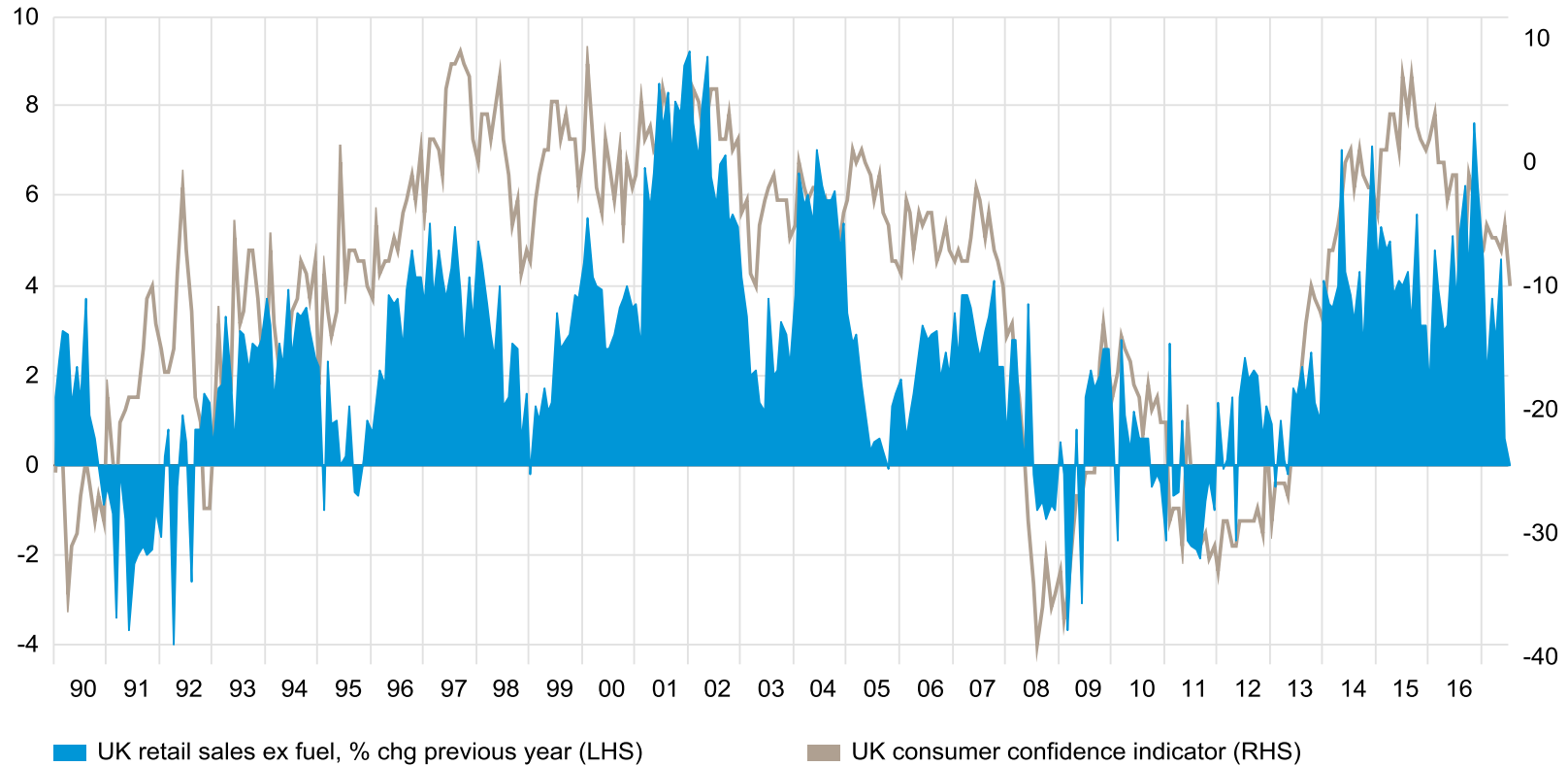


Earnings forecast, % change rebased for calendar years 2008 to 2017 YTD



# Example 2: UK underweight as Brexit phoney war ends

From 31 Dec 1989 to 30 Jun 2017



Past performance is not indicative of future performance.

# Risk factor approach can 'intrinsically' diversify

Data for GAM Composite Global Equity as at 30 Jun 2017

Factor	Exposure			Risk
	Port	Bench	Active	Contribution %
EU Size	-0.05	0.06	-0.11	7.37
JP Size	-0.06	0.04	-0.10	5.99
US Value	0.16	0.01	0.15	2.80
US Size	0.07	0.16	-0.09	2.13
JP Value	-0.06	0.00	-0.06	1.86
JP Profit	0.08	0.00	0.08	1.64
JP Growth	0.10	0.00	0.10	1.61
JP NKY	0.03	0.06	-0.03	0.97
EU Trade	0.00	0.03	-0.03	0.90
EU Div Yield	-0.03	0.02	-0.06	0.84
US Earnings Variable	-0.07	-0.02	-0.04	0.55
EU Momentum	0.02	0.00	0.02	0.52

Factor	Exposure			Active
	Port	Bench	Active	
Size	0.03	0.34	-0.31	
Trade Act	0.12	-0.02	0.13	
Growth	0.09	-0.02	0.11	
Div Yield	-0.05	0.05	-0.10	
Profit	0.12	0.06	0.06	
Leverage	-0.04	0.02	-0.06	
Earnings Variable	-0.03	-0.07	0.04	
Value	0.03	0.01	0.02	
Volatility	-0.01	-0.02	0.01	
Momentum	0.00	-0.01	0.00	

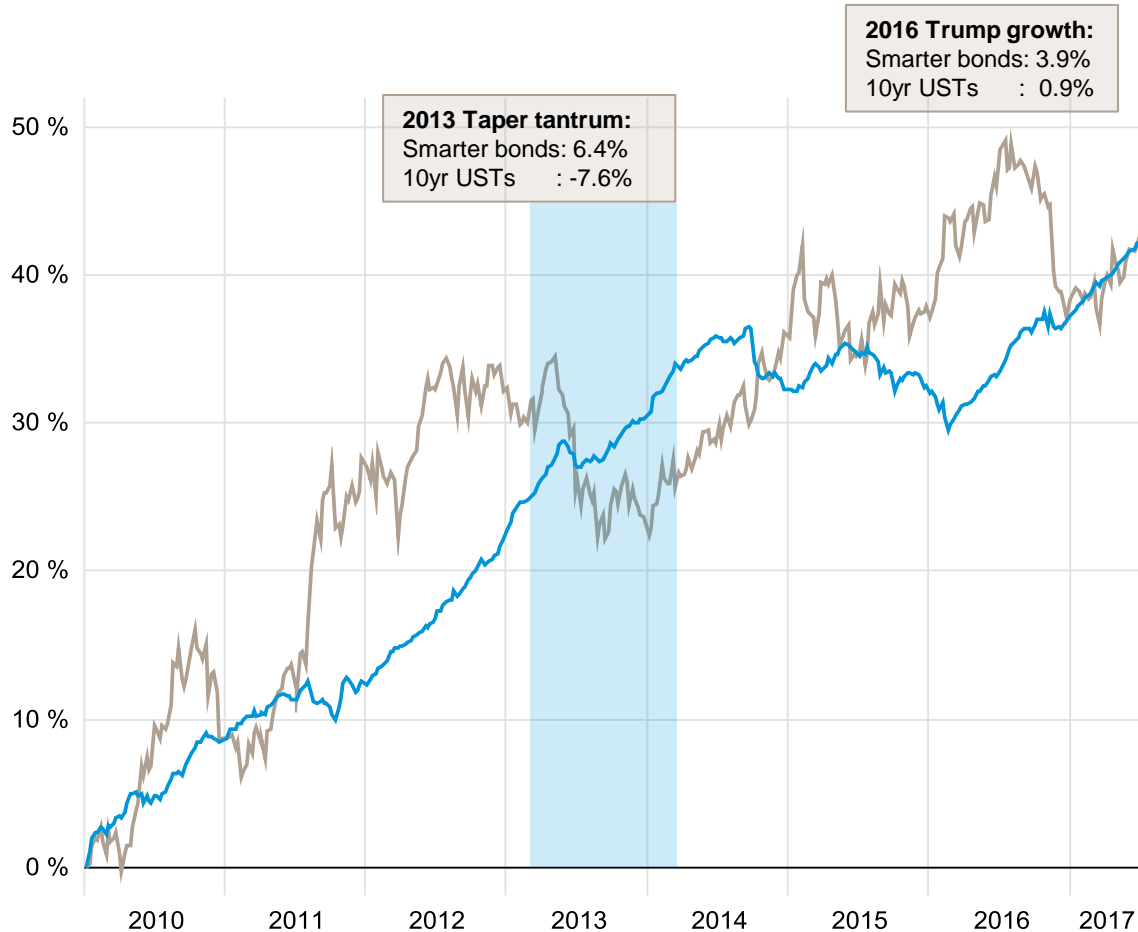
- Within style factors, largest contributor to risk comes from EU and JP Size factor, followed by US Value (overweight).
- Tables to the right illustrate largest active factor bets versus index: US Value and JP Growth

Factor	Exposure			Risk
	Port	Bench	Active	Contribution %
<b>Top 5 bets</b>				
US Value	0.16	0.01	0.15	2.8
JP Growth	0.10	0.00	0.10	1.61
AS Gamma Factor	0.09	0.00	0.09	0.14
JP Profit	0.08	0.00	0.08	1.64
JP Earnings Variable	0.07	-0.01	0.08	0.42
<b>Bottom 5 bets</b>				
EU Size	-0.05	0.06	-0.11	7.37
JP Size	-0.06	0.04	-0.10	5.99
US Size	0.07	0.16	-0.09	2.13
JP Div Yield	-0.06	0.00	-0.07	0.44
JP Value	-0.06	0.00	-0.06	1.86

# Capital Preservation - compelling risk-return possible



Performance from 31 Dec 2009 to 30 Jun 2017



	Simple Perf. %	Ann. Perf. %	Ann. Std. Dev.
■ CMPBF	42.4	4.8	2.4
■ US10P	40.7	4.7	6.5

**Duration:**  
Smarter bonds: 1.29  
10yr USTs : 2.43

■ GAM Composite AR USD - Fixed Income and Credit  
■ 10-year US government bond index USD

Past performance is not indicative of future performance. Performance is provided gross of fees.

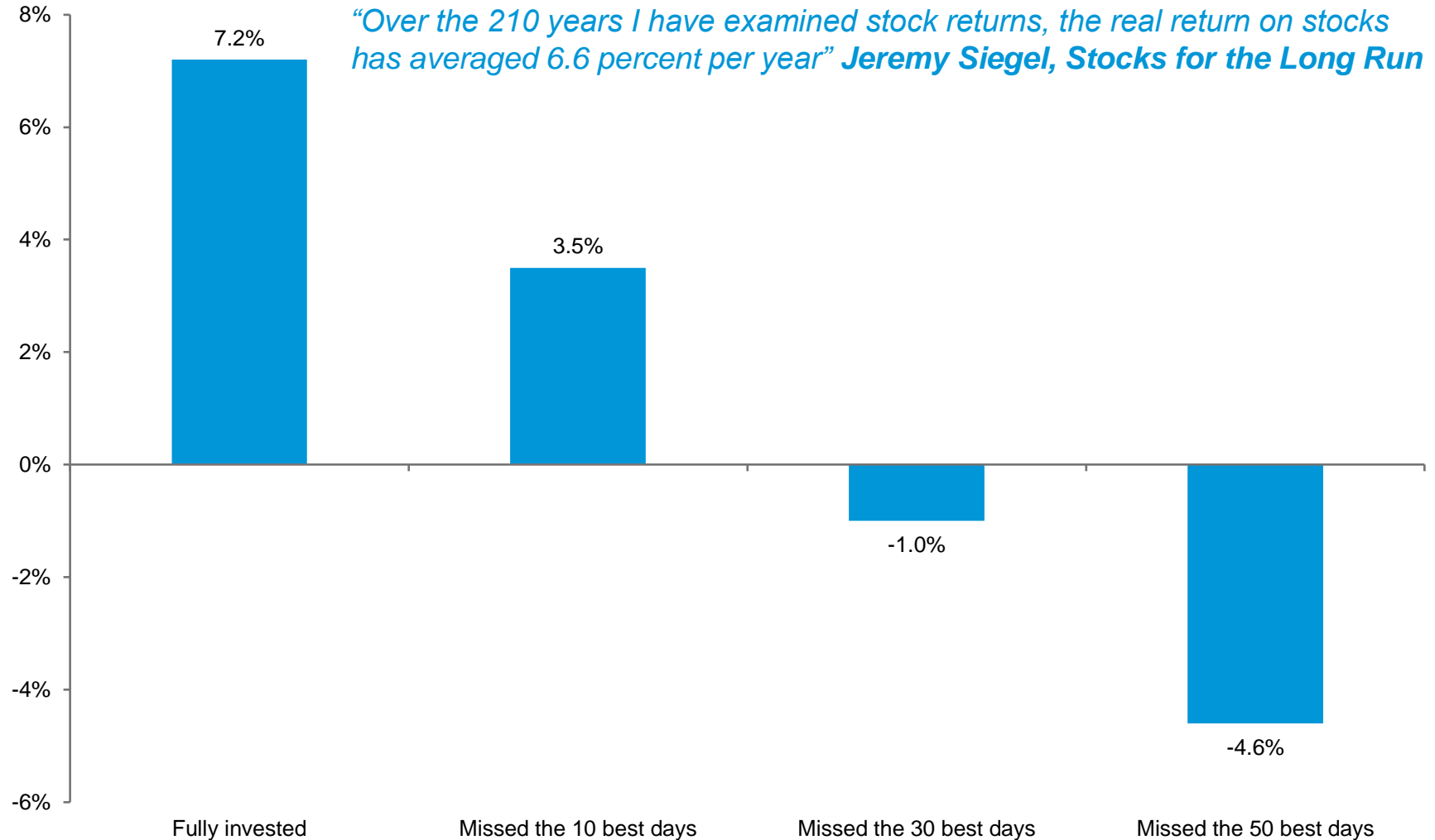
Source: GAM, Thomson Reuters

GAM Composite Absolute Return USD – Fixed Income and Credit is a performance series based on the Fixed Income and Credit portion of the Absolute Return portfolio. It is not in itself a fund or strategy that can be accessed separately and so its performance must always be viewed in the context of the wider Absolute Return portfolio.



# But time is the best equity diversifier of all

CAGR of S&P 500 total return from 30 Jun 1997 to 30 Jun 2017



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# POSITIONING AND PERFORMANCE UPDATE

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# Our latest 12m scenario analysis (for AR strategies)



Data as at 13 Jul 2017

Probability: %	Crisis: 10%	Slowdown: 25%	Sideways: 50%	Acceleration: 15%
	<ul style="list-style-type: none"> <li>Global GDP &lt;0%</li> <li>DM slows, EM follows</li> <li>Geopol./systemic crisis</li> <li>Profits relapse</li> <li>Market correction</li> </ul>	<ul style="list-style-type: none"> <li>Global GDP 1%-2%</li> <li>Reflation stalls, EM lags</li> <li>Geopolitical tensions</li> <li>Profits growth deteriorates</li> <li>Markets soften</li> </ul>	<ul style="list-style-type: none"> <li>Global GDP 2%-3%</li> <li>Moderate DM, EM growth</li> <li>Geopolitics contained</li> <li>Profit recovery stalls</li> <li>Modest market progress</li> </ul>	<ul style="list-style-type: none"> <li>Global GDP &gt;3%</li> <li>DM thrives, EM takeoff</li> <li>Geopolitics benign</li> <li>Profits beat forecasts</li> <li>Markets accelerate</li> </ul>
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Allocation	55%	50%	40%	25%
Implied contribution	1.9%	1.3%	0.8%	0.0%
<b>Alternatives</b>	<b>-2 to 5%</b>	<b>-1 to 5%</b>	<b>-1 to 5%</b>	<b>-2 to 5%</b>
Allocation	20%	25%	25%	20%
Implied contribution	0.3%	0.5%	0.5%	0.3%
<b>Liquidity</b>	<b>0% to 0.5%</b>	<b>0% to 1%</b>	<b>0.5% to 1.5%</b>	<b>2% to 3%</b>
Allocation	15%	10%	5%	5%
Implied contribution	0.0%	0.1%	0.1%	0.1%
<b>Expected return</b>	<b>0.8%</b>	<b>1.1%</b>	<b>2.4%</b>	<b>4.2%</b>
<b>Including alpha</b>	<b>1.6%</b>	<b>2.0%</b>	<b>3.4%</b>	<b>5.1%</b>

**Probability-weighted expected return including assumed alpha = 3.1%**

Source: GAM. For reference, OECD full year 2017 forecast for world GDP growth is 3.3%.

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# Strategic and tactical views – summary

Data as at 13 Jul 2017

	Low Conviction	Cautious	Neutral	Positive	High Conviction
Equities		<b>UK</b> [recession risk, unclear Brexit path] <b>US</b> [exhaustion, marginal underweight]	<b>Japan</b> [underperformed, improving prospects]	<b>Europe</b> [Political risks easing, economy improving] <b>Emerging Mkts</b> [sound fundamentals, ex-US theme]	
Neutral					
Fixed Income		<b>Active aggregate bonds</b> [diversification rather than upside]	<b>Absolute Return approaches</b> [rates opportunities, careful risk control]	<b>Financial credit</b> [regulatory trend, steady underlying cashflows] <b>Liquid high yield</b> [safer return extraction]	<b>MBS</b> [steady return profile] <b>Insurance-linked</b> [low correlation to major indices]
Positive					
Alternatives			<b>Macro trading</b> [potentially rich opportunity set for managers to exploit]	<b>Market neutral Equity L/S</b> [innovative non-directional approaches]	<b>Merger Arbitrage</b> [spread extraction with diversification can provide steady return profile]
Cautious					
Flexibility	<b>Government bonds</b> [shorts in USTs, bunds, Sweden]			<b>JPYUSD / Gold</b> [cheap risk-off hedges] <b>Thematic equities</b> [European buybacks, Tech, H-Shares]	<b>Diverse carry</b> [EM, HY, MBS] <b>Currency themes</b> [EURUSD]
Positive					

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# Q & A

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