IMPERIUM CAPITAL

momentum

Global Matters Weekly

TISATAAFL

29 June 2020

– Andrew Hardy, CFA

Not that there aren't enough acronyms flying around the investment world already, but today I will reference a lesser known one – only to debunk it. TANSTAAFL: "there ain't no such thing as a free lunch". The etymology is uncertain, but the principle is intuitive; there aren't many things in life that come for free without some form of cost, be it direct or indirect, explicit or implicit. However, there is one (and only one) in finance – diversification. Most famously highlighted by Harry Markowitz, Nobel Laureate and pioneer of investment theory, this has underpinned several decades of progress towards building more sophisticated, more resilient approaches to portfolio management. Although well diversified portfolios have arguably disappointed versus expectations this year, we believe they are more relevant than ever in today's market environment and should continue to be the strategy of choice for long term investors.

First, some caveats. True diversification requires careful research, analysis and consideration. There is no 'free lunch' available from just assembling a portfolio that is diversified only by names – a list of different companies or funds that have similar return drivers or characteristics. Also, although defensive assets are often regarded as the best diversifiers for a portfolio, they usually reduce long term return potential. Instead, the 'free lunch' argument is strongest when one considers investments with similar return prospects but different drivers and characteristics. This underpins the long-term case for a multi-asset investment approach; combining asset classes and individual securities that are less than perfectly correlated, resulting in portfolio volatility that is lower than the sum of the parts.

However, through the crisis period in February and March, well diversified strategies lagged some that were more narrowly invested. High growth stocks and government bonds mostly held up well, but most other asset classes were hit much harder and cross asset correlations rose to their highest levels in over 20 years. Volatility spiked to over 5x the level of the prior five years in the case of corporate bonds and listed real estate, while even global government bonds collapsed 9% over a 10-day period in March. Some of these moves were consistent with past crises, but the extent of the underperformance of areas such as real estate and infrastructure and the sell-off in corporate bonds were very unusual.

This talks to why well diversified strategies did not provide as much downside protection as may have been expected but should not be viewed as undermining the long-term case for portfolio diversification.

Instead, such an extreme and unexpected scenario should remind us of the fundamental reason for seeking diversification. In what is a similarly possible and extreme theoretical scenario of a cyber virus, the market moves may have been turned on their head with investments in the physical world holding up instead of those in the digital world. The so called 'FANGS' (comprising Amazon, Netflix and the like) may be great businesses and ones that we all enjoy the benefits of, but with a universe of thousands of securities to choose from, should an investor in US equities really have nearly a quarter of their money in those few companies like passively managed strategies have?

There's a natural tendency to concentrate portfolios into yesterday's winners, either through a passive approach that chases winners by design or as the path of least resistance. Some of the greatest value that professional investment managers can add is through countering the behavioural biases that so often undermine investor returns. Periods of dislocation create high levels of mispricing and present opportunities to multi-asset investors like us and the specialist managers we allocate to. As markets have rebounded since late March many multi-asset strategies have exceeded expectations, particularly those which were invested for the long term and didn't cut risk at that point of most pain. We believe this outperformance can continue as many parts of markets – including sub-investment grade bonds, real estate securities and value stocks – remain at depressed levels and are paying investors handsomely as providers of capital whilst they wait for a recovery. Many offer yields in the mid to high single digits, compared to near zero for most high growth stocks and government bonds.

Perhaps the coronavirus will threaten portfolios once again, but risks abound and it's the ones that catch investors by surprise that we should worry about most. There are many known unknowns that could come into greater focus, such as around the US election or a resurgence in trade wars, as well as many unknown unknowns. As was well put by another Nobel Laureate, Neils Bohr: "prediction is very difficult, especially if it's about the future!". At a time when explicit portfolio insurance - in the form of traditional defensive assets or options strategies - is relatively expensive, genuine diversification should be ever more appealing.

The **Marketplace**

- Global reported cases of Covid-19 passes 10 million with over 500k deaths.
- IMF revise outlook on global economy: now forecast a -4.9% contraction vs -3.0% previously.
- Brent crude fell -2.8% ending the week at $41.0 a barrel
- Gold rose 1.6% ending the week at $1771.3 an ounce

Market **Focus**

US

- 33 US states now have an R number over 1.
- An all-time high of new daily cases of Covid-19 was recorded on Saturday, at over 45,400.
- Existing home sales in the US fell to 3.9m annualised, against 4.1m expected.
- The latest weekly initial jobless claims numbers were 1.5m initial claims against 1.3m expected (for the week through 20th June).
- The US has listed 20 Chinese companies, including Huawei Technologies Co, that it states are owned/ controlled by the Chinese military and thus are open to additional US sanctions.
- The Senate approved a measure to punish banks doing business with Chinese officials that are involved in the security law China is intending to impose on Hong Kong.

Europe

- European officials may exclude US travellers when reopening borders next month following the recent rise in cases.
- The ECB announced an expansion of €600bn for their Pandemic Emergency Purchase Programme.
- The Euro area composite PMI was 47.5 against 43 expected for June.
- Germany estimated their R number is now 1.8 after being below 1.0 earlier in June.
- The Ifo business climate indicator from Germany rose to 86.2 against 85 expected in June.

UK

- The number of new daily cases fell below 1,000 for the first time since the full lockdown began in March.
- PM Johnson announced a significant easing of restrictions in England to come into effect on 4th July – including reducing the 2m social distancing rule to 'one metre plus'.
- He also announced that the UK will undergo large spending on hospitals, schools, and other areas to stimulate the economy and rejected a potential return to the austerity policies following the 2008 financial crisis.

Asia/Rest of The World

- EU leaders warned the Chinese president of unfavourable consequences over its plan to impose a national security law in Hong Kong.
- Kim Jong Un ordered the suspension of military action against South Korea.
- Negotiations between China and the EU on an investment treaty are entering a "critical stage" to address issues in the two sides' trading relationship.

Past performance is not indicative of future returns.

Source: Bloomberg. Returns in local currency unless otherwise stated.

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Asset Class/Region	Currency	Currency returns			
		Week ending 26 June 2020	Month to date	YTD 2020	12 months
Developed Market Equities					
United States	USD	-2.9%	-1.1%	-6.2%	4.7%
United Kingdom	GBP	-2.1%	1.3%	-17.9%	-15.2%
Continental Europe	EUR	-1.7%	3.2%	-9.7%	-1.5%
Japan	JPY	-0.3%	0.9%	-7.2%	5.3%
Asia Pacific (ex Japan)	USD	0.3%	8.4%	-5.9%	0.7%
Australia	AUD	-0.6%	2.6%	-10.4%	-7.8%
Global	USD	-2.3%	0.5%	-7.7%	1.7%
Emerging markets equities					
Emerging Europe	USD	-1.4%	1.5%	-23.3%	-15.4%
Emerging Asia	USD	0.5%	8.6%	-3.2%	6.2%
Emerging Latin America	USD	-4.3%	4.7%	-35.6%	-32.8%
BRICs	USD	-0.1%	8.2%	-7.3%	0.8%
China	USD	0.2%	9.1%	3.6%	14.4%
MENA countries	USD	-0.8%	2.2%	-15.9%	-15.8%
South Africa	USD	-1.1%	9.2%	-25.0%	-25.4%
India	USD	2.3%	8.4%	-19.2%	-18.9%
Global emerging markets	USD	-0.2%	7.7%	-9.5%	-2.4%
Bonds					
US Treasuries	USD	0.6%	0.3%	9.4%	11.5%
US Treasuries (inflation protected)	USD	0.6%	1.3%	6.5%	9.1%
US Corporate (investment grade)	USD	-0.1%	1.9%	4.9%	10.0%
US High Yield	USD	-1.1%	1.3%	-3.5%	0.5%
UK Gilts	GBP	1.1%	-0.5%	10.0%	11.9%
UK Corporate (investment grade)	GBP	0.7%	1.6%	3.3%	7.0%
Euro Government Bonds	EUR	0.4%	1.1%	2.1%	2.9%
Euro Corporate (investment grade)	EUR	0.0%	1.4%	-1.1%	-0.2%
Euro High Yield	EUR	-0.4%	2.0%	-5.2%	-1.8%
Japanese Government	JPY	0.0%	-0.3%	-0.9%	-1.6%
Australian Government	AUD	-0.1%	0.0%	4.0%	4.1%
Global Government Bonds	USD	0.4%	0.6%	4.7%	5.6%
Global Bonds	USD	0.2%	0.9%	3.6%	5.1%
Global Convertible Bonds	USD	-0.6%	2.3%	4.2%	9.1%
Emerging Market Bonds	USD	-0.2%	1.8%	-0.4%	1.3%

Source: Bloomberg. Past performance is not indicative of future returns

Asset Class/Region	Currency	Currency returns			
		Week ending 26 June 2020	Month to date	YTD 2020	12 months
Property					
US Property Securities	USD	-3.4%	0.0%	-21.2%	-14.8%
Australian Property Securities	AUD	-2.0%	0.6%	-20.2%	-24.8%
Asia Property Securities	USD	-2.3%	3.7%	-17.6%	-16.3%
Global Property Securities	USD	-4.4%	1.7%	-20.5%	-14.2%
Currencies					
Euro	USD	0.3%	1.2%	0.0%	-1.3%
UK Pound Sterling	USD	-0.2%	0.3%	-6.9%	-2.8%
Japanese Yen	USD	-0.3%	0.6%	1.3%	0.5%
Australian Dollar	USD	0.2%	3.4%	-2.2%	-1.7%
South African Rand	USD	0.4%	1.7%	-19.1%	-17.7%
Swiss Franc	USD	0.4%	1.5%	2.0%	3.2%
Chinese Yuan	USD	-0.1%	0.8%	-1.6%	-2.8%
Commodities & Alternatives					
Commodities	USD	-2.6%	1.5%	-27.3%	-25.3%
Agricultural Commodities	USD	-2.3%	-1.6%	-13.2%	-13.3%
Oil	USD	-2.8%	16.1%	-37.8%	-38.3%
Gold	USD	1.6%	2.4%	16.3%	25.4%
Hedge funds	USD	0.3%	1.9%	-1.0%	3.5%

Source: Bloomberg. Past performance is not indicative of future returns

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