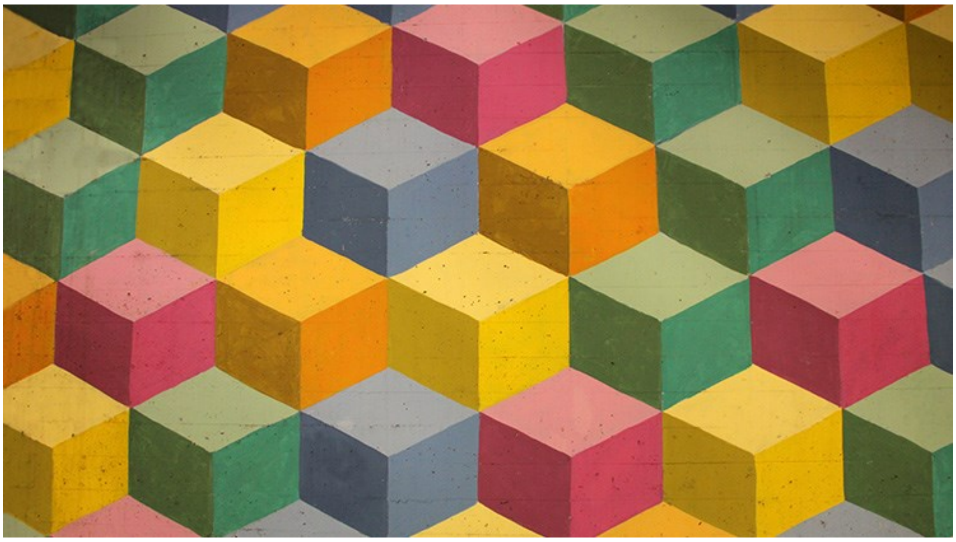
PROTECTING YOUR PORTFOLIO FROM MAJOR DOWNTURNS



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It is nine years after the global financial crisis but we still have ultra-low interest rates. This is great if you are a borrower, but not if you are a saver. If you avoid risk today and invest in interest rate products (cash, term deposits etc), your returns will almost certainly be very low and potentially lower than inflation.

Yet if you take more risk in the pursuit of higher returns, you could be worse off if equity markets sell off. Bear markets are most detrimental to your wealth if they coincide with other life events where you are forced to sell at the bottom. For example, because of poor health, changing family circumstances or needing to fund living expenses in retirement thus turning a paper loss into a permanent one. Therefore, managing risk is important for anyone seeking financial security.

The Perpetual solution to that risk challenge – especially as you near retirement – is:

- an active asset allocation process
- building a more diversified portfolio by including sometimes difficult to access asset classes
- incorporating explicit downside protection.

Who should focus on diversification?

Typically, the longer your investment time horizon and higher your tolerance for volatility, the less diversification you need. (There are exceptions to this generalisation.)

Indeed it is important to take a longer term view when your biggest asset is your personal income and your focus, quite rightly, is on building your career. Time in the market, dollar cost averaging, compound returns and the earnings growth of companies may be powerful allies to maximising wealth.

This may begin to change as your ability to recover from losses starts to diminish in the lead up to retirement. Balancing sequencing risk (the dangers of a negative return that hits when your investment portfolio is large and you're starting to withdraw money to fund your living expenses) and longevity risk (the risk of outliving your savings) may become important.

For investors near or in retirement, the focus often shifts from maximising returns to minimising risk. "Certainty of returns" is important. For an investor looking for increased certainty of returns, it is important no single investment position should be allowed to put your overall investment objective at risk. This is where diversification and risk management (not risk avoidance) can provide peace of mind leading up to and during retirement.

Most people who should be diversified are not – but think they are.

According to the Australian Bureau of Statistics[1], the typical Australian household has 55% of their wealth invested in residential property. On a look through basis, almost two thirds of people's wealth is linked to housing via direct exposures or via Australian banks which in turn have 60%[2] of their loan books exposed to residential housing.

This has been an exceptional portfolio to hold given Australia has avoided a recession for 26 years. However, it is also a highly concentrated and may be sub-optimal given today's starting point – i.e. residential property is expensive on almost all valuation metrics and Australian household debt to disposable income is one of the highest in the world[3] . Diversifying portfolio risk should receive a lot more attention than it does.

Should I hold more bonds in my portfolio as I approach retirement?

The traditional approach to building multi-asset portfolios (and to managing sequencing risk) is to diversify by investing in bonds. Falling sharemarkets are typically associated with a weak economy, declining inflation and heightened risk aversion. Bonds typically perform well under this scenario, as bond holders receive a fixed income stream irrespective of economic conditions. Therefore, a combination of growth assets (i.e. shares) and defensive assets (bonds) has the potential to deliver more consistent returns.

However, the fixed payment stream of bonds, which until now has been a source of reliability, may now be the asset class' weakness. With low bond yields, investors receive lower income and face the risk of interest rates rises leading to capital losses. A 1% rise in interest rates for a ten year bond could erase three years of income at current yields.

With this in mind, investors should be wary. The level of risk of any investment is largely determined by the relationship between the price of an asset and its intrinsic value. Unless you believe inflation will remain low indefinitely, bond yields should eventually rise. In short, bonds can be defensive (i.e. protect against deflation), but can be a source of risk too.

What could happen to my portfolio's diversification if bond yields rise?

Equities may perform well if bond yields rise (prices fall) due to improvements in economic growth provided that is reflected in company earnings growth. One scenario is that an investor may experience low or slightly negative returns from bonds but that this is offset by the performance of equities. If this is the case, then the benefits of portfolio diversification may largely remain intact.

However, we may experience a period when bonds are no longer a diversifier of equity risk, and are instead the **source** of risk.

In short, investors may need to be able to move away from bonds as their main source of risk reduction in a portfolio. Robust portfolios must be able to cope with:

- Low returns from bonds, including possibly negative returns if bond yields rise from here, and
- Higher correlations between bonds and other asset classes, including equities.

What can we do to improve diversification?

Having access to the widest range of asset classes is important. Investments such as emerging market debt, commodities, and alternatives all have a role to play. The optimal approach to diversification is about ensuring your exposures to sources of returns are genuinely diversified.

Look through asset class labels to what drives risk

In addition to having exposure to different **sources** of return, it is important to look through asset classes which appear diversified from the outside to identify those which have the same underlying drivers of risk, and to manage those risks independently. For example, Commodities is one asset class that may be seen as a source of diversification. However, many Australian investors already have significant exposure to hard commodities (like iron ore) via their equity holdings or those of their superannuation fund (for example, by holding shares in BHP Billiton or Rio). The portfolio needs to be considered as a whole.

Rather than simply investing across the whole commodity market, an investor could focus on "soft" commodities (for example, cotton, wheat, sugar) which then complements the existing portfolio, avoids 'double up' and ensures genuine diversification.

Putting it all together

Intelligent diversification is about firstly ensuring you're examining the underlying drivers of returns and ensuring diversity amongst the assets you're investing in. The aim is a collection of distinctly unrelated investment opportunities. These investment opportunities need to be significant enough to ensure they are material for the outcome of the portfolio. Finally, it's about making sure your allocation to these investments can change as quickly as the prospective risk and returns of those investments.

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Perpetual's Multi Asset team invests across a diverse range of strategies, regions and sectors. To find out more visit www.perpetual.com.au/investments/multi-asset, contact our Adviser Services team on 1800 062 725 or speak to your Business Development Manager today.

1 Household and Income Wealth, Australia, 2015-16

2 http://www.smh.com.au/business/the-economy/moodys-move-shines-light-on-australias-home-loan-risks-20170619-gwufh4.html

3 http://www.abc.net.au/news/2017-08-21/how-lending-culture-is-leaving-australians-vulnerable/8816822