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ASSET ALLOCATION AFTER A CRISIS: THE THREE D'S

It did not take long for the investing community to draw parallels between the pandemic-related market volatility of 2020 with the global financial crisis of 2008. Every recession is different, and every market correction has its own nuances, but there are some patterns that are common: risky assets post large negative returns, volatility metrics spike sharply, and everyone becomes concerned about liquidity. While we are still in the midst of this particular episode, we feel that it is also useful to look beyond the immediate circumstances to consider how investors should think about asset allocation. This can be summed up into three D's: Dislocations, Diversification, and Downside Protection.

Dislocations

It is generally well-known that when risky assets struggle, they all seem to struggle at the same time — "correlations all go to one" for the mathematically inclined. In volatile episodes such as this one, it is hard to find an asset class that has bucked the trend of the broader selloff. In theory, commodities could be an area which moves in a different direction, but that was certainly not the case during this period as a price war led to a supply glut concurrent with collapsing demand. Oil markets and broader commodity indices corrected sharply and any benefit that might have been derived from diversification was lost. It is important to keep in mind, however, that while all risky assets might correct, the degree to which they correct can be quite different.

The following chart illustrates two major dislocations that occurred in 2008:

Exhibit 1: Historical options-adjusted spreads (OAS)

Source: Bloomberg; Columbia Threadneedle Investments; through March 13, 2020. Option-adjusted yield spread versus equivalent Treasury security for the Bloomberg Barclays Mortgage-backed Securities index and the Bloomberg Barclays corporate high yield Index.

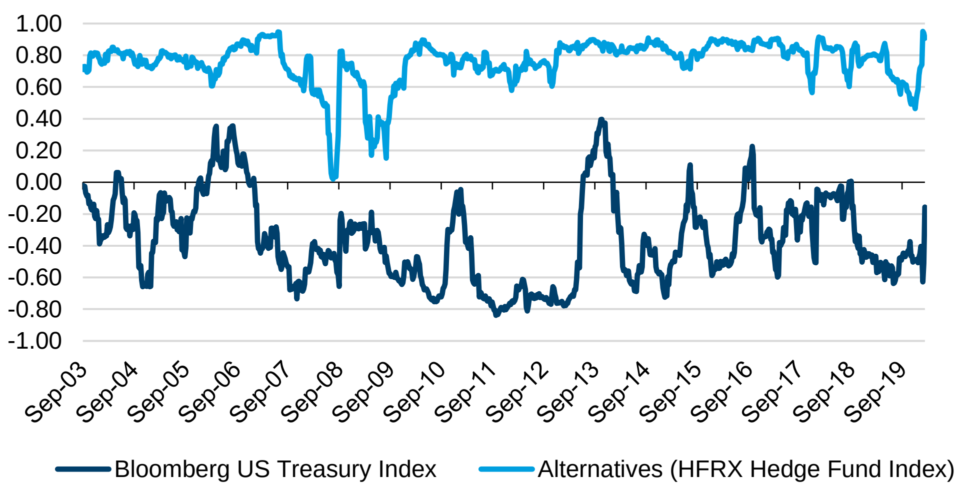
Both of these asset classes, high yield (HY) bonds and mortgage-backed securities (MBS) were at the heart of the market challenges in 2008. You can see that spreads spiked up considerably over that period. As of right now, in 2020, you can see that HY bonds are once again seeing a huge widening, but MBS have not moved much in comparison. This sort of analysis that looks at dislocations in asset classes gives us some hints about where the greatest opportunities would be following a crisis. We can look at the price movements across all risky assets — equities, credit markets, commodities and other alternatives — and look for the biggest opportunities for a rebound. Sometimes these dislocations are broad, such as a general high yield opportunity, and an investor can take advantage of it with a number of readily available vehicles. But other times, the dislocations occur in a narrow part of a market, such as a widening in a specific credit default swap contract, which can best be handled under the hood of a mutual fund.

Diversification

The ideal situation is for investors to be diversified during a market volatility episode, not after. But investor psychology does not always work that way. We saw investors growing increasingly frustrated with diversified portfolios in 2018 when concentration was being rewarded to an outsized degree. Why buy the whole equity market when a few key stocks can outperform it? Why buy a global portfolio when the U.S. equity market is outperforming international assets by double digits? And why buy any assets outside of equities when they are experiencing such attractive returns? At least in terms of equity concentration, the current environment is reminding investors why diversification was a good idea in the first place.

This chart looks at the rolling six month correlation of the S&P with two classic "diversifiers", U.S. Treasuries as well as alternatives (as measured by the Hedge Fund Research Global Hedge Fund Index):

Exhibit 2: Rolling six month correlations with S&P 500



Note: Bloomberg Barclays US Treasury Total Return index (from January 1, 2000); Hedge Fund Research Global Hedge Fund Index (from April 1, 2003) – through March 13, 2020. Source: Bloomberg; Columbia Threadneedle Investments.

Treasuries have been a very successful diversifier, both in terms of 2008 and the most recent years as well. Alternatives have had a different path. In the 2008 experience, they appeared to be good diversifiers, less correlated with equity markets.

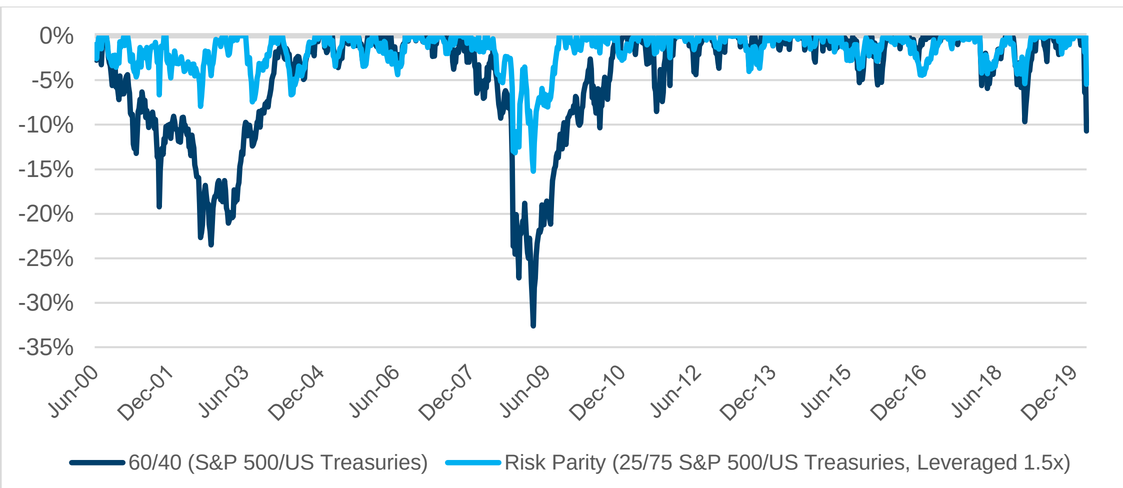
But in recent years, as well as in the current episode, many alternatives funds have behaved similarly to the market. What is different in 2020 relative to 2008? Part of it could be structural, with a lot more money having been place into alternative markets after their success during the previous crisis. Part of it could be that alternatives funds themselves have gravitated towards strategies linked to the direction of equity markets after years of watching success of those markets.

Regardless, this current market volatility calls a lot more attention to the need for diversification, the relevance of asset allocation portfolios, and the greater sophistication required to implement a diversified portfolio generally. Whether diversification is delivered via model portfolio, asset allocation funds, or constructed in a bespoke fashion, simply assembling assets is not enough; successful diversification also requires knowing how the asset mix needs to be adjusted to optimize non-directionality.

Downside safeguards

The challenges of 2008 resulted in a great deal of investment science attacking the problem of avoiding outsized negative returns. Risk measures such as VaR (value at risk) became important elements of investment oversight and have remained relevant through the present. One particular area that grew in popularity was risk allocation, the idea that developed from the notion that equity risk tends to dominate a multi asset portfolio given its higher volatility. By reducing equity exposure and substituting it with fixed income, one could then move toward more balanced total return outcomes. Charts such as this one appear in many of the cases for these sorts of strategies:

Exhibit 3: Drawdown comparison



Source: Bloomberg; Columbia Threadneedle Investments; January 1, 2000 through March 13, 2020. Leverage in the risk parity portfolio established through the use of futures.

This illustrates that a risk parity approach (which seeks to equalize the contribution of equity and fixed income risk) could have experienced much less severe drawdowns during the tech crisis and its aftermath, as well as in 2008-09. The strong returns of Treasuries in 2020 may make these sorts of strategies relevant again.

The idea of downside protection also highlights the need for sophisticated implementation. Risk parity strategies may be implemented on a static or adaptive basis. Strategies such as mean reversion, managed volatility and regime-based investing all require a trading capability that may make model delivery the optimal means of implementing these drawdown limiting approaches.

Conclusion

With market volatility still unabated, it is premature to declare the full degree to which the current period is similar or different from 2008. But we do know at this point that certain assets have experienced dislocations, diversification is being rewarded, and downside protection is an essential feature to portfolio construction. In this sense, the aftermath of the 2020 period can be assessed with a similar framework as 2008 and other market crises.

Disclosures

The **Bloomberg Barclays U.S. Mortgage Backed Securities (MBS) Index** covers agency mortgage-backed passthrough securities

The **Bloomberg Barclays U.S. Corporate High-Yield Index** measures the market of USD-denominated, non-investment grade, fixed-rate, taxable corporate bonds. Securities are classified as high yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below.

The **Bloomberg Barclays US Treasury Index** measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury.

S&P 500 Index includes 500 leading companies and covers approximately 80% of available market capitalization.

The **HFRX Global Hedge Fund Index** is designed to be representative of the overall composition of the hedge fund universe. It is comprised of all eligible hedge fund strategies; including but not limited to convertible arbitrage, distressed securities, equity hedge, equity market neutral, event driven, macro, merger arbitrage, and relative value arbitrage. The strategies are asset weighted based on the distribution of assets in the hedge fund industry.

It is not possible to invest in an index.

Diversification and asset allocation do not assure a profit or protect against loss. Investing involves risk including the risk of loss of principal.

Past performance does not guarantee future results. Important note: Charts are for illustrative purposes only and is not intended to represent any investment product.

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