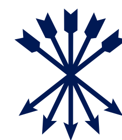

How we deliver sensible portfolio diversification

Quarterly Letter

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Rothschild & Co
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Foreword

When the sun is shining on markets, it's understandable that our readers want to learn more about how we seek to find the investments that are going to make them money.

But while return assets are a crucial part of our portfolios, diversifying assets are just as important. They provide essential protection for those times when the weather inevitably takes a turn for the worse.

In our last *Quarterly Letter*, we touched briefly on how our diversifiers had helped offset some of the recent falls in equities seen amid the COVID-19 crisis. What we didn't explain was which diversifiers we currently hold, why we have them and how they work.

We'd like to take the time to do that now.

Regular readers of our *Quarterly Letter* will know that we usually prefer to take a more conceptual approach to framing our topics. We enjoy exploring ideas in imaginative ways, using metaphors, anecdotes, quotes and allegories to bring them to life.

Those elements are all still here, of course, but now we'd also like to delve a little deeper into the technical side of our investment approach than perhaps we ordinarily would. Unexpected market shocks are anxious times, and we believe greater clarity and detail can bring reassurance during a period of volatility.

I'd also like to reassure our readers once again that Rothschild & Co continues to operate as normal during these difficult times. We sincerely hope that you and your loved ones remain healthy, happy and safe.

Thank you for reading.

Helen Watson
CEO, Rothschild & Co Wealth Management UK

Cover image:
Envelope from a Presidential 'Thank you' sent to Nathaniel 1st Lord Rothschild (1840–1915), Senior Partner N M Rothschild & Sons, from President Theodore Roosevelt (1858–1919) in 1904. Courtesy of The Rothschild Archive.

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How we deliver sensible portfolio diversification

Don't put all your eggs in one basket.

It's a well-worn proverb that every investor has heard when the topic of diversification comes up. However, practising true diversification requires more than just a mantra. There are many ways to diversify, but there are far fewer ways to get it right.

Adding multiple new asset classes to a portfolio isn't necessarily genuine diversification, for example. It may instead be what mutual fund manager Peter Lynch described as 'diworsification'[1]; a situation where investors pad their portfolios with more holdings, adding unnecessary risk (and often cost) while sacrificing better returns. The worst of all worlds.

Adding multiple new asset classes to a portfolio isn't necessarily genuine diversification.

This can be an easy mistake to make because many asset classes move in the same direction as equities, especially when markets fall. In other words, placing your eggs in many different baskets isn't a shrewd plan if you store all your baskets in the same barn. Particularly when the barn catches fire!

Our *Quarterly Letters* often emphasise Rothschild & Co's primary goals: to preserve and grow our clients' wealth. But when times are good, it can be easy for investors to forget why a preservation first approach is so important. And one of the keys to unlocking long-term growth is avoiding significant losses.

In this letter, we'd like to explain more about our distinctive diversification approach, with a special focus on how we're prepared for when the biggest shocks strike financial markets.

From chickens to swans

"Why don't we see how we (almost) always miss the big events? I call this the scandal of prediction."
– Nassim Nicholas Taleb.

[1] *One up on Wall Street: How to use what you already know to make money, Peter Lynch, April 2000*

Eggs in baskets aren't the only animal-related metaphor in investment circles. The industry has a fondness for them. Analysts don't speak of upward or downward trends; they talk about bull and bear markets. Monetary policy experts are labelled hawks, doves or – occasionally – pigeons.

Dynamic, fast-growing economies are tigers, unless they're in Africa, in which case they might be called lions. Other felines, sadly, get short shrift; few investors are happy to see a dead cat bounce.

A fairly recent addition to this expanding metaphorical menagerie is the swan. Black Swans, to be specific. In 2007, former risk analyst and essayist Nassim Nicholas Taleb published the international bestseller *The Black Swan: The Impact of the Highly Improbable*.

According to Taleb, Black Swans are major world events that have three key characteristics:

1. they are completely unexpected;
2. they cause massive shockwaves; and
3. their arrival and impact seem obvious in hindsight (although this is often a trick of the mind).

Why are they called Black Swans?

For centuries, Europeans presumed black swans didn't exist, and so the term was used humorously to describe implausible possibilities. Until the late 17th century, invoking the image of a Black Swan was the equivalent of saying 'when hell freezes over' or 'when pigs fly'.

However, in 1697, Dutch explorers became the first Europeans to witness black swans in Western Australia. The moral of the story is that entire systems of belief built up over many years can be undone almost instantaneously. In this case, with the observation of just a single Black Swan.

Black Swans can be good (the rise of computers, lasers and the internet) or bad (Black Monday, World War 1 and 9/11). But they are all unknown unknowns. Not only are we not aware of them, we don't even know we're not aware of them.

That makes Black Swans unpredictable, impossible to model precisely and potentially devastating for markets.

Preparation rather than prediction

"*What you should learn when you make a mistake because you did not anticipate something is that the world is difficult to anticipate. That's the correct lesson to learn from surprises: that the world is surprising.*"[2]
– Daniel Kahneman

So, how can investors avoid Black Swans? The simple answer is they can't. That's why they are Black Swans.

"Our predictors may be good at predicting the ordinary, but not the irregular, and this is where they ultimately fail," Taleb writes in his book, adding: "What matters is not how often you are right, but how large your cumulative errors are. And these cumulative errors depend largely on the big surprises."

Taleb claims that we can't predict certain events. We shouldn't even try. Instead, he advises building Black-Swan-robust societies to help us take advantage of positive situations, while offsetting the worst effects of negative ones.

Our investment approach follows a similar line of thought. Black Swan or not[3], big market shocks are inevitable and they're usually unpredictable. That's why we don't spend a lot of time trying to forecast them at Rothschild & Co.

We prefer to build robust investment portfolios that have two core elements: resilient 'return' assets and genuine diversifiers. This combination aims to deliver growth above inflation during the good times while avoiding big losses when markets take a (swan) dive.

It's a simple, yet distinctive strategy that is underpinned by exhaustive research into the assets that we invest in. Put simply, we want to put our eggs in different baskets *and* store them in different barns.

Return assets: a quick recap

To better understand our diversifying assets, it can help to view them in the wider context of what they are diversifying against.

Approximately two-thirds of our representative balanced portfolio is currently invested in equities and assets that behave like them. They are the main driving force of long-term growth.

We favour a 'bottom-up' investment approach, so we focus our efforts on finding individual securities or funds that we believe we should own over the long term. From experience, we know our clients' objectives are more reliably achieved by investing in great businesses. That's where we focus our comprehensive research and analysis, rather than trying to beat arbitrary benchmarks or pre-empt macroeconomic trends.

That's not to say the bigger picture isn't important. We keep a close eye on any factors that could affect our investments. But we understand the crucial difference between shallow and deep risk[4], and we only invest in companies that meet our strict criteria across three key areas:

1. **The business**: we are looking for companies with proven sustainable competitive advantages, such as powerful branding, efficient scale or significant cost benefits. The key word here is 'sustainable'; few businesses have the resilience to fend off competitors over the long term.
2. **Management**: our research teams look for experience and longevity within the leadership structure. We also seek evidence of a strong history of running the company well, including sensible capital allocation and prudent succession plans.
3. **Price**: after finding resilient businesses, we then gauge what long-term returns we can expect across various scenarios based on the company's current share price. We're patient and are willing to wait for the price to come into range.

However, a portfolio containing only equities is similar to a speedboat. You may travel much faster towards growth, but you're more likely to have a bumpy ride when waters are choppy.

[2] *www.bernhardtwealth.com/blog/dr-daniel-kahneman*

[3] *Taleb has clarified that he doesn't consider pandemics, including COVID-19, as Black Swans. He argues that epidemics are actually white swans because they are not only predictable but expected. Policy analyst Michele Wucker instead claims COVID-19 is a 'gray rhino'; a highly probable, big-impact threat that is nevertheless neglected or ignored.*

[4] *Shallow risk is temporary, resulting in relatively quick capital recovery. Deep risk is the permanent loss of real capital that can occur, among other situations, when an investment doesn't ever recoup its losses after a collapse in value. Read Our investment approach for more information.*

With that in mind, let's take a closer look at how we diversify our portfolios in line with our key goals of preservation and growth.

Preservation through diversification

"Uncertainty is the only certainty there is. And learning to live with insecurity is the only security."
– John Allen Paulos.

Kevin Gardiner is our Global Investment Strategist. It's his job to review the wider economic environment and offer insights into how this could affect clients' portfolios.

In his 2015 book *Making Sense of Markets*, Kevin argued that people spend too much time looking in the rear-view mirror after big market shocks such as the Global Financial Crisis. Overanalysing the past often leads to missing new opportunities on the road ahead.

We believe this also applies to future risks and uncertainty. To borrow his metaphor, if investors are too focused on the reasons why they drove into the last pothole, they won't see the next one coming. And they definitely won't be prepared for any Black Swans in their blind spot.

In an ideal world, choosing the right return assets would be enough to secure long-term growth. However, the investment road is rarely straight and smooth; there are always obstacles along the way.

In an ideal world, choosing the right return assets would be enough to secure long-term growth. However, the investment road is rarely straight and smooth; there are always obstacles along the way.

This is why sensible diversification matters. Our diversifying assets must act independently of our return assets or be directly negatively correlated to them. We want them to perform well when equities falter or provide other forms of downside protection. They should do their job in the background while you focus on the journey ahead.

Diversifiers currently comprise around a third of our representative balanced portfolio, and they typically fall under four broad categories: cash, portfolio protection, bonds and alternative strategies.

Cash

Holding cash in a portfolio may seem unproductive when it could be used for more growth-oriented assets. If there are many attractively priced opportunities elsewhere in the market, we would tend to agree.

However, cash provides us with the ability to quickly respond to changes in market conditions. It's there for when asset prices are depressed and we need to move swiftly to take advantage, but it's also generally useful to have on hand because it can be tough to raise cash at a time when markets are strained.

Extending our investment journey metaphor, cash is similar to having a spare tyre in the boot of your car. Most of the time, it seems like a waste of valuable space, particularly when your suitcases are relegated to the back seat. But when you get a flat tyre, an easily accessible spare gives you the immediate flexibility needed to get back on the road as quickly as possible.

Portfolio protection

Portfolio protection is the equivalent of car insurance for your investment vehicles. They protect your portfolio against crashes, but of the stock market variety. We typically buy put options, which are financial market contracts where the equivalent of a premium is paid to protect portfolios against times when equities plummet.

These premiums are paid upfront, and – like any insurance policy – options won't provide returns if you steer clear of hazards. When return assets crash, however, the resulting payouts should far exceed the amount paid in 'premiums'.

But this can be an expensive form of protection. And we firmly believe in diversifying our diversifiers. That's why we invest in funds like Okura. The fund buys equity put options, yes, but it also buys put and call options across other markets, including currencies and commodities.

Okura sets out to perform well in a crisis. Their goal is to take advantage of volatility when significant market shocks occur. The more volatility, the higher the rewards. In the midst of the COVID-19 crisis, for example, the Okura fund was up almost 150% between February and April 2020.

Bonds

The relationship between equities and bonds can be a tempestuous one. For large portions of the 70s, 80s and 90s, there was a high correlation between the two – when equities dropped in value, so did bonds. Over the last 20 years, the correlation has mostly been negative, leading to fixed-income assets being popularly used as a hedge against poor equity performance.

But the recent emergence of negative-yield bonds means the lender pays – yes, we mean pays – to lend money to the borrower. Investors buying these assets actually lose money when they're held to maturity. It's not difficult to see how this is a problem for our central concept of wealth preservation.

While bonds have historically formed an important part of our diversification approach, we don't currently believe they act as an effective diversifier, given their high valuations. As with any insurance policy, once the costs outweigh the benefits of coverage, it's time to move on to another provider.

Hitching a ride on trends

Trend following is an investment approach where traders don't try to forecast specific prices or market movements. Instead, they identify when they believe a trend is occurring and hitch a ride on that trend, expecting prices to continue travelling in the same direction.

Complex algorithms and mathematical models are used to buy and sell at the best times, and every trend follower has different techniques and metrics for establishing when markets are trending.

For example, one of our trend followers, the CFM Trends program, seeks to track clear and sustained trends across five asset classes: government bonds, short-term interest rates, currencies, commodities and equity markets.

Meanwhile, the Artemis Volatility fund has a much narrower focus, seeking to capture volatility in the S&P 500 only. It aims to take advantage of excessive optimism and pessimism in the markets, capitalising most when markets fail to normalise quickly.

Our extensive research has found there is robust empirical evidence to support trend following. However, it's important to remember that while trend followers can perform well during a crisis, they are not the same as portfolio protection. They tend to do less when trends shift and, of course, their models can be wrong.

Alternative strategies

At Rothschild & Co, we don't just believe in diversity of assets, we believe in diversity of thought and process. Echo chambers can be dangerous when investing, which is why we look beyond our own expertise to find funds operated by specialist managers.

Importantly, these alternative strategies usually provide sources of return that are not solely tied to rising equity markets. We don't want to stretch our metaphor too far, but they operate like GPS in a car. They find different, sometimes unconventional routes towards your destination when traffic or roadworks would otherwise bring you to a standstill.

Our external partners may share many of our investment principles, but they must also add value and not simply replicate what we already know and do. These funds pursue a range of alternative strategies, including trend following.

Kicking the tyres

Lastly, we'd like to emphasise that our diversification efforts don't exist in a vacuum. They are an essential part of how we manage uncertainty, but far from the only part.

We also perform regular stress tests seeking to ensure portfolios can endure lengthy market downturns. Stress testing helps us assess how a portfolio will behave in certain scenarios. We use both historic scenarios, such as the 2008 Global Financial Crisis, and hypothetical future scenarios.

> **Kicking the tyres is one thing, predicting exactly what's going to happen on the open road is another. Ultimately, modelling can't capture every eventuality.**

We're kicking the tyres, so to speak.

In addition to portfolio stress testing, we thoroughly review and monitor all of our portfolio holdings as part of an ongoing process. In previous letters, we've discussed how we look for robust businesses with sustainable competitive advantages. We also want to have confidence they'll remain resilient, so we analyse and model how businesses and funds are likely to perform during recessions or market downturns.

But as we've hopefully illustrated, anticipating big market surprises is always difficult and sometimes impossible. Kicking the tyres is one thing, predicting exactly what's going to happen on the open road is another. Ultimately, modelling can't capture every eventuality.

When market shocks like COVID-19 occur, we dig deeper into our research and perform more specific analysis and tests into our holdings and their respective sectors. This involves extensive reviews of company balance sheets, in-depth discussions with senior management teams and insights gleaned from our network of industry experts.

We have very deliberately structured our approach and processes with a clear goal – to preserve and grow our clients' wealth.

Take Ashtead, for example. Our analysis and testing suggested the equipment rental business could survive revenues dropping 80% for at least three quarters before its cash reserves ran dry or debt covenants were breached. An encouraging level of resilience against a typical market downturn. But a pandemic isn't typical. Could COVID-19 push that durability to breaking point?

After further investigation and discussion with Ashtead, we decided that the business' performance and revenue projections were better than expected across the US market, and the company had increased its credit facility by $500 million, bringing its cash and liquidity resources up to $2.1 billion.

These and other factors gave us increased confidence the company could withstand this crisis.

Conclusion

There is no crystal ball when investing. Black Swan events will always occur, and they will always be unpredictable.

We have very deliberately structured our approach and processes with a clear goal – to preserve and grow our clients' wealth. We aim to be prepared for Black Swans or run-of-the-mill bear markets.

Notes

At Rothschild & Co Wealth Management we offer an objective long-term perspective on investing, structuring and safeguarding assets, to preserve and grow our clients' wealth.

We provide a comprehensive range of services to some of the world's wealthiest and most successful families, entrepreneurs, foundations and charities.

In an environment where short-term thinking often dominates, our long-term perspective sets us apart. We believe preservation first is the right approach to managing wealth.

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