Invesco Global Solutions

Why diversification may be coming back in style

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Key takeaways

- There are two main challenges we believe investors will need to navigate in 2018.
- Our estimated returns for equities and bonds are trending lower than they were five years ago.
- We expect volatility to increase from 2017's very low levels.

The Invesco Global Solutions team builds multi-asset, outcome-oriented portfolios that are diversified by asset class (stocks, bonds and commodities) and by investment style (active, passive, factor-based and alternative strategies). Therefore, when we think about our outlook for 2018, we look for themes that can help us reduce risk and boost return potential – and we're always on the lookout for blind spots that can pose an unexpected threat.

Key issues for 2018

The foundation of our process is the development of capital market assumptions – long-term forecasts for the behavior of different asset classes. Our expectations for returns, volatility and correlation serve as guidelines for our long-term, strategic asset allocation decisions.

Given our capital market assumptions, there are two main challenges we believe investors will need to navigate in 2018.

Return expectations are tepid across the markets.

Our estimated returns for equities and bonds are trending lower than they were five years ago. For example, in 2012, we expected S&P 500 Index returns of more than 7.5% and MSCI EAFE returns of more than 8.5%. In 2017, those expectations have slipped to less than 6% for each. On the fixed income side, our estimates for US high-yield corporate bond returns fell from 5.67% to 4.63% and for US investment grade corporates from 2.91% to 2.50%.

- **Equities.** Equity returns are being challenged by elevated valuations – a byproduct of the extended bull market rally for stocks – and dividend yields are coming down as well. As for the third component of returns – growth – we don't expect a significant enough increase to overcome the negative effects of valuation and yield. Developed markets are feeling the pressure more than emerging markets.
  - Our equity expectations lead us to be more constructive on the UK and Asia ex-Japan, neutral in the US and eurozone, and less optimistic about Japan.
- **Bonds.** We expect credit spreads to widen, as they are generally tight going into 2018. In our view, tight credit spreads argue for incrementally trimming high yield, lengthening duration and improving credit exposure.
  - Our fixed income expectations lead us to be more constructive on US mortgage-backed securities and less so for bank loans and high yield. Due to our expectations of a flatter term structure for interest rates, we see more value in seeking higher yields by moving out on the yield curve versus taking on more credit risk, an approach that may face headwinds in the near term from widening spreads.
  - Within emerging markets, our return expectations for bonds bottomed in 2016, two years after the energy/commodity sell-off in 2014 that impacted EM commodity exporters. But while our expectations have improved somewhat since then, we haven't yet seen a strong trend of improvement.

We expect volatility to increase, and believe a volatility shock is likely at some point.

The level of volatility experienced in 2017 is very low versus history. Over the past five years, the 22-day moving average of the VIX index has exceeded 20 only two times – and in the first 10 months of 2017, it hasn't crossed 15. The last spike in volatility was seen briefly after the US election in November 2016.

Compare that to the prior 10 years, when the VIX moving average was rarely below 20. We expect volatility to move higher toward more historical levels. At the same time, however, we expect correlations across asset classes to decrease, boosting the potential for diversification to help reduce overall portfolio risk.

Where are the potential blind spots?

When equity markets experience the type of extended rally that we've seen over the past nine years, it's very easy for investors to lose sight of the value of diversification. Not just among equities, fixed income and commodities – which is critical – but within each asset class as well.

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For example, in many of the portfolios that we analyze for our clients, we see significant exposure to credit and reduced exposure to duration within fixed income allocations. Because credit exposure has a higher historical correlation with stocks, this has led to equity-like exposure in a fixed income portfolio and removes the component of fixed income — duration — that is expected to provide a diversification benefit in periods of stress for stocks.

Another blind spot that we see is the use of alternatives. Alternative strategies by definition are designed to provide diversification, specifically during market stresses, and clearly investors in alternatives have waited a long time for this to pay off. However, given our market expectations, there may not be a more important time to own alternatives than now, when we believe the market could eventually shift from a late expansion stage to early contraction.

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What's important to understand about alternatives is what each particular strategy is designed to do, and how to fund your allocation. Different types of alternatives are expected to outperform in different markets, and whether you redirect money from stocks or bonds to buy an alternative strategy depends on your goals. There is no one "right" way to include alternatives in a portfolio.

Stay focused on diversification

In an environment where returns are compressed, volatility is expected to be higher and correlations among asset classes are lower. It is very important to be well-diversified. That's why we believe factor awareness is very important.

Different factors are expected to outperform or underperform in different types of environments. For example, when markets are highly volatile and risky assets are underperforming, our expectation is for low volatility and quality to outperform and momentum to underperform. When equities rise rapidly, we expect value and momentum to outperform and low volatility to underperform.

We view factors as another dimension to consider when building a diversified portfolio. In our process, once we address the overall asset allocation among asset classes, we then assess our diversification across factors. Ignoring this dimension can result in a portfolio that's overweighted toward a single factor, which can potentially cause unexpected underperformance in a multi-asset portfolio.

Important Information