

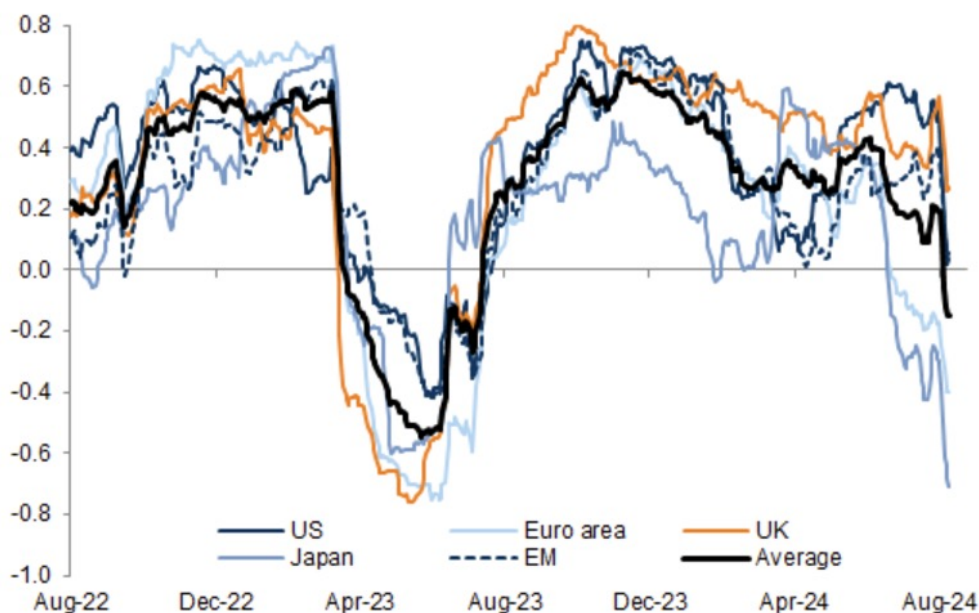
The Benefits of Diversification

Sir John Templeton famously said “The only investors who shouldn’t diversify are those who are right 100% of the time. Unfortunately, in the fund management industry, we operate in a world where even some of the very best portfolio managers only get around 60% of their stock selection decisions right. In our experience, this success rate is even lower when it comes to fund managers making heroic asset allocation calls.

In the 1950s, in creating his Modern Portfolio Theory, Nobel Prize winner Harry Markowitz introduced the concept of creating the “optimal portfolio” with diversification at its core in order to achieve the highest return relative to risk. This led to the concept of the 60/40 portfolio with 60% held in equities to provide the long term return generation but with associated volatility and periodic large drawdowns, and 40% in bonds to provide a lower but more stable return profile, hopefully also proving to be a “safe haven” when equity markets are in decline.

Unfortunately theory and practice can differ significantly for long periods and, with interest rates and inflation at record lows for long periods up until the Covid crisis, the optimal ratio would have been very different. In more recent years, we’ve also seen the negative correlation between equities and bonds that was core to some of Markowitz’s conclusions become much less reliable with equities and bonds often moving in the same direction. In the most recent period of market volatility, this correlation has moved negative once more.

3m rolling equity/bond correlation of weekly returns



Source: Datastream, Goldman Sachs Global Investment Research

Who can also forget the Liz Truss “episode” in 2022 where those investors that held UK gilts as their protection saw their “safe-haven” bond portfolios suffer losses of up to 40% just as equity markets were also in drawdown.

These often rapid swings in market direction and correlation between asset classes are extremely hard to time. This is why, at YOU Asset Management, within our multi-asset funds and portfolios we are big believers in maintaining prudent diversification by asset class, by geography and by investment style at all times.

Our fixed income portfolios are not simply focused upon the UK but are globally diversified. Although we could never have predicted the gilt crisis in the UK, this global diversification proved highly advantageous when UK gilts were in turmoil. Within our multi-asset funds, we have also held exposures to idiosyncratic and uncorrelated fixed income opportunities like long dated US Treasuries, high quality Chinese bonds and local currency emerging market debt.

We also don't solely rely on fixed income to provide our clients with diversification versus equities. Within most risk profiles, we include further diversifying allocations to Absolute Return Strategies and to some more inflation-sensitive strategies like Managed Futures, Commodities and Listed Infrastructure. These sorts of asset classes have been commonplace within professionally constructed institutional portfolios for decades. With most of our senior investment team and Investment Committee members possessing decades of experience in the institutional investment arena, we understand the significant benefits these investments can provide to enhancing and diversifying our clients' portfolios.

For example, we estimate our Absolute Return blend of three quite different managers has delivered a combined return of over 10% over the last 12 months to the end of July 2024. More importantly for us, in a volatile period for markets due to high variability in interest rate expectations, these returns have been achieved with almost no sensitivity (or beta) to equity or fixed income markets.

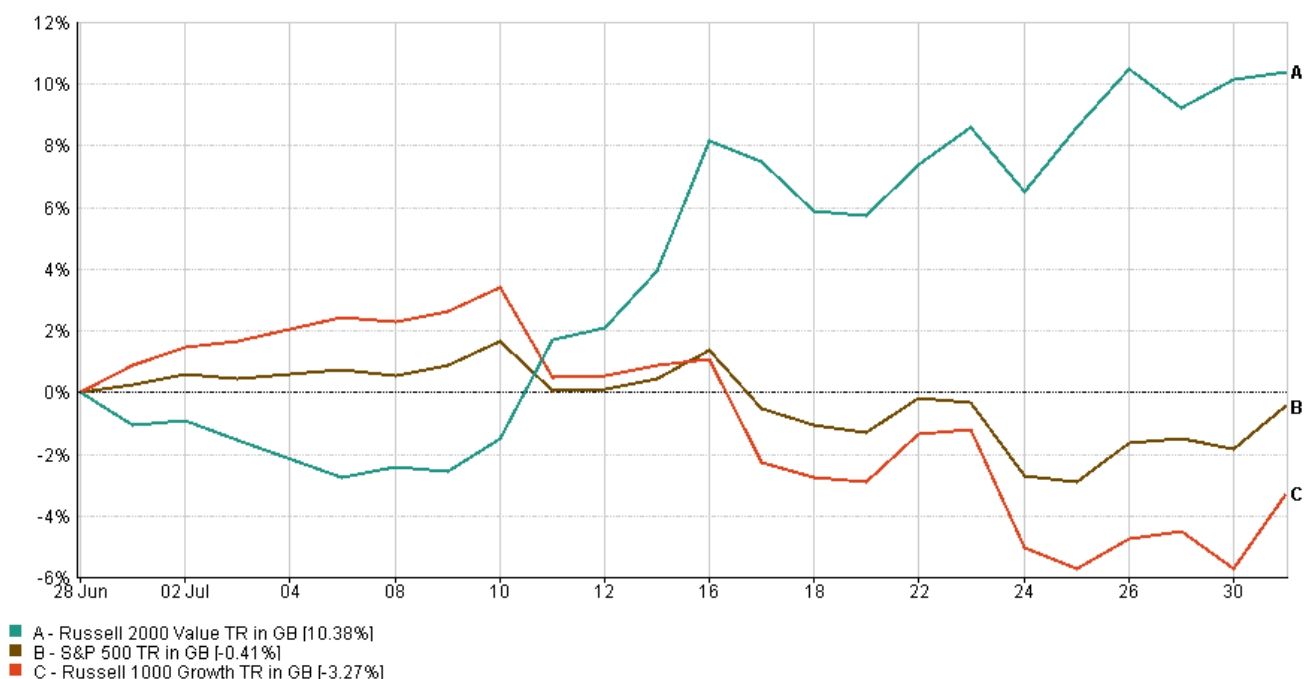
Of course, we still expect equities to be the long term driver of our clients' portfolios' returns. But even within equities, we seek diversification by geography and investment style. In this regard, our flagship Multi-Asset Blend Funds maintain exposure to a blend of active and passive equity managers within the UK, US, Japan, Continental Europe, Emerging Markets and Developed Markets.

And within each of these regional components, we employ a highly sophisticated and proprietary manager blending process to ensure that we utilise a collection of managers who provide highly differentiated but wholly complementary investment styles. This blending process is critical to our goal of using style diversification to smooth the pattern of outperformance within each region and ensure we have some exposure to whichever style is currently leading the way.

Although we fully appreciate that certain investment styles such as growth, value, large cap or small cap can outperform for lengthy periods, this leadership tends to reverse very sharply

and often when you least expect it. Look at the dotcom bubble in the 1999/2000 period where technology stocks were the only game in town until they fell off a cliff. Highly respected value oriented managers were losing their jobs, being cited as too old or out of date, just as their style paid off in style as the dotcom bubble burst.

Just last month, after a long period of the Magnificent Seven tech stocks in the US leading the market higher, we witnessed a sharp reversal again. As you can see from the chart below, having been unloved for some time, small cap value stocks as measured by the Russell 2000 Value Index suddenly outperformed large cap growth stocks (Russell 1000 Growth) by over 13% in a single month!



28/06/2024 - 31/07/2024 Data from FE fundinfo 2024

This is why we believe it is so important to maintain a blend of styles within a well constructed investment portfolio. Timing these style or factor rotations is notoriously difficult and by heeding Sir John Templeton’s words and understanding you will not be right anywhere near 100% of the time, we believe a carefully constructed portfolio that is diversified by asset class, region and investment style can set you up for a successful long term investment journey.

You may ask whether our theory works in practice. In July, the IFSL YOU Multi-Asset Blend Balanced Fund and ISFL YOU Multi-Asset Blend Growth Fund both passed their 5 year anniversaries and their long-term focused, diversified approach has helped place both funds in the top quartile of their respective peer groups in terms of both return and return relative to risk taken. With the Balanced Fund recently crossing £1 billion and the Growth Fund surpassing £500 million and YOU Asset Management’s total assets under management about to cross £3 billion, there are a growing group of well informed clients who understand that diversification really is your friend.



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