CIO Academy

Diversification 3.0

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Contributors

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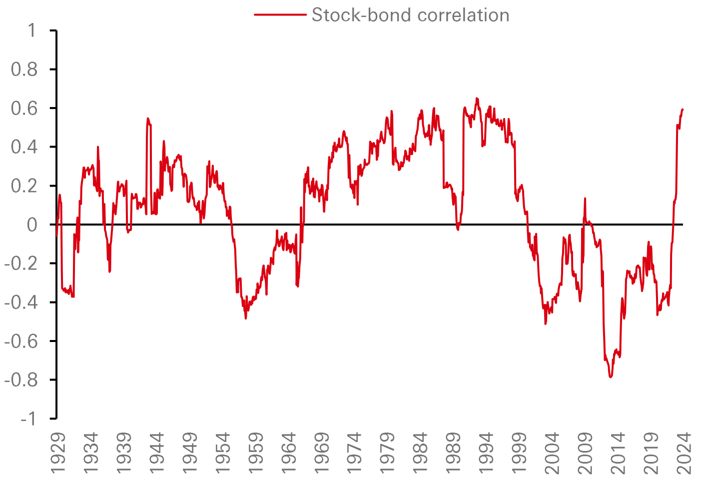
Our investment process has a firm commitment to diversification. Usually, this is seen as a necessary step to help manage volatility; this is particularly relevant for the moment as correlations have increased. But we also see diversification as a way to broaden the opportunity set. Both objectives point to the need to move from 'lazy' diversification using just stocks and government bonds to an 'active search for diversification' including sub-asset classes within fixed income and equities, as well as alternatives, including private markets and infrastructure.

The challenge

During most of the period following the 2000 dot-com crash, government bonds have been the go-to asset for portfolio diversification. The correlation between the S&P 500 and a diversified basket of US Treasuries averaged -0.3 during this period. This led to a historically exceptional outcomes for simple stock-bond portfolios in the 20-year period, as diversification was very easy to achieve.

Looking at the longer historical sample, the correlation between stocks and bonds has in fact been positive in most historical periods. While many investors may anchor their expectation to the period between 2000 and 2020 simply due to having experienced it first-hand, the data shows that this was an outlier. Importantly, the correlation has significantly increased in the post-COVID world. Relying only on government bonds to achieve diversification no longer seems sufficient, and we need to look for opportunities elsewhere.

Figure 1: Historical stock-bond correlation



Source: Bloomberg, University of Lausanne, HSBC Private Banking, as of February 2024. The red line represents 3 year rolling correlation between the monthly returns of the S&P 500 Index and US Treasuries.

High inflation and a big focus on central bank's actions is to blame, in our view. And although inflation is down from its peak, it may well remain higher than what we experienced in the past decade. We believe that we are now back in the regime where the correlation may once again remain in the positive territory for the foreseeable future.

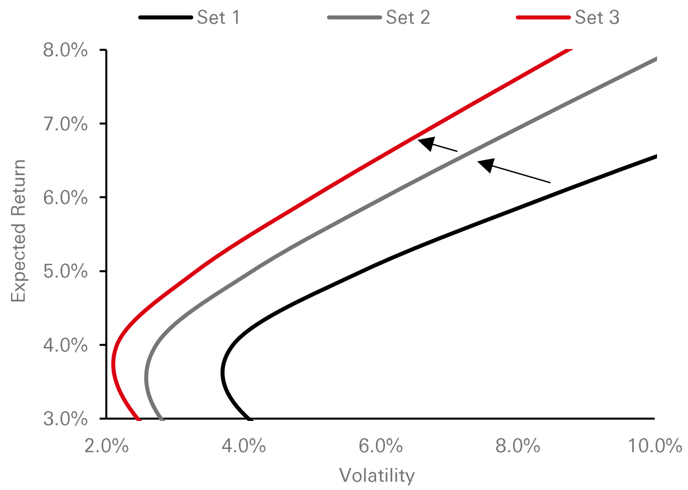
The solution

How can investors diversify their portfolios when stocks and bonds are moving in tandem? The simple answer it to look for additional sources of returns that are not perfectly correlated. We start with investment grade credit, which is an essential asset class, but in this regime also has limitations on its value-add due to effectively being a bundle of duration risk (present in the government bond allocation), and credit risk (related to equity risk of listed large-caps).

We broaden the opportunity set in Figure 2, which represents the mean-variance frontiers, based on our latest capital market assumptions. As investment grade and government bonds are more highly correlated to equities than usual, we need to actively seek additional diversification opportunities elsewhere, and first examine the benefit of adding other sections of the income generating asset classes and strategies. And indeed, we can observe that better portfolios ('Set 2') can be built by expanding the universe to include High Yield, Emerging Market Debt, Securitised and Catastrophe ("Cat") bonds, as well as Covered Call strategies. So where appropriate and available to investors, we like to consider these strategies as a means of reducing risk and/or increasing expected portfolio return over the long term. In our view, they bring additional, differentiated return sources to the portfolio, without sacrificing liquidity.

We note that we could make a similar observation for equities: while equities overall are more highly correlated with bonds than usually, the correlation between different equity sectors, and the correlation between different geographical equity markets is relatively close to the historical average. So diversifying within the sub-parts of global stock markets is important.

Figure 2: Unconstrained efficient frontiers for various sets of asset classes



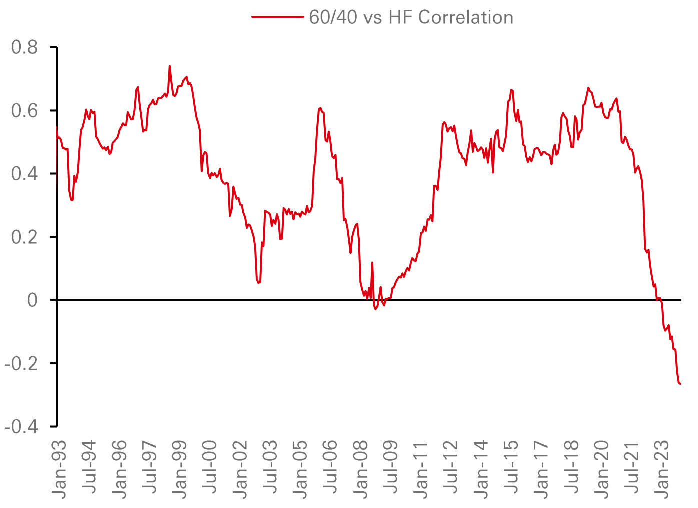
Source: HSBC Asset Management, HSBC Private Banking, as of February 2024. The projections are based on our latest expected returns with the 10 year horizon. Set 1 includes Developed and Emerging Market Equities, Investment Grade Credit and Global Government Bonds. Set 2 includes Set 1 plus Global High Yield, Hard and Local Currency Emerging Market Debt, Catastrophe Bonds, and Covered Call strategies. Set 3 includes Set 2 plus Private Equity, Private Credit, Direct Real Estate, Infrastructure and Hedge Funds.

Coming back to the multi-asset approach and our Figure 2 above, even more diversification can be achieved by introducing less-liquid allocations across private markets and hedge funds (Set 3). Key private market allocations include private equity, credit, real estate, and infrastructure. As most of the businesses in the US and around the world are actually not listed on the stock exchange, investing privately allows investors to substantially expand their opportunity set.

Direct private investments are managed in a highly active manner, which can generate additional sources of return, above and beyond those of listed investments, and less correlated to the market direction. Due diligence and active influence on the underlying holdings present a unique source of alpha that is very difficult to attain in public markets. Further upside potential sits in manager selection due to high dispersion across private market fund returns, which is driven by portfolio concentration and limited overlap between different funds.

As for infrastructure, we like both its opportunity set and diversification potential. A world which is characterised by digitalisation, the net-zero transition and re-onshoring efforts, a lot of infrastructure will need to be built in coming years. From a return perspective, a solid and predictable income stream can help reduce volatility. And the fact that income is often linked to inflation makes it different from most other sources of income, adding to diversification potential.

Figure 3: Correlation between macro hedge funds and the 60/40 portfolio



Source: Bloomberg, University of Lausanne, HSBC Private Banking, as of February 2024. The red line represents 3 year rolling correlation between the monthly returns of the HFRI Macro Total Index and the 60/40 mix of S&P 500 Index and US Treasuries.

Compared to long-only funds that carry a substantial market exposure, Hedge Funds are unconstrained, able to take on both long and short positions, and hedge market risk. Figure 3 shows the historical correlation between Macro Hedge Funds and simple stock/bond portfolios. The return of macroeconomic and policy volatility has pushed markets firmly back into the "old normal" regime, and we are now seeing that hedge funds have become even more valuable in the portfolio context, as reflected by their presently negative correlation with balanced portfolios. We expect that the markets would remain in this regime for quite some time, and therefore emphasise the importance of maintaining an allocation to hedge funds for all diversified investors, where appropriate and available.

Conclusion

As we return to the "old normal" regime of positive correlation between defensive fixed income and equities, portfolio diversification requires a more nuanced approach and some "outside the box" thinking. For investors with a strong preference for liquidity, this means incorporating additional fixed income markets in their portfolios, such as High Yield, Emerging Market Debt, Securitised Credit, Cat Bonds, and Covered Call strategies, where appropriate and available. Investors with a meaningful illiquidity budget can further push out the efficient frontier by allocating to private equity, private credit, direct real estate, infrastructure, and to a range of hedge fund strategies.

Risk Disclosures

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Risks of investment in fixed income

There are several key issues that one should consider before making an investment into fixed income. The risk specific to this type of investment may include, but are not limited to:

Credit risk

Investor is subject to the credit risk of the issuer. Investor is also subject to the credit risk of the government and/or the appointed trustee for debts that are guaranteed by the government.

Risks associated with high yield fixed income instruments

High yield fixed income instruments are typically rated below investment grade or are unrated and as such are often subject to a higher risk of issuer default. The net asset value of a high-yield bond fund may decline or be negatively affected if there is a default of any of the high yield bonds that it invests in or if interest rates change. The special features and risks of high-yield bond funds may also include the following:

- Capital growth risk - some high-yield bond funds may have fees and/ or dividends paid out of capital. As a result, the capital that the fund has available for investment in the future and capital growth may be reduced; and
- Dividend distributions - some high-yield bond funds may not distribute dividends, but instead reinvest the dividends into the fund or alternatively, the investment manager may have discretion on whether or not to make any distribution out of income and/ or capital of the fund. Also, a high distribution yield does not imply a positive or high return on the total investment.
- Vulnerability to economic cycles - during economic downturns such instruments may typically fall more in value than investment grade bonds as (i) investors become more risk averse and (ii) default risk rises.

Risks associated with subordinated debentures, perpetual debentures, and contingent convertible or bail-in debentures

- Subordinated debentures - subordinated debentures will bear higher risks than holders of senior debentures of the issuer due to a lower priority of claim in the event of the issuer's liquidation.
- Perpetual debentures - perpetual debentures often are callable, do not have maturity dates and are subordinated. Investors may incur reinvestment and subordination risks. Investors may lose all their invested principal in certain circumstances. Interest payments may be variable, deferred or cancelled. Investors may face uncertainties over when and how much they can receive such payments.
- Contingent convertible or bail-in debentures - Contingent convertible and bail-in debentures are hybrid debt-equity instruments that may be written off or converted to common stock on the occurrence of a trigger event. Contingent convertible debentures refer to debentures that contain a clause requiring them to be written off or converted to common stock on the occurrence of a trigger event. These debentures generally absorb losses while the issuer remains a going concern (i.e. in advance of the point of non-viability). "Bail-in" generally refers to (a) contractual mechanisms (i.e. cotractual bail-in) under which debentures contain a clause requiring them to be written off or converted to common stock on the occurrence of a trigger event, or (b) statutory mechanisms (i.e. statutory bail-in) whereby a national resolution authority writes down or converts debentures under specified conditions to common stock. Bail-in debentures generally absorb losses at the point of non viability. These features can introduce notable risks to investors who may lose all their invested principal.

Contingent convertible securities (CoCos) or bail-in debentures are highly complex, high risk hybrid capital instruments with unusual loss-absorbency features written into their contractual terms.
Investors should note that their capital is at risk and they may lose some or all of their capital.

Changes in legislation and/or regulation

Changes in legislation and/or regulation could affect the performance, prices and mark-to-market valuation on the investment.

Nationalisation risk

The uncertainty as to the coupons and principal will be paid on schedule and/or that the risk on the ranking of the bond seniority would be compromised following nationalisation.

Reinvestment risk

A decline in interest rate would affect investors as coupons received and any return of principal may be reinvested at a lower rate. Changes in interest rate, volatility, credit spread, rating agencies actions, liquidity and market conditions may have a negative effect on the prices, mark-to-market valuations and your overall investment.

Risk disclosure on Dim Sum Bonds

Although sovereign bonds may be guaranteed by the China Central Government, investors should note that unless otherwise specified, other renminbi bonds will not be guaranteed by the China Central Government. Renminbi bonds are settled in renminbi, changes in exchange rates may have an adverse effect on the value of that investment. You may not get back the same amount of Hong Kong Dollars upon maturity of the bond.
There may not be active secondary market available even if a renminbi bond is listed. Therefore, you need to face a certain degree of liquidity risk. Renminbi is subject to foreign exchange control. Renminbi is not freely convertible in Hong Kong. Should the China Central Government tighten the control, the liquidity of renminbi or even renminbi bonds in Hong Kong will be affected and you may be exposed to higher liquidity risks. Investors should be prepared that you may need to hold a renminbi bond until maturity.

Alternative Investments

Hedge Fund - Please note Hedge Funds often engage in leveraging and other speculative investment practices that may increase the risk of investment loss. They can also be highly illiquid, are not required to provide periodic pricing or valuation information to investors, and may involve complex tax structures and delays in distributing important information. Alternative investments are often not subject to the same regulatory requirements as, say, mutual funds, and often charge high fees that may potentially offset trading profits when they occur.
Private Equity - Please note Private Equity is generally illiquid, involving long term investments that do not display the liquid or transparency characteristics often found in other investments (e.g. Listed securities). It can take time for money to be invested (cash drag) and for investments to produce returns after initial losses.

Risk disclosure on Emerging Markets

Investment in emerging markets may involve certain, additional risks which may not be typically associated with investing in more established economies and/or securities markets. Such risks include (a) the risk of nationalisation or expropriation of assets; (b) economic and political uncertainty; (c) less liquidity in so far of securities markets; (d) fluctuations in currency exchange rate; (c) higher rates of inflation; (f) less oversight by a regulator of local securities market; (g) longer settlement periods in so far as securities transactions and (h) less stringent laws in so far the duties of company officers and protection of Investors.

Risk disclosure on FX Margin

The price fluctuation of FX could be substantial under certain market conditions and/or occurrence of certain events, news or developments and this could pose significant risk to the Customer.

Leveraged FX trading carry a high degree of risk and the Customer may suffer losses exceeding their initial margin funds. Market conditions may make it impossible to square/close-out FX contracts/options. Customers could face substantial margin calls and therefore liquidity problems if the relevant price of the currency goes against them.

The leverage of a product can work against you and losses can exceed those of a direct investment. If the market value of a portfolio falls by a certain amount, this could result in a situation where the value of collateral no longer covers all outstanding loan amounts. This means that investors might have to respond promptly to margin calls. If a portfolio's return is lower than its financing cost then leverage would reduce a portfolio's overall performance and even generate a negative return.

Currency risk – where product relates to other currencies

When an investment is denominated in a currency other than your local or reporting currency, changes in exchange rates may have a negative effect on your investment.

Chinese Yuan ("CNY") risks

There is a liquidity risk associated with CNY products, especially if such investments do not have an active secondary market and their prices have large bid/offer spreads.

CNY is currently not freely convertible and conversion of CNY through banks in Hong Kong and Singapore is subject to certain restrictions. CNY products are denominated and settled in CNY deliverable in Hong Kong and Singapore, which represents a market which is different from that of CNY deliverable in Mainland China.

There is a possibility of not receiving the full amount in CNY upon settlement, if the Bank is not able to obtain sufficient amount of CNY in a timely manner due to the exchange controls and restrictions applicable to the currency.

Illiquid markets/products

In the case of investments for which there is no recognised market, it may be difficult for investors to sell their investments or to obtain reliable information about their value or the extent of the risk to which they are exposed.

Environmental, Social and Governance ("ESG") Customer Disclosure

In broad terms "ESG and sustainable investing" products include investment approaches or instruments which consider environmental, social, governance ('ESG') and/or other sustainability factors to varying degrees. Certain instruments we classify as sustainable may be in the process of changing to deliver sustainability outcomes. There is no guarantee that ESG and sustainable investing products will produce returns similar to those which don't consider these factors. ESG and Sustainable investing products may diverge from traditional market benchmarks. In addition, there is no standard definition of, or measurement criteria for, ESG and sustainable investing or the impact of ESG and sustainable investing products. ESG and Sustainable investing and related impact measurement criteria are (a) highly subjective and (b) may vary significantly across and within sectors. HSBC may rely on measurement criteria devised and reported by third party providers or issuers. HSBC does not always conduct its own specific due diligence in relation to measurement criteria. There is no guarantee: (a) that the nature of the ESG / sustainability impact or measurement criteria of an investment will be aligned with any particular investor's sustainability goals; or (b) that the stated level or target level of ESG / sustainability impact will be achieved. ESG and Sustainable investing is an evolving area and new regulations are being developed which will affect how investments can be categorised or labelled. An investment which is considered to fulfil sustainable criteria today may not meet those criteria at some point in the future.

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