



Diversified or Diworsified? | July 2018

“The idea of excessive diversification is madness.”

Charlie Munger

The route to creating and building wealth usually involves concentrated bets. Entrepreneurs notoriously put all their eggs (and often some borrowed ones) into a singular basket. Others pursue and accumulate riches through focusing their time, energy, and resources on a chosen career path. After all, it would be odd and perhaps disconcerting if your doctor also ran a successful law practice.

But when it comes to managing our accumulated wealth, more and more of us prefer the diversified approach. Over the past fifty years, the trend has been towards greater and greater diversity, as the average number of holdings in funds has steadily increased since the early 80's.

The rationale behind spreading your eggs over several baskets is prudence (and to help sleep well at night). After all, any single investment or asset class could experience severe drawdowns. As Ray (A Man for All Seasons) Dalio once put it, over a lifetime ‘it’s almost certain that whatever you’re going to put your money in, there will come a day when you will lose fifty to seventy percent.’

But in our pursuit of risk reduction through diversification, have we become folly to ‘diworsification’?

The shift towards broader portfolios is attributed to Harry (‘diversification is the only free lunch’) Markowitz. His Noble Prize-winning Modern Portfolio Theory illustrated the risk mitigating benefits of constructing portfolios across various investments and provided a mathematical framework to do so. This elevated investing from individual security selection to holistic portfolio management, where the game becomes optimizing risks and returns.

Furthering the trend has been the proliferation of index funds. In and of themselves tools for diversification through broad market exposure. But beyond their direct intention, they have also had the knock-on effect of increasing the number of positions held by active managers. This is due to client and benchmarking pressures, which has increased the average number of holdings in active equity mutual funds to over 200 stocks. Given the benefits of diversification become negligible after 20-40 holdings, is this overkill?

The risks in over-diversification are compromising and confusing quality for quantity. In the compromise, an active manager’s skill and strategy become diluted to the point of producing broad market returns, leaving the investor paying for nothing. In the confusion, there can be a false sense of security in owning numerous positions even when they are highly correlated. Furthermore, as the number of securities in a portfolio grows, we risk not seeing the forest for the trees and spending too much time debating a 1% position than on the real drivers of success.

We are never fans of throwing babies out with the bathwater and are not arguing for the abandonment of diversification. After all, even giving all your money to Warren Buffet would have led to two 50% drawdowns in the past twenty years. But while a diversified approach might be appropriate given an investor’s objectives and risk tolerance, a more than superficial application of the concept is required.

Ultimately, the objective is maximizing return for a given level of risk, and while diversification is a means to this, it is not an end unto itself.



The Fund

It was the best of times, it was the worst of times. Ok, that's a bit dramatic and not totally accurate, but July was a tale of two markets. After the worst start to a year in a decade, US credit saw the strongest monthly rally in two years. US investment-grade spreads tightened an impressive 15 bps driven by a slow down in issuance, renewed interest from Asian buyers, and very low dealer inventories.

Canadian credit marched to a different drummer as corporate bond spreads were mostly unchanged on the month. Although we also saw a reduction in new issues (approximately \$7.5bn in July), dealer inventories remained high in the absence of meaningful investor demand following a very robust June supply (\$12.7bn). This led to brief rallies being met with profit taking and ultimately produced an unremarkable month on this side of the border.

We didn't alter the portfolio composition in a meaningful way, however, we did reduce some of the hedging positions which slightly improved the carry. Three-quarters of the month's 0.46% return was from interest earned with active trading contributing the rest.

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2018	1.19%	(0.45%)	(0.35%)	0.77%	(0.25%)	0.26%	0.46%						1.63%
2017	1.73%	1.30%	0.44%	1.03%	(0.22%)	0.53%	0.94%	(0.09%)	0.70%	0.83%	0.45%	0.50%	8.46%
2016	0.19%	1.49%	5.32%	3.51%	0.60%	0.54%	1.73%	1.63%	1.01%	1.86%	1.60%	1.62%	23.15%
2015	-	2.29%	2.51%	1.27%	2.46%	0.25%	0.73%	(0.25%)	1.68%	1.71%	1.37%	0.87%	15.86%

The Algonquin Debt Strategies Fund LP was launched on February 2, 2015. Monthly returns are based on 'Series 1 X Founder's Class' NAV as calculated by SGGG Fund Services Inc. and are shown in Canadian dollars, net of all fees and expenses.

Credit

With the Canadian market still digesting the new supply from the first half of the year, the typical summer "grind" tighter did not materialize in July. But there are signs that it might just be delayed by a month: the issuance calendar should be light, dealer inventories are shrinking, and investor cash balances have increased.

Given these factors, it is possible that the domestic market plays a little catch-up to the US market. The challenge is balancing the appropriate risk posture into a seemingly more constructive near-term credit environment while recognizing that fall typically presents plenty of opportunities to add to credit through new issues. We have increased our exposure slightly as we believe that a 'catch-up' move is a reasonable probability, but are keeping a close eye on a host of percolating issues: tariffs, NAFTA, Brexit, Italy, Turkey, and interest rates to name a few.



Rates

As expected, the Bank of Canada (BoC) raised rates to 1.5% in response to surprisingly resilient economic growth. Headline inflation is well above 2%, and so far there is little sign that the headwinds of elevated house prices and NAFTA uncertainty are having a material negative impact on the economy. After having been in the camp of 'one and done' this year, we have shifted to thinking that the BoC raises again in 2018. A positive outcome on NAFTA probably seals another hike in the fall, and even if a deal has yet to be reached, the chances of a move remain high.

The shape of the yield curve continues to perplex everyone. The fact that you need little more than your fingers and toes to count the number of basis points between 2-year and 10-year rates has people worried that an inversion (long yields lower than short yields) and hence a recession is just around the corner. While this may be the case, the European Central Bank and Bank of Japan quantitative easing programs continue to exert significant influence on bond markets. When the Bank of Japan allowed 10-year yields to drift from 0 towards 10 bps, yields around the world also rose. It is quite possible that as these central banks throttle back on their buying that the curve takes on a more normal shape.

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