



Diversification is working better than ever

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Several big ticket announcements in recent weeks in London, Washington and Beijing are the latest attempt by authorities to restore some confidence and order to the global financial system. The market reaction to each of these announcements reminds investors of an important lesson on diversification: the Bank of England and US Federal Reserve are to buy billions of pounds worth of government debt and yields plummet; US treasury secretary Tim Geithner announces a bank rescue package which lacks detail and shares slide only to rebound sharply when details are forthcoming; China hints at a new package of stimuli and commodities soar.

Anticipating the likely asset-class leaders around each lap of the economic cycle is difficult so it makes sense, especially at such uncertain times, to hold a well-diversified portfolio of stocks, bonds, commodities and cash. Such a mix of assets would have performed well over the past 30 years with a low level of volatility.

However, this doesn't get away from the fact that there are clearly good times and bad times to hold each asset class. Each time a bull-run in one asset class comes to a halt, the baton passes to another. When equities peaked in 2007, commodities surged. When commodities ran out of steam in mid 2008, government bonds started their charge. When the world economy recovers from its current difficulties, stocks will take up the running once more. This is where tactical asset allocation comes in.

To get the most out of multi-asset investing investors need to tilt their exposure in the right direction at the right time. To recognise these opportunities requires an understanding of the economic cycle. There are four phases identifiable by gauging the strength of the world economy and the direction of inflationary pressures. In each phase, a particular asset class tends to offer its best performance.

Right now, the world economy is very firmly in the "Reflation" phase, characterised by economic weakness and falling inflation rates. This calls for a defensive strategy overweighting bonds and underweighting equities and commodities. With central banks slashing interest rates, government securities are performing very well and look set to continue now the sovereign buyers have entered the market on such a massive scale.

So should investors abandon equities and put all of their savings into gilts? Certainly not! Bond investors risk missing out on substantial gains in equity, property and commodity markets when growth finally recovers. They could also suffer losses when risk aversion abates and today's feverish buying interest dries up.

Economic momentum is still to the downside but investors should keep in mind that the cycle is likely to hit its low point this year or early next after an unprecedented array of stimulus from governments and central banks. President Obama is pushing through economic stimulus at a furious pace and the US Federal Reserve is expanding the money supply, mirroring the policy that got America out of a tailspin in the 1930s. Global economic recovery relies on these measures to work and this (hyper) activity is encouraging.

Shares are beginning to look good value when compared to earnings and asset values and dividend yields are high. Interest-rate sensitive consumer cyclicals and defensive industries such as consumer staples and healthcare are most attractive to start with. Financial and property stocks are likely to recover strongly when the current ultra-loose monetary policy takes effect. Economic recovery and a new bull market will not be far behind. By retaining some exposure to equities but balancing this with other asset classes, a long term investor can be there at the bottom – without suffering too much pain on the way down.

