Equity volatility highlights the importance of diversification

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In this Q&A, Josh Kutin discusses the importance of diversification and not being complacent about equity risk.

How unique is the current market volatility from an asset allocation perspective?

Josh Kutin: Every recession is different, and every market correction has its own nuances. A pandemic and intentional economic shutdown are unique, but some of the patterns we see are common: risky assets post large negative returns, volatility metrics spike sharply, and everyone becomes concerned about liquidity. It didn't take long for the investing community to draw parallels between the pandemic-related market volatility of 2020 and the global financial crisis of 2008.

Is this a market where it's helped to be a diversified investor?

Josh Kutin: The current market calls a lot of attention to the need for diversification. It's fairly well-known that when risky assets struggle, they all seem to struggle at the same time, or "correlations all go to one," for the mathematically inclined. In volatile episodes such as this one, it was hard to find an asset class that has bucked the trend of the broader selloff, but U.S. Treasuries have been very successful diversifiers.

Alternatives have been less beneficial, and in the past several years, many alternatives funds have behaved similarly to the equity market. Most recently, commodities, which should have been an area offering diversification, have failed to help — a price war led to a supply glut concurrent with collapsing demand.

Download the full paper: Asset allocation after a crisis: The three D's.

Joshua Kutin
Head of Asset Allocation, North America

Given what you've described, how can asset allocation strategies help?

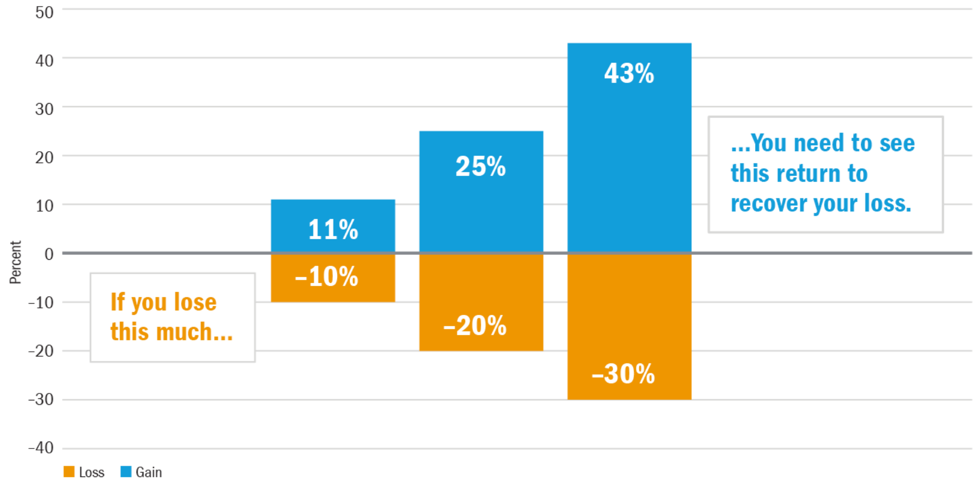
Josh Kutin: While broad asset classes may be moving in concert, we can look at the price movements across all risky assets — equities, credit markets, commodities and other alternatives — and look for the biggest relative opportunities for a rebound. Sometimes dislocations between assets are broad, such as a general high-yield opportunity, and an investor can take advantage of a number of readily available vehicles.

But other times, the dislocations can occur in a narrow part of the market — such as changes in a specific options contract — which may be better handled with professional management.

What should investors be thinking about when it comes to asset allocation strategies?

Josh Kutin: The pursuit of downside protection. The math of recovery makes it clear that losing less up front is essential to building long-term wealth. If an investor loses 50% on a $100 investment, they'd need a 100% gain to get back to zero. Asset allocation and diversification seek to minimize the amount you might lose. 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. At least in terms of equity concentration, the current environment is reminding investors why diversification was a good idea in the first place.

The math of recovery: Why minimizing losses matters



Source: Columbia Threadneedle Investments. This chart is intended to illustrate that as the percentage lost on principal value becomes greater, a larger percentage gain on the *remaining* principal is required to return to the original value invested.

Do you expect any long-term changes in asset allocation approaches?

Josh Kutin: After the market losses in 2008, there was a lot of effort put toward 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, and I think that we could see greater emphasis on this approach as investors recover from current market losses. Previously, this type of approach has not been used in strategies like target date funds, but it has tremendous application there. A strategy that seeks to mitigate losses through risk allocation, especially right before retirement, is invaluable.

Disclosures

Diversification and asset allocation do not assure a profit or protect against loss. Investing involves risk including the risk of loss of principal. Market risk may affect a single issuer, sector of the economy, industry or the market as a whole.

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