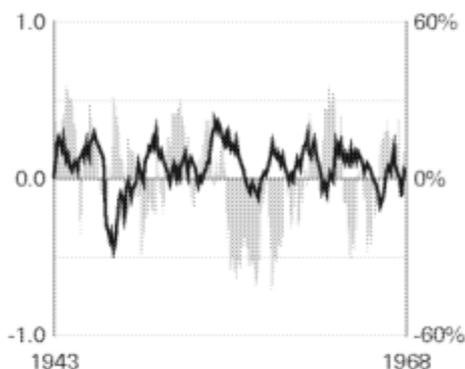
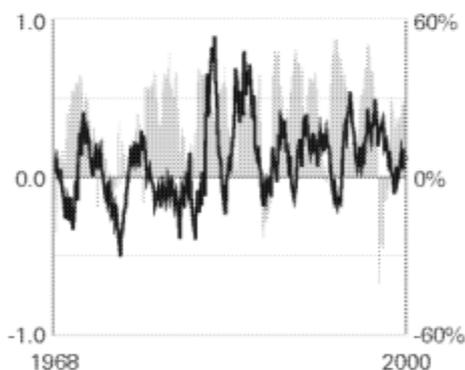


Figure 2.  
 Correlations change over time

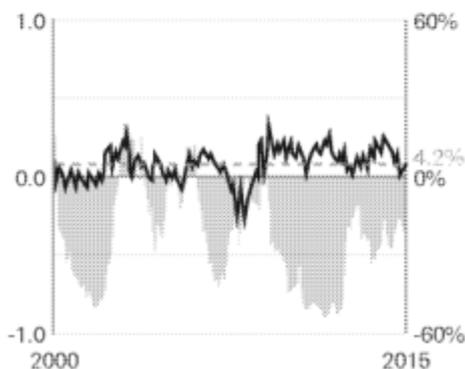
Unstable correlation



Predominantly positive correlation



Predominantly negative correlation



Portfolio diversification has become an important issue in this cycle. The natural diversifiers, fixed-income sovereigns, are now zero-yield, negative-convexity assets. Inter-asset-class correlation (looking beyond bonds) has also increased substantially over the last few years and – as we know – tends to increase to one in larger risk-aversion events.

Augmenting strategic asset allocation  
 As a result, multi-asset investors may need to recalibrate their strategy. Over the last 5-10 years, strategic asset allocation might have accounted for 80% or more of a portfolio’s performance. This is no longer the case. Effective tactical asset allocation, individual security selection and risk management may now account for 50% or more of performance.

In this new, active, multi-asset-management world, key concepts include contrarian trading, risk premia or style investing and smart

implementation, i.e. selection. The way in which they are implemented and their relative importance will change over time.

Our current approach can be characterized as follows. With the largest contribution to overall portfolio risk coming from equities it may be warranted taking on slightly less strategic risk than usual. This could allow a portfolio to better cope with and also to provide a sufficient risk budget to buy into larger sell-offs. Across a strategic base portfolio, a “carry-and-income” strategy can offer the ability to add tactically when market dislocations occur.

Diversification across styles can add value  
 Within the equities exposure, limited expected upside to index targets, together with high expected volatility, suggests focusing on getting the right equity style (i.e. investing criteria). Income-generating dividend stocks and strategies designed to minimize volatility/variance may be important considerations.

Fixed-income “carry” assets (i.e. those offering appreciable yield) look set to be more interesting than equities for the next couple of months. U.S. investment grade, euro high yield and emerging-market (EM) hard-currency debt may appeal.

Correlations and returns

- Correlation S&P 500 vs. 10Y UST (lhs)
- Annual return of a U.S. based multi asset portfolio (60% bonds, 40% equities, rhs)
- Average annual return, 2000-2015 of a U.S. based multi asset portfolio (60% bonds, 40% equities, rhs)

Past performance is not indicative of future returns.

Sources: Thomson Reuters Datastream, Global Financial Data, Robert Shiller, Goldman Sachs Global Investment Research. Data as of December 2015. Past performance is not indicative of future returns. Readers should refer to the explanatory notes at the end of this document.