NEW ROAD CAPITAL
INVESTMENT MANAGEMENT

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Optimising Diversification

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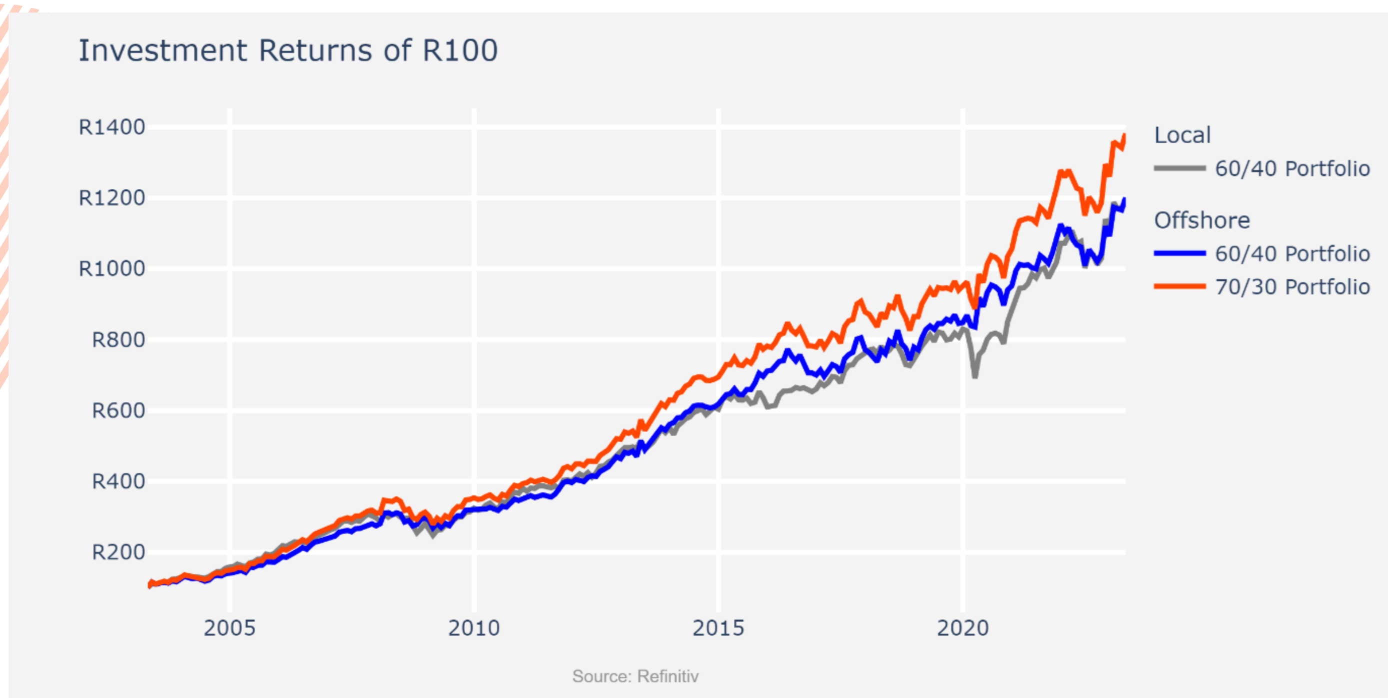
The concept of diversification allows investors to generate more stable returns by taking advantage of the fact that, in general, not all investment risks materialise at the same time. This results in losses of some securities to be offset by gains in others. However, constructing a well-diversified portfolio takes more consideration than simply distributing capital across as many different sources of risk as possible, with the interaction between different securities guiding the optimal allocation toward each asset class. Traditionally, this process is done by minimising the volatility of the portfolio for a given level of return, also called mean-variance optimisation. Placing too much focus solely on volatility, however, may lead to money left on the table.

Despite its simplicity, the 60% All Share/40% All Bond portfolio has done well over the past 20 years. It has comfortably outperformed the ASISA high equity category average on an absolute return basis without taking on the maximum allowable equity risk. As a trade-off, it subjected investors to a larger drawdown, 27.7% vs 22.3%, which inevitably would have resulted in more emotional pain. Through the selection of another asset class, it is possible to bring the drawdown experienced down to a more acceptable level, while maintaining the same level of simplicity and returns.

The figure below shows a comparison between the local 60/40 portfolio and an offshore 60/40 portfolio, where local bonds are replaced with offshore bonds and rest remains invested in the ALSI. Both portfolios produced an annualised return of 13.4% p.a., but crucially, the construction of the offshore 60/40 portfolio resulted in significantly better maximum drawdown protection at 19.0% down vs 27.7%. This seemingly lower level of overall portfolio risk means that one could construct a third portfolio with a higher allocation toward equities without the maximum drawdown exceeding that of the original 60/40 portfolio. An offshore 70/30 portfolio achieves an annualised return of 14.2% p.a. by increasing equity exposure but still has a lower maximum drawdown at 25.6%.



The table below gives a summary of the drawdowns and returns of each respective portfolio.

Portfolio	Drawdown	Return
Local 60/40	27.7%	13.4%
Offshore 60/40	19.0%	13.4%
Offshore 70/30	26.5%	14.2%

The yields on investment grade global sovereign bonds have historically been very low compared to the frequent double-digit yields available locally to South African investors. Given the volatility local investors would be exposed to due to currency movements alone, it has previously been difficult to justify investing in an instrument that yielded below 3%. However, as yields have improved offshore, the attractiveness of offshore bonds increases. The important difference in equity volatility and global bond volatility, is that the volatility in global bonds is heavily skewed to the upside and negatively correlated with that of equities. The beneficial interaction effect means that the drawdown offset by the flight-to-safety effect outweighs some of the lower returns. This simple example shows that through intelligent portfolio construction, more utility may be extracted from an investment and that not all routes to risk management are equal. Although a focus on volatility is important, volatility itself does not necessarily always increase the risk of drawdowns.

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