What is an asset class, really?

The term refers to a group of assets with similar exposure to the fundamental drivers of the economy, of which only a handful really make a difference.

Today, diversification and alternative returns are our top portfolio concerns. Why? Because low interest rates may have driven valuations of stocks, bonds, and other asset classes to unsustainable heights, so we’re forever on the lookout for uncorrelated assets to incorporate into our portfolios.

And of course, product providers are all too happy to accommodate us, touting everything under the sun as a new asset class that can diversify risk.

But let’s take a step back and consider what an asset class is in the first place. There is no universally accepted definition. Some describe it as a financial asset with certain cash flows. But then commodities wouldn’t qualify. So maybe an asset class has to pay a risk premium. But then cash and money market investments wouldn’t count either.

Here’s the definition I’ve been using: an asset class is a group of assets with similar exposure to the fundamental drivers of the economy. The problem with this interpretation, of course, is that it simply shifts the question one level up. It’s like saying that life didn’t start on Earth but was brought here by aliens. But how did alien life start, then? So, the ultimate question is: what are the economy’s fundamental drivers, and how do they influence different asset classes?

The economy has many drivers, but only a handful really make a difference. Those are:

- Growth
- Inflation
- Human ingenuity
- Labour
- Land
- Resources and infrastructure
- Greed

Some of these – growth, inflation, and human labour – are self-explanatory. Others require a little more context.

What I mean by greed is the human desire to want more of everything, money in particular. The urge to create more wealth out of existing capital is at the heart of the entire financial industry.

What it all means

All of this reveals something both important and obvious: we don’t need many different asset classes in our portfolios.

The deluge of “alternative” assets are mostly a relabeling of exposures to these various fundamental drivers. So the next time someone comes along promoting the benefits of, say, aircraft leasing as an asset class, we can refer to the chart and see that this “asset” is simply an expression of greed: it’s a credit instrument with a touch of economic growth exposure thrown in. Which, if we already have stocks and high-yield exposure in our portfolios, won’t add much in the way of diversification benefits.

Many alternative asset classes aren’t truly different. This tends to become glaringly obvious when a crisis hits and all the “uncorrelated” alternative assets suddenly nosedive in tandem with stocks. So why not avoid such a painful realisation? After all, all markets do focus on the exposure to these fundamental drivers and their expected future development. So by breaking down what our assets are exposed to, we can anticipate how they’ll react in a crisis.

CFA SINGAPORE INSIGHTS

By Joachim Klement

How it all lines up, really?

Asset classes and their fundamental drivers

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Illustration: PIGEON.COM

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Joachim Klement, CFA, is a trustee of the CFA Institute Research Foundation and offers regular commentary at Klement on Investing. Previously, he was CIO at Wellershoff & Partners Ltd, and before that, head of the UBS Wealth Management Strategic Research team and head of equity strategy for UBS Wealth Management.