Is Diversification Living Up to the Promise?
CFA Institute Private Markets Webinar (Sponsored by PGIM)
6 June 2023

Speakers

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Background

The first of a series of three CFA Institute Private Markets webinars sponsored by PGIM addressed the promise of diversification typically offered by alternative investment allocations and whether these investments are truly able to mitigate risk and enhance returns.

The discussion covered a wide range of topics, several of which are highlighted in this research note along with suggestions for further reading. The full webinar is available at https://players.brightcove.net/1183701590001/experience_5e833b9e5001c600241d474d/share.html.

Economic Outlook and Future Public/Private Market Correlation

The panelists addressed the potential of a near-term recession and whether the "decoupling" of public and private markets—that is, the strong outperformance of private versus public markets seen since 2009—will continue, or whether a "recoupling" of returns across public and private markets will result amid higher rates and higher inflation.

Although a recession is widely anticipated, it has so far failed to materialize. That said, with core inflation lower but remaining elevated at 4.5%, it seems likely that unemployment must rise and trigger a recession for inflation to fall back to 2%. Under this recession scenario, a recoupling of markets is more likely as private valuation of less liquid alternatives remains initially elevated until the macroeconomic backdrop deteriorates and causes valuation cuts, as is typical during the cycle.

Correlation

It was suggested that correlation is often not the right measure to use for diversification of public versus private markets, particularly in cases of nonlinearity, and that markets may experience a "correlation breakdown" in the event of a swift downturn.

The webinar also noted that a correlation coefficient is simply an estimate and subject to estimation error when calculating the coefficient using a sample from a larger population. Estimating the margin of error or uncertainty associated with the correlation through hypothesis testing or a confidence interval with stress periods over the life of an investment can be a useful approach in mitigating these concerns.

The interconnectedness of markets is also likely to increase in the near term, with accelerated information flow likely causing greater intramarket correlations. Although financial markets are complex, they are also adaptive. That is, as Andrew Lo's adaptive market hypothesis suggests, they constantly change based on new circumstances.

Investment Time Horizon

The proper evaluation horizon for the diversification "promise" was raised. Short-term valuation (say, under a year) provides insights into the impact of market conditions and can help identify portfolio imbalances or risks that need to be addressed promptly. Temporary market fluctuations, however, may not accurately reflect long-term performance.

Medium-term analysis over one to three years allows investors to assess strategy effectiveness while smoothing short-term market noise and allowing for a more reliable measure of performance. It also allows for adjustments based on changing market conditions and investment goals.

Long-term evaluation of three years or more, however, is considered most appropriate for assessing portfolio diversification. This time frame allows for the effects of market cycles to be observed and provides a clear picture of the portfolio's performance.

Although no single time horizon applies to all investors, it is important to understand behavioral biases, such as short-termism, that can influence investor expectations and may result in unrealistic expectations of what diversification can achieve. Also, diversification requires monitoring and disciplined portfolio rebalancing to ensure alignment with the intended strategy.

Alternative Investment Valuations

In the case of less liquid alternatives, private valuations often use discounted cash flow analysis based on risk-free rates, public credit spreads, public market multiples, and recent public transactions. When interest rates rise or market multiples fall, private funds often seek to avoid overreacting to adverse public market changes, given the longer (7- to 10-year) investment time horizon and focus on fair value and the long-term nature of the assets, which private funds expect to be relatively uncorrelated with public markets as part of their portfolio construction.

Evolution of Private Markets

Recent changes in private markets were also cited as a cause for closer future correlation between public and private market performance given efforts to make alternative assets "less alternative", such as placing alternative assets into 40 Act funds and offering partial liquidity. A recent example involved Blackstone's BREIT fund and its private credit fund, which are both interval funds that allowed investors to liquidate a portion of their assets on a quarterly basis.

Liquid Alternative Strategies in a High-Inflation Environment

PGIM recently published a research note citing the diversification benefits of managed future strategies compared with the traditional 60% equity, 40% bond portfolio under high-inflation scenarios as well as different macroeconomic circumstances over the past five decades.

For example, in 2022 during a period of high and unexpected inflation, managed future strategies outperformed the 60/40 portfolio by more than 30 percentage points. Also, going back historically, similar periods such as the 1970s when actual inflation was higher than unexpected inflation, managed futures played a valuable diversification role. In particular, it was shown that over the 10 worst periods for a 60/40 portfolio, the managed futures strategy generated higher returns than other strategies on every occasion.

Overall, the study found that a conventional portfolio optimization approach suggested a significant allocation to managed futures of around 20%, while in practice most investors struggle to reach even a 5% allocation. Behavioral biases are often to blame for an underweighting of such strategies.

Artificial Intelligence (AI) and Private Markets—Promise or Threat?

The participants took an optimistic view of AI as a potential catalyst for transformative technological change, which may occur far more rapidly than the adoption of other technologies. For example, the rapid adoption of large language models and AI code generators is transforming several industries.

In fact, the potential surge in productivity associated with this trend could be a factor rationalizing the strong performance of equity markets in a difficult macroeconomic period. That said, despite the opportunities, the risks of AI and timing of those risks remain a black box for now.

Suggestions for Further Reading

Larry Cao, (editor), "Handbook of Artificial Intelligence and Big Data Applications in Investments," CFA Institute Research Foundation (March 2023).

https://www.cfainstitute.org/-/media/documents/article/rf-brief/ai-and-big-data-in-investments.pdf

Andrew Lo, 2004, "The Adaptive Markets Hypothesis," *Journal of Portfolio Management* 30 (5): 15–29.

https://www.pm-research.com/content/iijpormgmt/30/5/15

Sushil Wadhwani, "The 60/40 Portfolio and the Diversification Benefits of Managed Futures Strategies," PGIM Wadhwani LLP (June 2023).

https://www.pgimwadhwani.com/white-paper/diversification-benefits-managed-futures-strategies