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# Spreading one's bets

Diversification dissected

May 2022



WS Global CIO Office

# What is diversification?

Remember the time when you used to play hide and seek as a kid? The best strategy was for everyone to hide in different places in the house. This way, even if one or two people get caught, the rest will have a chance to win the game. In essence, this is what diversification is about, not having all eggs in one basket.

Diversification is an investment strategy of allocating your wealth across different asset classes to help manage and reduce risk in the overall portfolio. This is because each asset class behaves differently under various economic conditions. Therefore, in a well-diversified portfolio, the performance of any single investment should not have a disproportionate impact on the overall portfolio. Losses in one investment may be offset by gains in other holdings. Hence, over the long term, it improves the chances of investors staying the course and achieve more stability in their overall portfolio.

In this publication, we outline:

- 1 the importance of diversification;
- 2 different ways to diversify an investment portfolio;
- 3 a practical guide to building a diversified portfolio.

# Why do you need diversification?

We believe that having a portfolio with the right mix of investments that suit your risk and return profile is an important starting point to future wealth accumulation.

To construct such a portfolio, diversification is one of the most important principles that can help guide your on-going decision-making process for a successful journey to achieve your long-term goals.

01



## **Increase the resilience and robustness against market fluctuations**

If we have perfect foresight into the future, we would simply pick the best performing investment every single year and have a 100% allocation to that particular asset. Unfortunately, the performance of financial assets is anything, but certain. From the table on Page 4, we can see that the best performing asset differs every year. If one only invests in one particular asset, some years would have been good, but others less so. Therefore, having a diversified allocation can help reduce the impact of any one asset class on a portfolio and provide a more stable return pattern. This helps to increase the resiliency of a portfolio especially during periods of heightened market volatility, enabling investors greater staying power.



## A balanced allocation invested across major asset classes has proven to be less volatile and provide a smoother return trajectory over the long term

Yearly returns of different asset classes over the past 10 years (2011-2021)

| 2011                       | 2012                       | 2013                       | 2014                       | 2015                       | 2016                       | 2017                       | 2018                       | 2019                       | 2020                       | 2021                       |
|----------------------------|----------------------------|----------------------------|----------------------------|----------------------------|----------------------------|----------------------------|----------------------------|----------------------------|----------------------------|----------------------------|
| Gold                       | Asia ex-Japan Equities     | North America Equities     | North America Equities     | EM Sov HC                  | Commodities                | Asia ex-Japan Equities     | Cash                       | North America Equities     | Asia ex-Japan Equities     | Commodities                |
| 9.6%                       | 22.4%                      | 31.8%                      | 12.7%                      | 1.2%                       | 17.4%                      | 41.7%                      | 2.6%                       | 30.9%                      | 25.0%                      | 28.8%                      |
| EM Sov HC                  | DM HY                      | Global Equities            | EM Sov HC                  | North America Equities     | DM HY                      | Global Equities            | Global Bonds               | Global Equities            | North America Equities     | North America Equities     |
| 7.3%                       | 19.6%                      | 22.8%                      | 7.4%                       | 0.7%                       | 14.3%                      | 24.0%                      | -1.7%                      | 26.6%                      | 20.7%                      | 26.5%                      |
| Global Bonds               | EM Sov HC                  | DM HY                      | Asia ex-Japan Equities     | Cash                       | North America Equities     | North America Equities     | DM HY                      | Asia ex-Japan Equities     | Gold                       | Global Equities            |
| 5.5%                       | 17.4%                      | 7.3%                       | 4.8%                       | 0.4%                       | 10.9%                      | 21.2%                      | -4.1%                      | 18.2%                      | 20.5%                      | 18.5%                      |
| DM HY                      | Global Equities            | Alternatives               | Global Equities            | Global Equities            | EM Sov HC                  | <b>Balanced allocation</b> | EM Sov HC                  | Gold                       | Global Equities            | <b>Balanced allocation</b> |
| 3.1%                       | 16.1%                      | 6.7%                       | 4.2%                       | -2.4%                      | 10.2%                      | <b>12.0%</b>               | -4.3%                      | 15.6%                      | 16.3%                      | <b>4.7%</b>                |
| North America Equities     | North America Equities     | <b>Balanced allocation</b> | Cash                       | DM HY                      | Global Equities            | Gold                       | <b>Balanced allocation</b> | EM Sov HC                  | Global Bonds               | Alternatives               |
| 1.4%                       | 15.3%                      | <b>6.2%</b>                | 0.3%                       | -2.7%                      | 7.9%                       | 11.7%                      | <b>-4.6%</b>               | 15.0%                      | 10.4%                      | 3.7%                       |
| Cash                       | <b>Balanced allocation</b> | Asia ex-Japan Equities     | <b>Balanced allocation</b> | Alternatives               | Gold                       | DM HY                      | Gold                       | <b>Balanced allocation</b> | <b>Balanced allocation</b> | DM HY                      |
| 0.4%                       | <b>7.1%</b>                | 3.1%                       | <b>0.1%</b>                | -3.6%                      | 7.4%                       | 10.4%                      | -4.7%                      | <b>12.8%</b>               | <b>9.9%</b>                | 1.0%                       |
| <b>Balanced allocation</b> | Gold                       | Cash                       | Global Bonds               | Global Bonds               | Asia ex-Japan Equities     | EM Sov HC                  | North America Equities     | DM HY                      | DM HY                      | Cash                       |
| <b>-1.3%</b>               | 6.0%                       | 0.4%                       | 0.1%                       | -4.0%                      | 5.4%                       | 10.3%                      | -5.0%                      | 12.6%                      | 7.0%                       | 0.3%                       |
| Global Equities            | Global Bonds               | Global Bonds               | DM HY                      | <b>Balanced allocation</b> | <b>Balanced allocation</b> | Global Bonds               | Alternatives               | Commodities                | Alternatives               | EM Sov HC                  |
| -7.3%                      | 4.3%                       | -2.1%                      | 0.0%                       | <b>-4.3%</b>               | <b>4.5%</b>                | 8.2%                       | -6.7%                      | 11.9%                      | 6.8%                       | -1.8%                      |
| Alternatives               | Alternatives               | EM Sov HC                  | Alternatives               | Asia ex-Japan Equities     | Alternatives               | Commodities                | Global Equities            | Alternatives               | EM Sov HC                  | Gold                       |
| -8.9%                      | 3.5%                       | -5.3%                      | -0.6%                      | -9.2%                      | 2.5%                       | 7.6%                       | -9.4%                      | 8.6%                       | 5.3%                       | -4.3%                      |
| Commodities                | Cash                       | Commodities                | Gold                       | Gold                       | Global Bonds               | Alternatives               | Commodities                | Global Bonds               | Cash                       | Asia ex-Japan Equities     |
| -13.8%                     | 0.8%                       | -8.0%                      | -1.8%                      | -10.9%                     | 2.0%                       | 6.0%                       | -12.5%                     | 6.9%                       | 1.3%                       | -4.7%                      |
| Asia ex-Japan Equities     | Commodities                | Gold                       | Commodities                | Commodities                | Cash                       | Cash                       | Asia ex-Japan Equities     | Cash                       | Commodities                | Global Bonds               |
| -17.3%                     | -3.4%                      | -28.7%                     | -23.2%                     | -29.2%                     | 1.1%                       | 1.4%                       | -14.4%                     | 2.7%                       | -9.7%                      | -6.1%                      |

Source: Bloomberg, Standard Chartered. A balanced allocation is proxied by 10% cash, 45% bonds, 30% equities, 5% gold and 10% alternatives.

## 02

### Improve return potential over the long run

Diversification is not designed to maximize short-term returns, but instead, it can help enhance a portfolio return potential over the long run, by allowing investors to participate in certain investments that can be risky on a standalone basis. This can be due to specific sector/industry risks, which makes a large allocation into some of these high return potential investments less than ideal. While individual asset classes can be volatile, in a well-constructed portfolio there will be other asset classes that help offset that volatility, both on the upside and downside, producing a more stable return pattern. There is no free lunch to investments, but diversification may just be the next best thing when it comes to investing. By investing in a broad range of asset classes, it allows a client to reduce risk while simultaneously enhancing returns, based on a client's risk tolerance and investment objectives.

## 03

### Provide stability and peace of mind

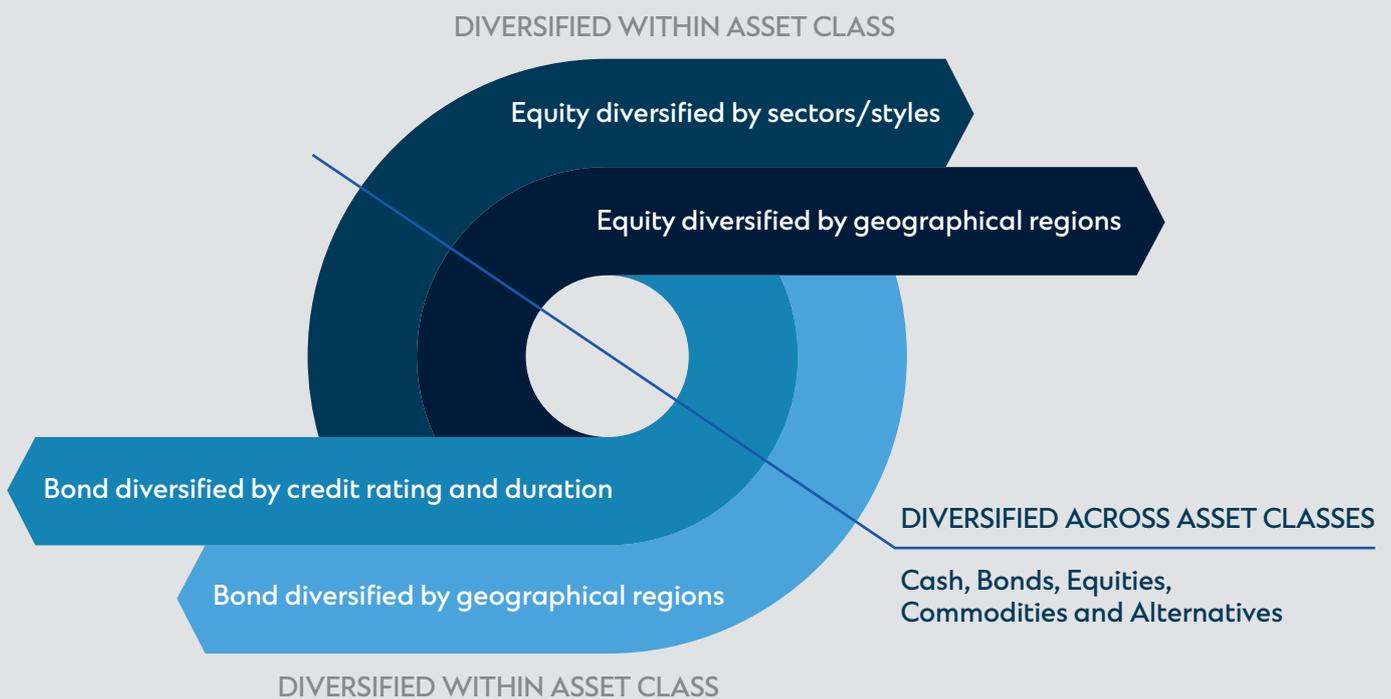
Investing is not just about the destination, the journey matters too. Higher stability in performance from a diversified portfolio can bring investors much-needed peace of mind in this multi-year and even multi-decade long journey. Markets will swing from optimism to pessimism and back, often very quickly. We believe 'time in the market' is absolutely critical to long-term investment success. Against this backdrop, the greatest risk to investors is taking emotional decisions in the heat of the moment – for instance selling allocations after sharp declines. A well-diversified portfolio likely see lower losses compared to one which is highly concentrated in risky assets, hence, enabling investors to stay the course and be less susceptible to make suboptimal investment decision driven by emotions.



# What are the different ways to diversify?

We believe there are two ways to diversify your portfolio: across asset classes and within asset classes.

Diversification across and within asset classes



Source: Standard Chartered.

## Diversify equity exposure by regions and sectors/ styles

### By asset classes

One of the simplest to diversify your investment is across broad asset classes such as cash, bonds, equities, commodities and alternative investments. Most of these major asset classes do not move in concert with each other and they tend to behave differently under the same market conditions (table on Page 4). For example, in times of heightened uncertainty, equity markets tend to do poorly while gold may shine, delivering positive returns. Equities have tended to outperform during periods of growth, while returns on cash tend to be low. So the idea is, regardless of which assets are the winners or losers, a well-constructed and diversified portfolio across different asset class should be able to provide a more stable return pattern.

### Within asset class

To further improve the robustness of your overall investment portfolio, investors can consider diversifying their investments within the same major asset classes such as within bond and equity.

Different parts of equity markets may move in unison in the short term, however, major shifts in economic regimes or market sentiment can still create large differentiation in performance across equity regions over the long term. For example, in very high inflationary environment, emerging markets (EM) equities tend to outperform developed markets (DM) peers, given their greater exposure to commodities (table below). EM equities may also be more sensitive to country specific policy changes and developments, such as in China.

### EM equity performance supported by commodities prices in higher inflation regimes

Average 12m returns in different inflation regimes (since inception\* to 2021)

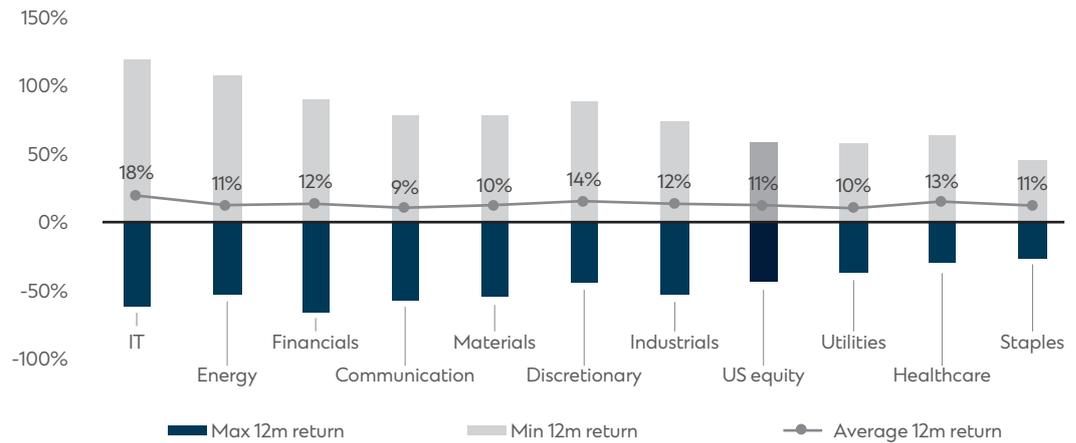
|               | Low   | Moderate | High  | Very high |
|---------------|-------|----------|-------|-----------|
| US            | 13.1% | 9.6%     | 0.8%  | -10.7%    |
| EU            | 8.8%  | 9.9%     | 0.3%  | -8.5%     |
| UK            | 6.9%  | 8.1%     | 3.1%  | -10.5%    |
| Japan         | 7.2%  | 9.9%     | -2.2% | -9.7%     |
| Asia ex Japan | 12.3% | 17.9%    | 8.8%  | 0.9%      |
| Other EM      | 9.2%  | 18.7%    | 9.7%  | -7.9%     |

Source: Bloomberg, Standard Chartered. \*Different inception dates are used for different equity indices.

Within the same equity region, investing in sectors can allow an investor to benefit from certain industry-specific trends. However, in general, performance of equity sectors tends to be more volatile than that of overall broad region. In the chart below, we note that, historically, the broad US equity market can provide similar average returns with much less volatility. The gap between the best and worst performances of US equity is much narrower than that of most sectors. It suggests that a broad diversified equity exposure across sectors can be more beneficial for investors over long term.

## A broad US equity exposure can provide similar level of return with less volatility

Average, min and max 12m return across different US sectors (1995 – 2022)



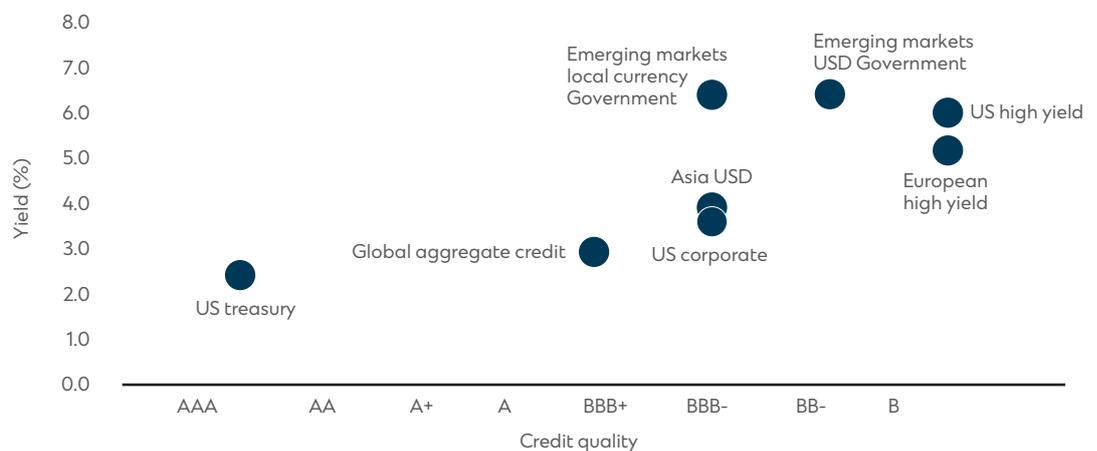
Source: Bloomberg, Standard Chartered.

## Diversify bond exposure by regions and credit rating

Bond investors can diversify their investment not only by regions but also by credit quality depending on their investment objectives and risk tolerance. Investors can go down the credit quality curve to achieve a higher income (chart below). However, this comes at the expense of higher credit risks. Investors can also consider EM bonds, which offer a higher yield for similar credit quality in DM. However, it is important to note that these high yielding bonds can experience similar drawdowns as risky assets in a risk off scenario (chart on Page 9). A diversified bond allocation may offer a more attractive risk-reward, with lower downside risk and lesser exposure to idiosyncratic credit risks.

## Lower credit quality bonds are generally compensated by higher income

Current yield to worst vs. credit quality buckets

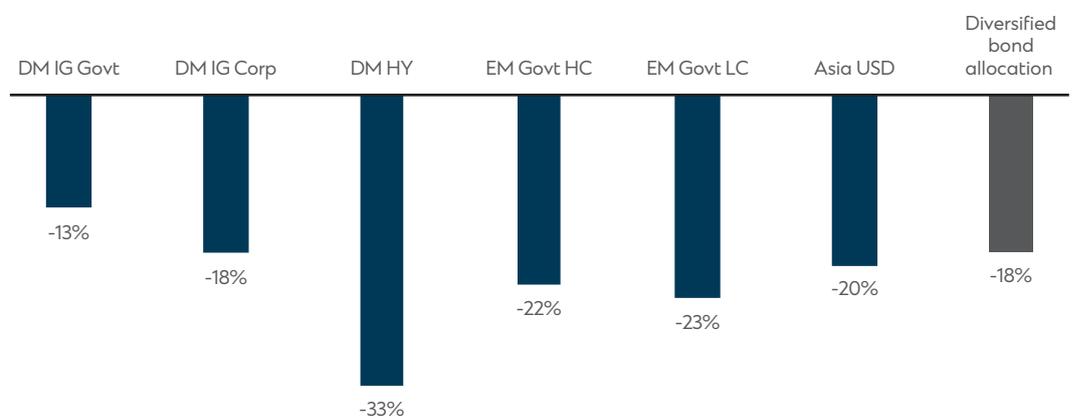


Source: Bloomberg, Standard Chartered.



## A diversified bond allocation can offer comparable level of income with lower potential drawdown

Max drawdown of major bonds components (2005 – 2022)



Source: Bloomberg, Standard Chartered. A balanced allocation is proxied by 18% DM IG Govt, 24% DM IG Corp, 18% DM HY, 13% EM USD Govt, 13% EM LCY Govt and 13% Asia USD bonds.

# How can you start diversifying your investments or portfolio today?

Behind every investment success, is a robust, long-term plan.

A robust plan starts with defining an investor's goals, risk tolerance, time horizon and other potential considerations, and having a solid foundation as an essential building block as part of a long-term investment strategy.

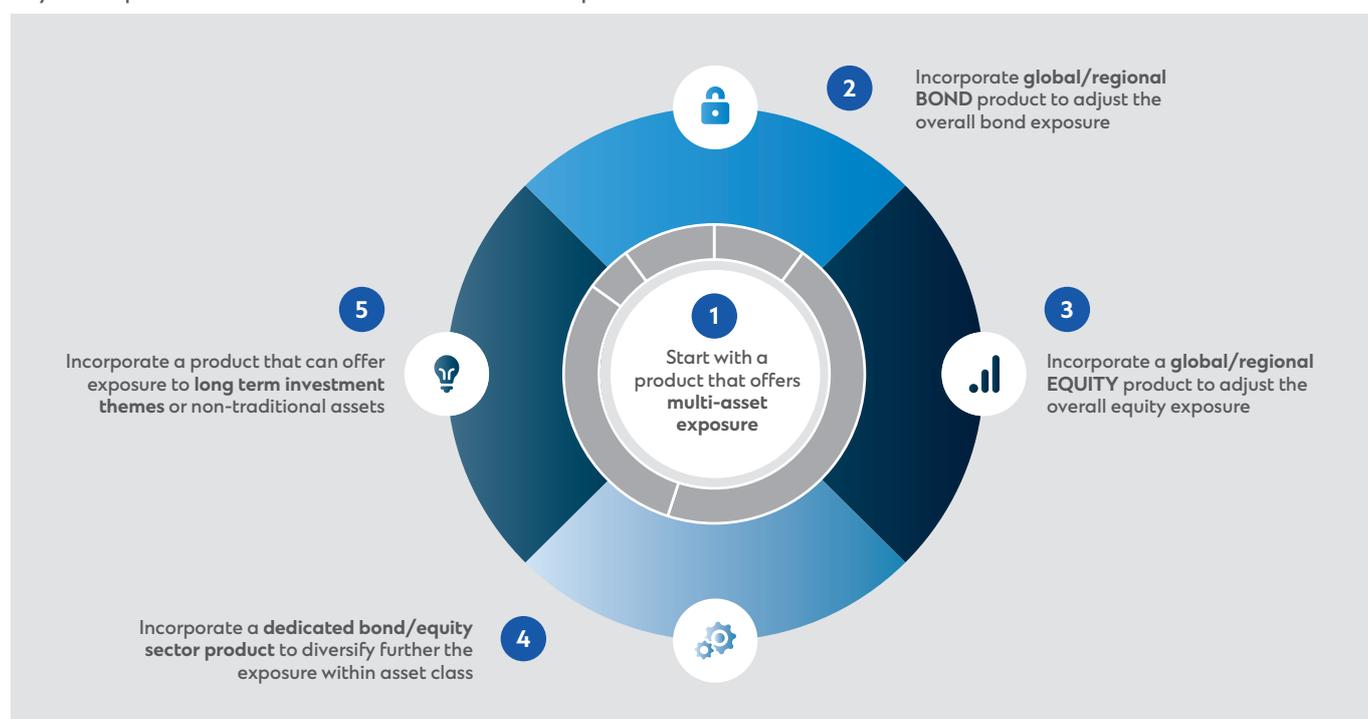
For investors who are just starting out their investment journey, it may be a challenge and costly to identify the right mix of assets to construct a properly diversified portfolio. An investor may need to buy more than 20 individual investments which requires large financial commitment and transaction costs. Therefore, a more efficient option for investment diversification may be for investors to first start off with a diversified multi-asset

product that can offer exposure across assets. Investors can then incorporate a global/regional bond or equity bucket to achieve the desired allocation of bond and equities, as seen in diagram below.

## The bottom line

Diversification does not mean that your investment is protected from all losses. After all, it is impossible to eliminate all risks completely. That said, when done right, diversification can help reduce the risk and magnitude of potential losses, allowing investors to stay the course against short term market fluctuations and continue to accumulate their wealth over the long run.

Stylized process to construct a diversified portfolio under various constraints

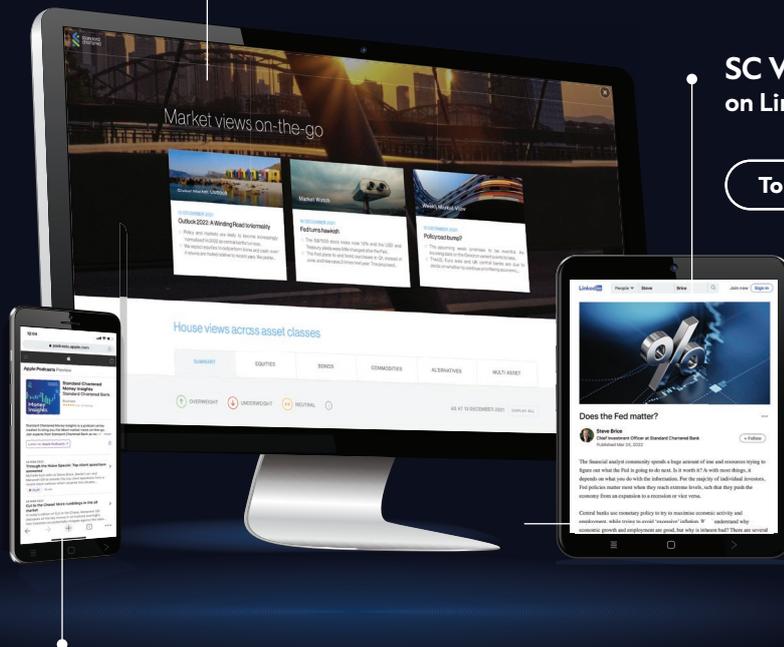


Source: Bloomberg, Standard Chartered

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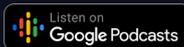
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