

When diversification doesn't work, then what?

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Graham Bentley, a Director of the Marlborough Group's IFSL International, explains why he believes advisers should question the habitual inclusion of high bond exposure to mitigate risk in multi-asset portfolios.

Diversification is an industry basic. "Don't put all your eggs in one basket" seems sensible advice; the assumption is that what happens to one basket is unlikely to be repeated with the other. However, if you're carrying two baskets and fall downstairs...

Most client portfolios are described as 'Balanced' or 'Cautious', featuring relatively heavy investment in debt issued by companies and governments, i.e. bonds. Bonds' returns carry more certainty than equities; they pay investors a fixed amount of interest and make a fixed capital repayment at maturity, however their price fluctuates beforehand. Consequently, investors focus on yields, not prices. Equities, conversely, are not obliged to pay a dividend and shares are only worth whatever someone pays for them. When investors worry about companies' earnings and share prices falling, bonds appear more attractive. If shares' yields rise (because their prices have fallen) then we expect bond yields to fall (and their prices to rise).

It is almost axiomatic therefore that diversification of a portfolio between equities and bonds should lower overall risk. This has been the experience for the last 20 years, with bond yields tending to move in the same direction as share prices - both up and down. The relationship between bond and equity yields is therefore generally assumed to be negative.

Today, ultra-low interest rates have engendered historically low bond yields. Yet remarkably, share prices remain high, because the 'safer' bond alternative provides so little reward; even high yield (aka junk) bonds in the US currently yield less than inflation. Relative risks are out of kilter; despite all-time high relative valuations, equities are currently perceived to be less risky given their superior longer-term returns (and competitive dividend yields) versus bonds. Yet bonds continue to dominate DB pension scheme portfolios, while many advisers habitually steer investing clients to perceived lower risk portfolios, despite bond and equity returns becoming highly correlated.

This is an accident waiting to happen. A negative correlation between share and bond yields is not the norm. Most notably, the late 20th Century saw the two assets positively correlated for 30 years, when inflation was a real concern. Bond investors' greatest fear is inflation. Bond prices fall because inflation eats into the value of the future interest payments; prices fall as yields rise to compensate, but also because interest rates generally rise to keep inflation in check. Under the relationship described above, rising bond yields should mean rising share prices. However, in inflationary times I should expect to pay less today for my future inflation-eroded earnings and dividend stream.

The post-COVID boom as economies reopen has caused production and supply bottlenecks that are in turn forcing up prices, in some cases quite steeply. US inflation rates are now at a 13-year high, while in the UK CPI is above the Bank of England target.

Fears of economic overheating are rising. The world's major central banks have been pumping astonishing amounts into their respective economies for more than 12 years. They did this by buying back billions of dollars and pounds-worth of bonds every month, thus ensuring an 'artificial' high demand, hence maintaining low yields (and higher bond prices). For younger advisers, this activity is 'normal'. For those of us with more than four decades of asset management experience, it is an unprecedented central bank strategy that will sooner or later have to be unwound, with no precedent on which to gauge the potential effects. If the US Federal Reserve counters the inflationary trend by turning off their QE taps and raising interest rates in a bid to keep inflation under control, bond prices could fall significantly. Indeed, the price of the world's 'risk-free' asset, the US 30-year Treasury Bond, fell 20% in the first quarter of this year.

Both bond and equity prices are currently at historically high valuations; any evidence of a sustained resurgence of above-target inflation could signal a significant revaluation of bonds



with an associated dramatic impact on the 'classic' balanced portfolio, where most retail investors find themselves invested.

Advisers need to question the habitual inclusion of high bond exposure to mitigate portfolio risk, challenging their providers' strategies to ensure Cautious and Balanced fund investors' forecast outcomes remain valid. Investors' long-term interests are best served by a focus on well-diversified

equity portfolios, incorporating large and small companies along with value and growth styles. This is the best defence against inflation. Marlborough's risk-managed portfolios carry higher equity and lower bond exposure than is typical for their sectors. This is with the intention of ensuring that the potential purchasing power of your clients' portfolios is maintained and indeed enhanced.

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To find out more about the Marlborough International Guernsey-domiciled feeder fund range and Fund of Fund range please contact:

Rod Guest

+44 (0) 7540 115891

rod.guest@marlboroughinternational.gg

Linda Johnstone

+44 (0) 7986 972844

linda.johnstone@marlboroughgroup.com

Further information is also available at www.marlboroughinternational.gg

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 **Marlborough International Management Limited, Town Mills South,
La Rue du Pre, St Peter Port, Guernsey, GY1 3HZ, Channel Islands**

 **Investor Support: +44 (0)1204 589 336**

 **Email: enquiries@marlboroughgroup.com**

 **Website: www.marlboroughinternational.gg**

 **Administrator: (Postal applications) EPEA Fund Services (Guernsey) Limited, Suites 7 & 8,
Fourth Floor, Windsor House, Le Pollet, St Peter Port, Guernsey, GY1 1WF**

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