Time to diversify

Mike Brooks, senior investment manager at Aberdeen, examines the relationship between equity and bond markets, and the benefits of diversification in the current environment

In the eyes of many investors, bonds and equities enjoy a domestic relationship much like the man and woman in a traditional Alpine weather house. The female figure comes out with a sunshade when it's dry, while the man comes out with a macintosh when it looks set to rain – and they are never out of the house at the same time.

It's often assumed that, in the same way, stock and bond values will not move together. Rises in one of the two asset classes have compensated for falls in the other, and the overall performance of portfolios based on a simple blend of equities and publicly issued debt has been strong. On this rock of certainty many portfolios have been built.

But on closer inspection this rock has cracks in it. There have only been two periods since the Second World War when five-year rolling returns for US stocks and US government bonds have shown a negative correlation: 1955 to 1965 and, more recently, over the last 15 years or so. In other words, the anomaly is not when stocks and bonds move in the same direction; the anomaly is when they don't. This relationship is embedded in the 'Fed model' of markets – if the yield that an investor can earn on bonds goes down, agnostic investors should also be willing to accept lower yields on equities.

If the sunwoman and the rainman do again start to come in and out together more frequently, investors will be in for a bumpier ride than they have been used to – and there are a few reasons to be concerned that this may prove to be the case over the years ahead.

The prospects for equities look favourable at the moment, with more robust economic growth in developed markets and an orderly slowdown in China, an important market for many multinationals. However, let's imagine a global economic crisis that pushes down equity prices. This might push down bond yields too. But they are already so low that they cannot go much lower than they are now, so the compensation for investors who have lost money on equities will be small. The sunwoman who buys stocks may go inside, but the rainman who buys bonds cannot come out much further than he is already.

The likelihood of a severe crisis in global stock markets is low. But there is a plethora of less spectacular pressure points that could still create equity market volatility to the downside, while making only a small countervailing difference – to the upside – to bond values.

These include continuing problems in Greece and other members of the eurozone periphery, as well as uncertainty about the withdrawal and introduction of quantitative easing (the injection of money by central banks via government bond purchases) in its various forms – and perhaps most acutely, the expectation of rising US interest rates.

What can investors do, if stocks and bonds start to behave in the same way? The solution is to find investable assets that do behave differently. This is not uncharted, dangerous territory. Portfolios based simply on stocks and bonds are no longer the norm. These days portfolios can be bolstered with alpha strategies, property and infrastructure, to name but three extra asset classes.

Some of these asset classes can offer a low correlation with stocks or bonds, while still providing the growth that investors need. Infrastructure investments benefit from cash-flow generating assets – such as wind and solar panel farms – rather than the vagaries of the stock market. The burgeoning market in catastrophe bonds goes one step further: defaults have nothing to do with the economic forces that plunge bondholders into financial trouble, and everything to do with the damage caused by extreme natural events.

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This lack of correlation between different asset classes confers another advantage on multi-asset investing: it reduces the volatility of the overall portfolio, because the different asset classes tend to move in different directions from each other. This lower volatility also means that investors should, on average, earn a higher return for the amount of risk they're taking. Spock and Kirk hurtle through space, the final frontier, in Star Trek. Wild Bill Hickok handled a gun on the Wild West Frontier. Investment managers battle to reach the efficient frontier – the portfolio mix that offers the highest expected return for any given level of risk. A wider range of asset classes improves the efficient frontier – it offers a higher return for the same risk.

It is, however, important to also remember that diversification should never be undertaken purely for diversification's sake. Simply buying an asset blindly is never a good idea. We find many attractive opportunities within alternatives and their inclusion in portfolios is therefore warranted on merit as well as for diversification reasons.

Ultimately, multi-asset investors no longer have a single couple living in their weather house. With the sunwoman and rainman joined by their weatherfamily and weatherfriends, there is now more chance to see someone standing outside the door, smiling down on the owner of the house. It's time to prepare for the future – it is time to diversify.

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