For better diversified growth portfolios, trust in the GODS

Toby Hayes explains why investments should be divided into four risk styles – growth, opportunistic, defensive and stable

We saw in 2008 that multiple asset classes can become correlated in times of market stress. That's because the drivers of different asset classes are often the same thing. Risk factor investing seeks to avoid some of the pitfalls of traditional asset allocation by focusing on diversifying the underlying risk components of asset classes rather than on the asset classes themselves – and it's the philosophy we employ behind the Franklin Diversified Growth Fund and the Franklin Diversified Income Fund.

For example, a corporate bond portfolio could be broken down into risks including interest-rate risk, credit risk, corporate earnings risk (the risk of default), and possibly yield-curve risk (the risk that long-term bonds outperform short-term bonds). In normal markets, interest-rate risk tends to dominate the return, providing useful diversification from small equity-market moves. Yet in stressed markets, credit risk can dominate as the market questions the issuer's ability to pay back the loan. As with equities, the credit component of a bond is linked to the earnings power of the company, and when that is questioned, corporate bonds can follow equities lower. Rather than mitigating volatility, the credit risk embedded in many fixed income portfolios can push correlations with equities higher, and instead of dampening the downturn, the traditional asset classes simply reinforce each other.

We apply risk factor investing by recognising we might not want all the component risks. We might just want specific components – yield-curve risk for example. We can now access individually a huge variety of component risk premia and each of them can be used in different ways. For example, one of the most useful for us is volatility. You can invest in it directly, use it to generate returns, as a hedge or for income. Above all, it's generally independent of traditional equity and credit market returns and we term this 'systematic beta'.

What has all this to do with the gods? It has led to an evolution in the way we view our portfolios. In the past, we showed risk contribution by asset class, in equities, currencies and bonds. Now, we bucket all of our investments into one of four styles to show more transparently where we are taking risk – giving us the acronym 'GODS'.

Growth: Strategies that aim to find opportunities that are deemed to have good growth potential.
Opportunistic: Strategies, either growth or defensive, which aim to capitalise on market dislocations or valuations that occur over short-term time horizons.
Defensive: Strategies that aim to protect investors against significant losses from major market downturns.
Stable: Strategies that aim to offer consistently higher returns than money markets while taking on modestly higher amounts of risk.

When taking a risk factor investing approach, breaking down the portfolio by asset class is not helpful for showing how the investment thesis is being put into practice. Even certain fixed-income investments can present growth characteristics, for instance, and shouldn't be considered as defensive. Our aim is to build a much more diversified portfolio in terms of managing the effective correlation between investments. In this way, we aim to manage the downside of market developments as well as the upside. That's where we think the real value lies.

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