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the tortoise & the hare

The magic of diversification

I hope some of you can recall my last article in the **Tortoise and Hare**, on the topic of return premia in asset allocation. To repeat:

"Carry is the return you get if prices don't move. Quality is the return you get if fundamental data can predict price changes. Momentum is the return you get as the market interprets previous price movements. Value is the return you get after prices and fundamental data have moved out of sync."

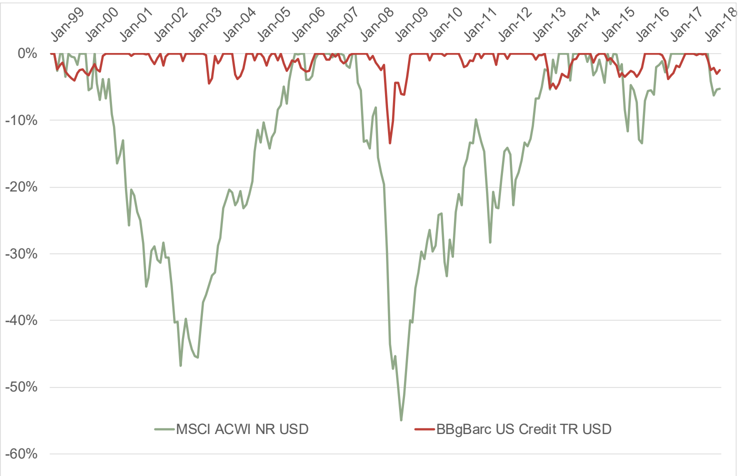
As you might be able to infer from the statement, all four premia are not expected to produce good performance all of the time, but it may be an idea to have them in your portfolio at the same time, because their good and bad stretches of performance often occur at different points in time. Today, I write about the benefits of combining different strategies that pursue these premia as well as the risks of doing so. To illustrate my beliefs, I am working with hypothetical performance data provided for three long/short strategies, labelled "Value", "Momentum" and "Carry", spanning January 1999 to June 2018 and therefore including two major market crises:

	ACWI*	Value	Momentum	Carry
Volatility	5.11%	14.64%	14.77%	10.76%
Return	5.66%	9.71%	10.56%	4.25%
Return per Unit of Risk	0.37%	0.66%	0.71%	0.39%

* MSCI All Country World Index

Confirming the academic evidence mentioned in my **previous article**, all three strategies would have delivered equivalent or better returns per unit of risk than a global equity investor has received over the same time period.

The following chart shows the performance drawdowns and recoveries investors experienced when the technology valuation bubble burst after June 2000 and the global financial crisis (GFC) in 2008.

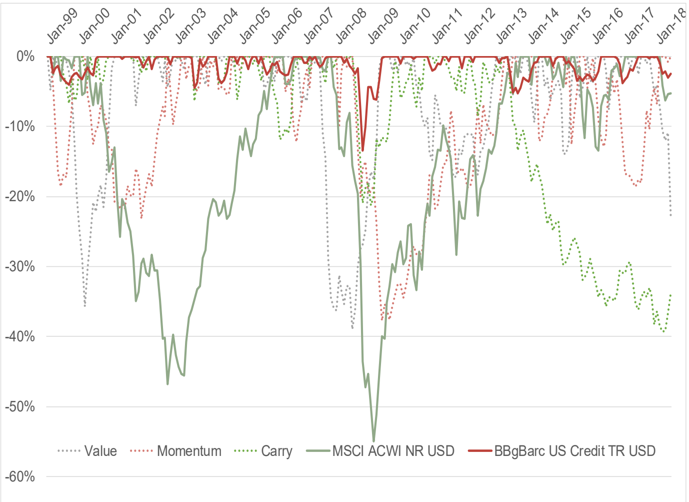


AQR data, MASECO calculations, to January 2018

US credit investors faired reasonably well in 2000 and 2001 during the crisis but experienced a traumatic performance drawdown above 13% in 2008. Global equity investors, taking on much higher investment risk than US credit investors, suffered in both crises and were hit by a performance drawdown in 2008 of nearly 55%.

The magic of diversification

If one were to target equity-like risk in an investment strategy pursuing Value, Momentum or Carry in isolation, the drawdowns would be almost as bad, nearly 40% in each scenario:

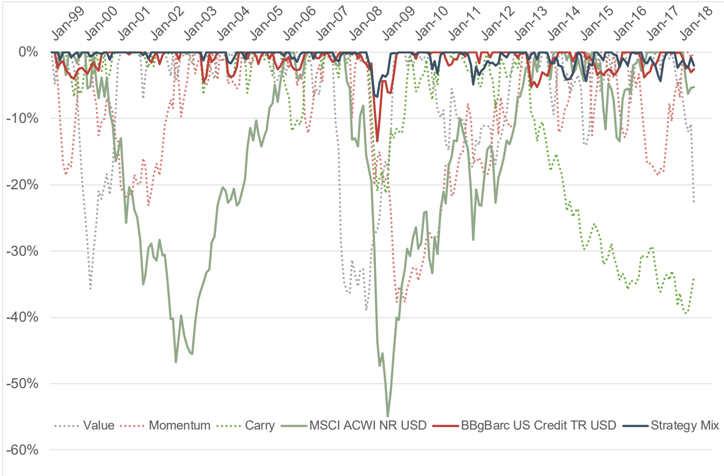


AQR data, MASECO calculations, to January 2018

Importantly, we are not suggesting you do this! Instead, we want our investors to benefit from investing in the combination of strategies. As we hypothesised at the beginning of this article, there might be diversification benefits to harvest. Look at performance correlations between the three premia strategies:

	Value	**Momentum**	**Carry**
Value	1		
Momentum	-0.67	1	
Carry	0.03	0.05	1

Carry is not correlated to either Momentum or Value and Momentum is negatively correlated to Value, meaning one usually has done well when the other has not. So let's see what happens if an investor simply made equal allocations to all three strategies each month.



AQR data, MASECO calculations, to January 2018

Source: Internal
The data above refers to simulated past performance and that past performance is not a reliable indicator of future performance.

What looks like magic is simply the power of diversification: The strategy mix (blue line) would have experienced drawdowns like those experienced by US credit investors, and not like global equity investors.

I am neither suggesting that we invest exactly in this strategy nor that the future repeats the past and of course simulated performance for the purposes of demonstrating how the strategies could work and reality are two different matters, not only because of fees. I am also not suggesting that such strategies offered by firms like AQR or Parametric are low risk, far from it, as those firms can choose to offer products that target higher risk than used in the above example and of course there are other aspects to consider like the complexity of such strategies. But what I do strongly believe in is that such systematic asset allocation strategies, with strong academic and empirical evidence behind them, are one of the best chances investors have in generating positive value add from tactical asset allocation. Because of this belief, it is our mission to educate our investors in understanding a variety of return premia and the benefits of diversification that could be realised over time.

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