

The importance of diversification

Why real assets are an important part of a well-balanced portfolio

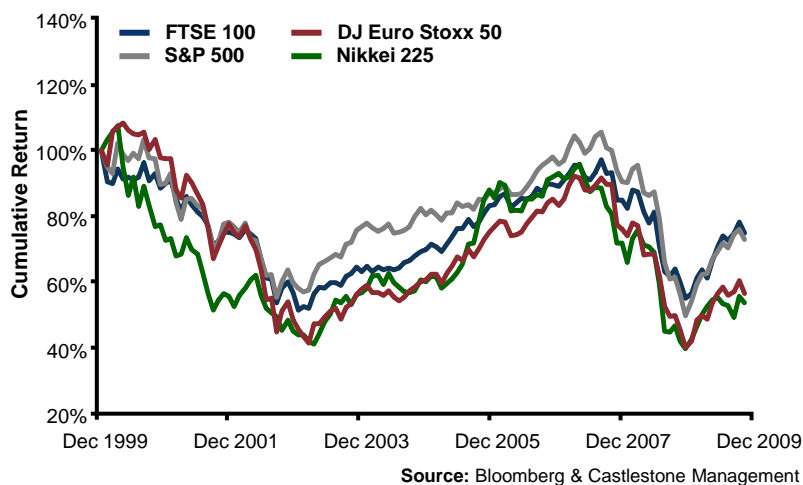
2010 has started in an uncertain vein and as the market torment continues, providing your clients with diversified investments becomes ever-more important. Using just one asset class in client portfolios, such as stocks, is simply too risky: we believe the best approach is to split investments between different asset classes which are not correlated to one another. And from this perspective, real assets such as commodities, precious metals and art are important for a well-balanced portfolio.

What is diversification?

Diversification is a risk management technique that spreads a client's investment portfolio between different assets in order to smooth returns over time. By investing in non- or low-correlated assets a portfolio is less susceptible to the specific risks associated with individual assets: for example, one asset may be declining whilst another is appreciating. Portfolio and risk managers carefully consider the most advantageous diversification strategy when making asset allocation decisions.

Why diversification is essential

There are many ways in which you can diversify a client's portfolio. Traditionally we think of diversification as spreading assets between different sectors and different countries. However, this approach will not be effective in the long-term, as using geographic and sector diversification alone will mean the portfolio becomes susceptible to systematic equity risk. The chart to the right shows the very close correlation between stocks from different nations. Whether they are Japanese, American or European, all the indexes show a strong degree of correlation – tending to both rise and fall together. The same would be true if we were showing a portfolio made solely of bonds or solely of commodities. Diversification is best achieved through a mix of different asset classes.



True diversification, is the diversification across various asset classes

The key to asset allocation is determining the right percentage mix of the six main asset classes needed to provide the highest possible return for the lowest possible level of risk. Ideally a portfolio should hold each of the six main asset classes. As different economic and market factors affect each asset class to varying degrees, they tend to move up or down independently of each other. Having some of each in your portfolio can help smooth out returns by lowering the portfolio's volatility. The amount of each asset held will depend on the individual investor's attitude to risk, their time horizon and their investment goals.

As illustrated not one asset class is always the highest performer

Rank	2004	2005	2006	2007	2008	2009
1	Property +31.43%	Real Assets +21.61%	Property +36.44%	Real Assets +26.81%	Bonds +8.85%	Property +27.77%
2	Real Assets +15.65%	Property +11.42%	Equities +15.79%	Equities +5.49%	Cash +1.37%	Equities +26.46%
3	Equities +10.88%	Equities +4.91%	Hedge Funds +9.25%	Cash +4.44%	Hedge Funds -23.25%	Real Assets +13.49%
4	Bonds +4.83%	Bonds +3.60%	Cash +4.83%	Hedge Funds +4.24%	Equities -37.00%	Hedge Funds +10.93%
5	Hedge Funds +2.68%	Cash +3.19%	Bonds +0.88%	Bonds +3.93%	Real Assets -47.29%	Bonds +0.86%
6	Cash +1.38%	Hedge Funds +2.72%	Real Assets -19.07%	Property -7.69%	Property -49.87%	Cash +0.15%

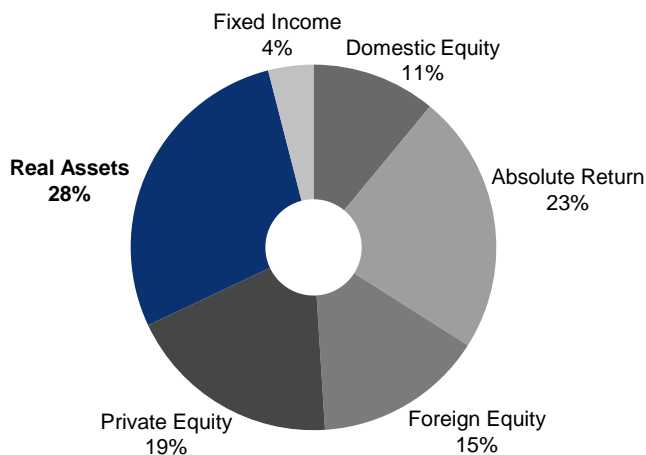
Source: Bloomberg & Castlestone Management. Cash: 3-Month T-Bill. Bonds: ML Global Government Bond Index. Hedge Funds: HFRX Global Hedge Fund Index. Equities: S&P 500. Real Assets: S&P GSCI. Property: MSCI World Real Estate.

Balancing a portfolio

Real assets over time have proven to be uncorrelated to more traditional asset classes and so can offer powerful diversification benefits. A growing number of pension funds and investment houses insist on an allocation to real assets within their investments. Yale University's investment fund, The Yale Endowment, has a 20-year record of producing average annual returns of 15.6%. At the beginning of 2010, its managers recommended a 28% allocation to real assets within the Fund.

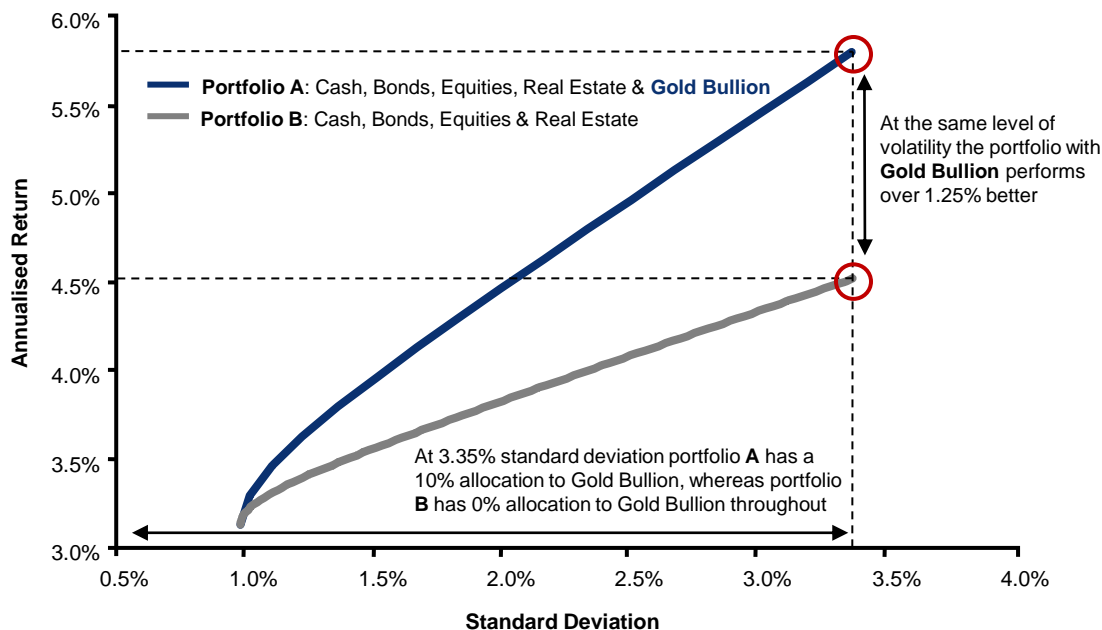
When gauging the balance between risk and reward in a portfolio, one of the most useful measures to look at is its efficient frontier. Good diversification among available assets enables investors to maximise potential returns while reducing risk. Including real assets will tend to improve the expected return by shifting the efficient frontier outwards: greater return for the same level of risk. The chart below shows the efficient frontier being shifted outwards (higher return for the same risk or lower risk for the same return) when real assets are added.

The Yale Endowment Fund allocated 28% to real assets in 2009



Source: Yale University, 2009. Real assets is defined by Yale as containing physical property and commodities.

Real assets such as gold bullion can improve your efficient frontier



Source: Bloomberg & Castlestone Management. Cash: 3-Month T-Bill. Bonds: ML Global Government Bond Index. Equities: S&P 500. Gold Bullion: London Market PM Fixing. Real Estate: MSCI World Real Estate. Data from January 2004 – December 2009

Conclusion

Diversification is essential when aiming to maximise the performance of a portfolio whilst minimising risk. The most effective way to diversify is by including a variety of assets. Adding real assets improves the efficient frontier of most portfolios, giving investors a better risk/reward trade off. Castlestone Management manages a range of funds which provide investors with the ability to diversify their portfolio in this way.

Diversification opportunities

Castlestone Management offer a range of funds designed to capitalise on the benefits of real assets and which can be used to help give your clients true diversification.

Aliquot Commodity (UCITS) Fund

An actively managed commodity fund using a fundamental research driven investment process, providing diversified exposure to: energy, precious metals, industrial metals, agriculture, livestock, alternative energy and water.

Aliquot Gold Bullion

A fund providing clients with 100% direct unleveraged exposure to gold bullion. Unlike gold equity funds, Aliquot Gold Bullion tracks the actual metal price.

Aliquot Precious Metals

A fund providing clients with 100% direct unleveraged exposure to physical gold, silver and platinum. Unlike precious metal equity funds, Aliquot Precious Metals tracks the actual metal price.

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