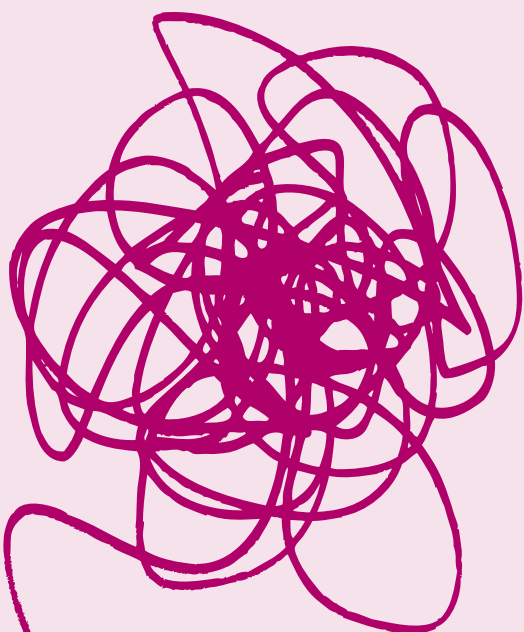


Recent market performance

The benefits of diversification

October 2011



“One notable aspect of the volatility that we have seen during August and September is that not all markets have been affected equally.”

Recent months have seen dramatic moves in a number of markets as investors come to terms with the deteriorating growth outlook for the global economy and the increase in sovereign risk in a number of developed countries.

However, one notable aspect of the volatility that we have seen during August and September is that not all markets have been affected equally. This has meant that investors that have introduced more diversification into their portfolios have been rewarded with significant outperformance relative to those that invest predominantly in equities.

Of course, this performance means little over such a short period of time. In this note we have set out the longer-term case for diversification and our approach to building portfolios that can balance true diversity of return with most investors’ desire not to overcomplicate their asset structure.

Recent market performance

In **Figure 01** we have provided both the short- and longer-term returns for a series of asset classes. Each of the non-equity asset classes has the important characteristic that it is represented by a widely referenced and liquid index.

It is clear that equities have fallen significantly further than the other asset classes shown during the period. Whilst we would not expect this pattern to be repeated to the same extent over the longer term (as indeed it has not), we do believe this demonstrates the benefits that diversification can bring both through dampening portfolio volatility and adding to return (both short and long term).

Figure 01. Many asset classes outperformed equities during August and September 2011

Asset class	August and September (%)	1 year (% pa)	3 years (% pa)
Global equities	-12.8	-6.3	-0.7
Global investment grade credit	-0.9	1.7	9.3
Emerging market debt	-6.1	-1.5	-
Emerging market currency	-4.1	-2.7	6.4
High-yield debt	-8.0	-0.2	12.9
Commodities	-9.6	0.5	-1.5
Reinsurance	2.3	4.7	8.6

Sources: MSCI, Barclays, JP Morgan, Credit Suisse, FTSE, Dow Jones, Bloomberg

During the financial crisis of 2008/09, the use of diversification was widely discussed due to the significant falls that occurred across a much broader spectrum of asset classes. In fact, though it is true to say that correlations between asset classes did increase during the period of most extreme risk aversion, diversification still provided significant benefits relative to a portfolio consisting predominantly of equities. **Figure 02** and **Figure 03** provide further information on the asset class returns and correlations during this period.

What drives asset returns?

Diversification means more than buying a range of different asset classes.

Figure 02. Returns during the credit crunch: October 2007 to February 2009

Asset class	Total return
Global developed equities	-43%
Emerging market equities	-35%
Global investment grade credit	-4%
Commodities	-35%
Reinsurance	-33%
Loans	-19%
UK Property	-25%
Global REITS	-58%
Emerging market debt	-8%
High yield	5%

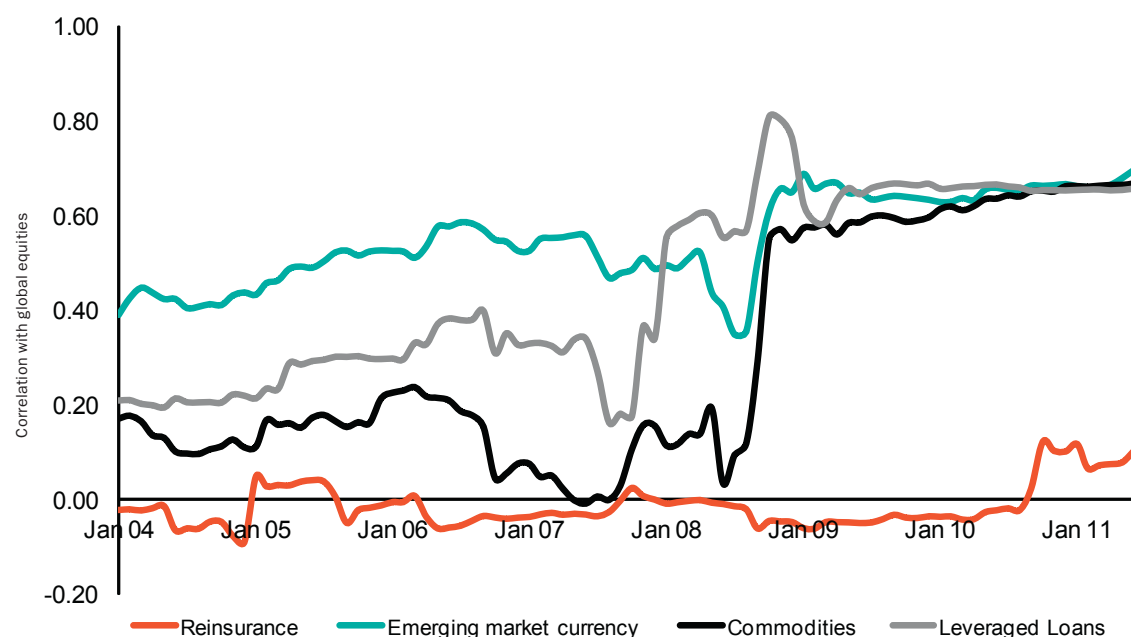
We have identified a range of 'return drivers' (see **Figure 04**) that we believe explain the return from asset classes. When considering how best to diversify a portfolio, it is not sufficient to just buy different asset classes, one must consider what drives the return of each asset class and ensure the portfolio has a broad exposure a wide range of return drivers.

In the past, it has been observed that most investors have been predominantly exposed to the equity return driver to deliver positive performance of their investment portfolio. A number of the new asset classes that have been introduced (for example, emerging market equity, private equity, some hedge fund strategies) still rely heavily on the 'equity risk' return driver to deliver positive performance. As a result, portfolios that might appear well diversified on paper remain relatively concentrated in a small number of return drivers.

Active manager diversification is important too

Recent market conditions have not only caused significant return differences between asset classes but also caused increased dispersion of manager returns within an individual asset class. For example, amongst our most highly rated hedge fund managers, returns for the month of August have ranged from +7.5% to -13.4%. Such results should probably not be surprising, even amongst skilled managers – bouts of risk aversion and changing market conditions will naturally favour different styles and approaches.

Figure 03. Rolling five year correlation with global equities



Source: Towers Watson, Bloomberg

Figure 04. We believe in using a range of different 'return drivers', examples of which are:

Equity Risk Premium (ERP): The future earnings from companies are uncertain leading investors to demand higher returns as compensation

Insurance: Investors who are providing insurance to another party expect to be rewarded

Time: Investors will demand compensation for holding assets that cannot be quickly or cheaply sold

Credit: Bond issuers may default on their obligations and not make repayments of capital or interest and so must offer returns above less risky government bonds

Skill: Skilled investment managers may be able to outperform the average and generate 'alpha'

This dispersion highlights that manager performance can be much more extreme than many investors realise in stress conditions, often exceeding the reported 'tracking error' of the fund.

A portfolio tracking error reflects the range around a benchmark that is expected roughly two thirds of the time. The rest of the time, performance is expected to be at least that far away from the benchmark, and could be a lot further away.

It is for this reason that we have for a long time advocated diversifying active manager risk. Those taking this approach should think carefully about the portfolios and approaches of each manager and combine different managers into a robust portfolio that is expected to perform well in a range of market conditions.

What can you do?

To many people, the subject of diversification can create fears over investing in obscure asset classes and having large numbers of manager relationships to juggle.

We believe that diversification is essential for all investors but needs to be carried out by focusing on return drivers. This can help to identify asset classes that fit well with your existing portfolio – often these can be accessed simply and at low cost (there are now a large number of 'passively managed' alternative asset classes). This approach to diversification will also avoid the situation that some investors have experienced whereby they have a lot of asset classes, a lot of managers but not much diversification

If the latest period of volatility has taught us anything, it is that outcomes are very uncertain and therefore it is riskier than ever for investors to put all of their eggs in one basket.

Further information

For further information, please contact your Towers Watson consultant.

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