GLOBAL EQUITIES

Is diversification merely a myth?

Diversification often dissipates during extreme market events. Being able to identify assets that offer high diversification potential is therefore crucial.

In the previous section (see p.26) we discussed the use of rand-hedge SA-listed stocks to protect, diversity and hedge against rand weakness in relation to domestic equities as a South African investor's predominant growth asset. We concluded that the merits of that investment case are far from conclusive and that each stock needs to be analysed on its own fundamental merits, as they behave idiosyncratically and not as one homogenous group according to the single driver of the rand exchange rate.

What of other asset classes, like offshore listed shares? Legae Peresec's paper discusses diversification and the previous research they have carried out in this field. Among other observations, they point out that diversification seems to disappear exactly when one needs it, most in extreme or left tail events, such as stock market crashes, particularly those brought about by global events. In such circumstances, positive correlations of most assets tend to increase significantly. This behaviour is coined the "myth of diversification".

In previous research by Legae, in 2013, they determined that the myth of diversification does indeed hold true for the majority of SA assets, with most assets displaying significant unattractive positive correlation asymmetry when paired against each other. Therefore, asset pairs generally became increasingly similar on the downside and increasingly different on the upside. Specifically, they found that local property and global equities provided poor forms of diversification for the local equities market.

Interestingly, the Resi-10 did provide attractive downside diversification.

However, there were some good diversifiers. Implied volatility, currency and interest rates (fixed income assets) showed negative or near-zero asymmetries in all given asset combinations. Local and global bond markets showed very high downside diversification potential.

In Legae's 2018 paper, this research was updated. The outcomes were similar -- there are still some asset pairs that provide appealing downside diversification. In particular, Legae found that implied volatility, global fixed bonds (in foreign currency) and local fixed-income assets act as natural diversifiers for the local equities market, with good downside protection and negative correlation in the event of a domestic equity sell-off, and little or positive correlation in the event of a domestic equity positive return.

This is the ideal asymmetrical pay-off for a diversifying asset versus domestic equities. Global equities, on the other hand, showed positive correlation (i.e. did not protect) in the case of a negative left tail ALSI return, and a smaller positive correlation (i.e. also produced high returns, but to a lesser extent) in the case of a positive right tail ALSI return -- not a helpful diversifier to domestic equities.

Research by Mark Sarembock and Petrus Bosman of Avior Capital Markets (Avior) in a paper entitled Strategic Asset Allocation for CPI+ Benchmark Funds: A Deeper Dive in November 2018, came to some similar conclusions insofar as global assets are concerned. Avior was interested in determining the optimal strategic asset allocation to achieve the highest probability of outperforming various real return or inflation plus objectives, as measured on a three-year rolling period.

Avior noted that from 1 January 1998 to 28 February 2018, rolling three-year asset class returns indicated that domestic equities were quite highly correlated to global equities. Avior concluded that, to achieve the optimal asset allocation for a CPI+5% return objective within Regulation 28 confines and without using hedged building blocks as investable assets, a high allocation to domestic bonds (slightly above 40%), about 25% to domestic equity and property and small allocations to gold and African equities (about 5% or less) was optimal. Interestingly, the balance, allocated to offshore assets, was exclusively to fixed-income assets -- US government bonds and US High Yield Corporate Bonds, with no allocation to global equities.

While Avior's research included in-depth analysis concerning various hedging strategies and other aspects of portfolio optimisation given varying parameters, for the purposes of this article, the aspect of most significance was that their findings tended to corroborate that of Legae's with respect to the optimal offshore asset allocation, based on fixed-income assets.

Sanlam Multi Manager International (SMMI) carried out conditional correlation analysis from January 2013 to December 2018 to examine these conclusions and broke the history into three regimes when the rand appreciated or depreciated, and the JSE All Share Index (JSE) produced...