January 2019

Investment Insights

Global Investment Consulting

In this issue

Why Diversify Now?

1 Introduction
2 Current Environment
3 Potential Routes of Diversification
4 Liquid Alternatives
4 Illiquid Alternatives
4 Other Ways to Diversify
5 Key Considerations
5 Conclusions

Subscribe to Our Investment Blog

Why Diversify Now?

Introduction

Volatility re-emerged globally in 2018. Although equity markets enjoyed a strong start to last year, uneasiness continued to seep into the markets as the year continued. There was no shortage of drivers for the uptick in volatility, ranging from concerns over a global growth slowdown, rising interest rates, increased trade tensions and continued geopolitical uncertainties. Against this backdrop, global equity returns turned negative in the fourth quarter of 2018 as the MSCI World Index declined by 8.4%. After a seismic drop of almost 6% in October, global equities recovered in November before plummeting again in December. In this economic climate, we firmly believe the case for diversifying institutional portfolios is stronger than ever.

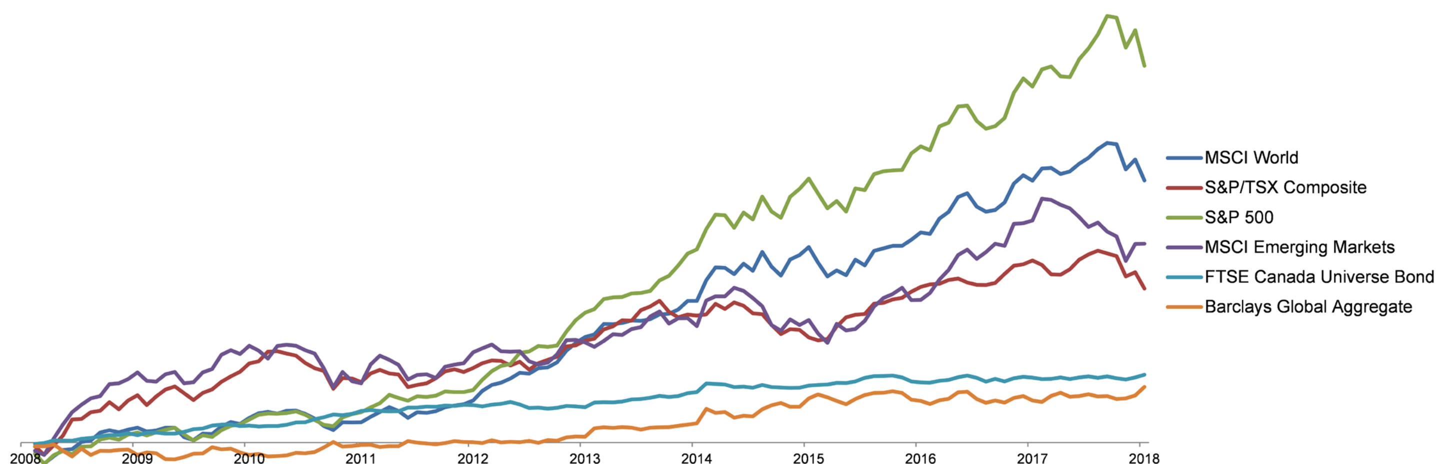
As a quick reminder, the aim of diversification is to minimize portfolio volatility by spreading a portfolio's asset mix across a wide range of asset classes with differing drivers of return and imperfect correlations. From a volatility perspective, since the 2008 recession, portfolios that were well diversified have generally benefited from lower levels of volatility relative to portfolios that were less diversified. From a performance perspective however, this also meant that well diversified portfolios underperformed portfolios with higher concentrations to equities, as these portfolios were able to take full advantage of accommodative central bank policies which helped launch global equities to a near-decade long run of dominance following the economic recovery.

In this note, we explain why today's economic climate presents an opportune time to re-evaluate the systematic risk that portfolios with only traditional asset classes contain. We then propose alternative asset classes as diversifiers whose inclusion can help reduce portfolio volatility, followed by an introduction to liquid and illiquid alternative asset classes clients can consider implementing.

Current Environment

In September 2018 we noted that the markets had moved into a 'transition' environment. Our belief was based on market conditions at the time which indicated a transition from a near-decade long period of risky asset strength towards an inevitable market downturn that would be characterized by a flight to quality. Although we do not believe such an economic downturn is imminent, the entry into a transition environment is significant because it reflects the reality of changing economic and tighter financial conditions.

Over the last ten years, equity and credit markets have generally performed well. Moving forward, we now expect that both equity and credit markets are likely to face more volatility with the potential for steep sell-offs. The chart below shows that equity markets have continued to advance steadily higher as economic growth and earnings have driven returns throughout much of the last decade. At the same time, many bond markets are still expensive as yields have fallen over recent years on the back of quantitative easing and global monetary policy (Canadian and U.S. government bonds are an exception, as their yields have risen substantially over the past three years).

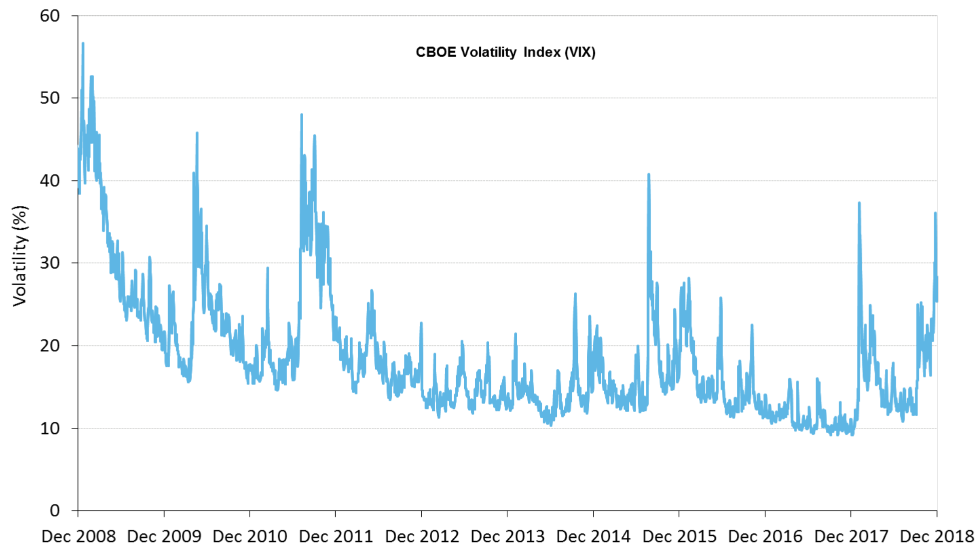


Source: Reuters

Given the decade-long rally in both asset classes, valuations remain high and have become increasingly dependent on positive news flow, which in current times is far from guaranteed. Although risky assets have been expensive for quite some time, other headwinds are now mounting in addition to valuation concerns. This expanded set of challenges includes rising interest rates, as highlighted by the U.S. Federal Reserve's decision to increase rates in December for the fourth time in 2018 and ninth time since 2015. A rise in global populism has muddied the trade waters, with protectionist stances threatening to jeopardize long-standing trade agreements after decades of embraced globalization. In recent years, we have seen decisions such as Brexit, the re-negotiation of NAFTA (CUSMA) and most recently, trade negotiations between the U.S. and China dominating headlines.

Continued market sensitivity to news flow and data releases would imply further surges in market volatility are entirely possible, especially as corporate earnings start to lose momentum in an environment of slowing global growth. Last year's rise in volatility was best illustrated by a tripling of the CBOE Volatility Index (VIX) twice in 2018; first in February and then again in mid-December (see chart below).

Volatility was on the rise in 2018 after a period of relative calm



Source: Factset/Yahoo! Finance

In recent years, equities were well supported by relatively low bond yields as interest rates were at or near historic lows. In today's rising yield environment however, market sensitivity to upward rises in interest rates remains a key risk. And, as volatility continues to enter the markets, we cannot discount the possibility that both equity and bond markets may fall at the same time, making the need to expand diversification efforts beyond traditional investments more critical than in previous market cycles.

Looking ahead, our outlook for several key asset classes are more muted for 2019 and beyond. In our view, we are likely to see flattening underlying price trends in risky assets with alternating cycles of optimism and pessimism, changes in market leadership, higher volatility and less conviction in returns. While we do not believe an economic downturn is imminent, we do believe that preparing for more difficult market conditions moving forward is warranted.

Potential Routes of Diversification

Despite the challenges of today's economic environment, we believe that investors should remain fully diversified. Presently, we recommend exposure to growth assets be maintained with the condition that adequate diversification and downside protection is incorporated. Investors can accomplish this in two ways:

(1) Investing in a mix of traditional return-seeking (equities) and risk-reducing (bonds) assets; and

(2) Allocating a percentage of portfolio assets to strategies that are uncorrelated to traditional assets (i.e. investing in alternative investments).

In the rest of this note we focus on the latter approach, including a discussion of strategies that can complement traditional asset classes with less exposure to traditional sources of returns and less directional market risk. These strategies generally aim to perform well in a variety of market environments.

We present a few liquid and illiquid alternative investment approaches. For a full range of opportunities, please contact your Aon investment consultant.

Liquid Alternatives

- **Diversified Growth Funds (DGFs)** – Perhaps the best-known liquid alternatives, DGFs have been a popular way of achieving diversification in a liquid context. DGFs are a diverse group of liquid strategies with a range of risk and return profiles and offer a blend of traditional and alternative strategies within a single fund. See our separate paper *'Do Diversified Growth Funds solve the diversification problem?'* dated 2015 for more details.
- **Alternative Risk Premia (ARP)** – A range of strategies that offer a premium for either taking risks others do not wish to bear or for exploiting market anomalies. They provide diversification and added return potential to traditional portfolios and are a viable proposition for investors looking for alternative sources of return at reasonable fee levels. See our separate paper *'Alternative Premia, Alternative Price'* dated August 2017 for more details.
- **Absolute Return Bonds (ARB) and Multi Asset Credit (MAC)** – ARB funds seek diversification from traditional asset classes by taking a wide range of active views in bond and currency markets, while MAC funds offer diversification across the credit universe by quality and region. See our separate paper *'Multi Asset Credit'* dated June 2015 for more details.

Illiquid Alternatives

Institutional investors are increasingly showing appetite for illiquid alternatives. Illiquid alternatives can be an attractive match for pension and insurance liabilities that tend to be longer-term in nature and allow these investors to collect an illiquidity premium. The illiquidity premium refers to the additional return demanded by investors in exchange for the additional risk of locking up their capital for a specified period of time. Examples include:

Insurance-Linked Securities – Funds that invest in a diversified portfolio of financial instruments whose values are driven by severe insurance loss events. A wide range of risk and return characteristics are available with these funds that generally offer quarterly or bi-annual liquidity (although some capital can be tied up for longer). See our separate paper *'Storms, Floods and Quakes'* dated March 2018 for more details.

Direct Lending and Property Debt – Direct Lending is a form of corporate lending typically made to small and medium-sized enterprises (SMEs). Loans are typically secured on company assets and investor returns primarily comprise a margin above cash and arrangement fees. See our separate papers *'Understanding European Direct Lending'* dated October 2018 and *'Direct Lending'* dated March 2018 for more details. Property debt is a loan secured against a property and its underlying income stream. In both types of loan sectors, we prefer funds that offer diversification by borrower, region, sector and number of loans. These funds offer the potential to provide income that can help meet benefit cash flows, and can be incorporated as part of a return-seeking portfolio or a cash flow-driven investment strategy.

Other Ways to Diversify

Portfolio diversification can also take place across geographies, sectors, styles and managers. We recommend that investors explore the full range of diversification possibilities available to them. Typically, funds are diversified to a certain extent as standard benchmarks aim to encompass full market coverage. See our separate paper *'How Diversified is your Global Equity Portfolio?'* dated January 2018 for more details.

Active managers have the potential to improve diversification and protect portfolio returns. For instance, by moving away from benchmark concentrations or selecting quality stocks that are more resilient in a market downturn, active management can serve as a useful weapon against market downturns.

Key Considerations

There are other issues that investors should consider in assessing diversification options.

Investors need to weigh their risk / return appetite coupled with their investment time horizon. For pension funds, this is often driven by their long-term funding objective. Investor willingness and ability to seek an illiquidity premium is also important.

Investors also must consider the asset allocation in a total portfolio context, which requires any subsequent portfolio inclusions to be considered from a complementarity and correlation perspective. Modelling and scenario stress-testing are two tools that can aid investors with this analysis.

Finally, investors need to be careful not to over-diversify, which can drive up costs with no associated reduction in volatility or increase in expected return.

Conclusions

- We have entered a 'transition environment' where the outlook for risky assets is more muted going forward.
- Today's economic climate offers an opportunity to ensure institutional portfolios are well diversified.
- There is a range of current opportunities that investors should consider to diversify their portfolios.

Suitable options will depend on individual client circumstances. Please contact your Aon investment consultant for more in-depth information.

Contact Information

If you would like further information on any of these topics, please contact your local Aon consultant:

- Tommy Peron (Quebec) tommy.perron@aon.com
- Mario Delisle (Montreal) mario.delisle@aon.com
- Calum Mackenzie (Toronto) calum.mackenzie@aon.com
- John Myrah (Regina) john.myrah@aon.com
- Julianna Spiropoulos (Calgary) julianna.spirooulos@aon.com
- Satinder Sidhu (Vancouver) satinder.sidhu@aon.com

Aon publishes *Investment Insights* for the purposes of providing general information. The information in *Investment Insights* does not constitute financial, legal, or any specific advice and should not be used as a basis for formulating business decisions. For information tailored to your organization's specific needs, please contact your consultant at Aon. This issue of *Investment Insights* contains information that is proprietary to Aon and may not be distributed, reproduced, copied or amended without Aon's prior written consent.

Important Information

Any opinions or assumptions in this document have been derived by us through a blend of economic theory, historical analysis and/or other sources. Any opinion or assumption may contain elements of subjective judgement and are not intended to imply, nor should be interpreted as conveying, any form of guarantee or assurance by us of any future performance. Views are derived from our research process and it should be noted in particular that we cannot research legal, regulatory, administrative or accounting procedures and accordingly make no warranty and accept no responsibility for consequences arising from relying on this document in this regard.

Calculations may be derived from our proprietary models in use at that time. Models may be based on historical analysis of data and other methodologies and we may have incorporated their subjective judgement to complement such data as is available. It should be noted that models may change over time and they should not be relied upon to capture future uncertainty or events.

This document does not constitute an offer of securities or solicitation of any kind and may not be treated as such, i) in any jurisdiction where such an offer or solicitation is against the law; ii) to anyone to whom it is unlawful to make such an offer or solicitation; or iii) if the person making the offer or solicitation is not qualified to do so. If you are unsure as to whether the investment products and services described within this document are suitable for you, we strongly recommend that you seek professional advice from a financial adviser registered in the jurisdiction in which you reside. It is your responsibility to be aware of and to observe all applicable laws and regulations of any relevant jurisdiction, including the one in which you reside.

In Canada, Aon Hewitt Inc. and Aon Hewitt Investment Management Inc. ("AHIM") are indirect subsidiaries of Aon plc, a public company trading on the NYSE. Investment advice to Canadian investors is provided through AHIM, a portfolio manager, investment fund manager and exempt market dealer registered under applicable Canadian securities laws

About Aon

Aon plc (NYSE:AON) is a leading global professional services firm providing a broad range of risk, retirement and health solutions. Our 50,000 colleagues in 120 countries empower results for clients by using proprietary data and analytics
to deliver insights that reduce volatility and improve performance.

© 2019 Aon Hewitt Inc. All Rights Reserved.

AON
Empower Results®