M&G Dynamic Allocation Fund

The benefits of diversification in periods of short-term volatility

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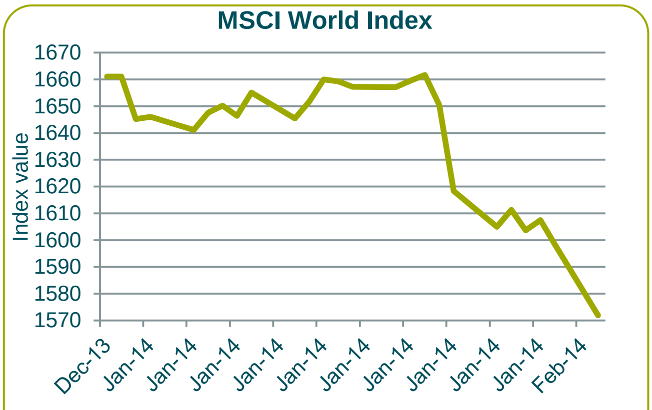
Fund managers – Juan Nevado and Tony Finding

Fund managers Juan Nevado and Tony Finding believe, in the face of significant uncertainty, it is vital to maintain a sense of perspective and carefully consider the true significance of events in a longer term, fact-based context. In their view, the chance of permanent loss represents true risk, while short-term volatility should not distract them from their longer term fundamentals-based convictions. However, it can be very uncomfortable to continue backing long-term convictions amid significant short-term turbulence. One of the benefits of a global multi-asset fund is the opportunity to construct a diversified portfolio of assets which may behave differently in the short term, potentially providing many alternative sources of return.

Recent equity market volatility

After enjoying an exceptional year in 2013, the start of 2014 has so far proved a painful reminder to equity investors that the recent past is no guide to the immediate future. The sudden return of 'risk-off' sentiment made for a difficult period for global equities in the past few weeks, as shown in the chart below:



Source: Bloomberg as at 4 February 2014, in US dollar terms

Juan Nevado and Tony Finding, managers of the M&G Dynamic Allocation Fund, are always careful to avoid being distracted by such short-term volatility, which is often fuelled by market 'noise' rather than longer term fundamental factors.

Although this very recent period has been challenging in terms of the fund's overweight equity exposure, their medium-term view remains that, against a backdrop of low inflation and modestly improving global growth prospects, selected equity markets are still attractive relative to short-dated government bonds and cash. The fact that equity valuations are cheaper than a month ago does not change their opinion – it simply means the assets they favour are offering even better value.

Short-term experiences in perspective

As humans, investors tend to reach for the comfort of perceived certainty over the discomfort of admitting that we can know very little about the future. This leads to attempts to forecast what is coming next, something Juan and Tony believe is impossible. In behavioural finance, the term 'availability bias' is used to explain how investors can become inappropriately confident in their ability to forecast the future, based simply on their most vivid recollections of the past. Since humans' most powerful memories tend to be of their most recent experiences, decisions on this basis tend to be short term in nature. This can have dangerous implications in terms of making investment decisions to deliver favourable risk/return characteristics over the long term.

For example, the strong performance of global equities last year may have made investors feel more positive about equities at the end of 2013 than at the start. However, an investor who, on this basis, bought equities at the end of last year will have had a painful experience since. Based on that experience, this investor may be tempted to now sell out of these equity positions, thus realising a permanent loss.

The M&G Dynamic Allocation Fund was overweight equities for the whole of last year, based on a long-term valuation view, rather than a short-term emotional response to recent market movements. As explained, Juan and Tony continue to believe equities are broadly attractively priced, even if to a lesser degree than before last year's rally. As such, they maintain overweight equity exposure in the fund. However, in doing so, they accept that they may have to tolerate some periods of short-term volatility in the course of backing their long-term conviction that equities are currently underpriced.

Nevertheless, it is always an uncomfortable experience for Juan and Tony when an asset they hold disappoints in the short term. However, the benefit of a global multi-asset fund is the opportunity to construct a diversified portfolio that includes assets with the potential to provide alternative sources of return during short-term periods of equity market weakness. Several such sources have helped the fund in recent weeks.

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Diversified equity exposures

A key theme in recent months has been increasing return dispersion between different equity markets at regional and sector level. As such, Juan and Tony's selectivity within the asset class has provided some degree of protection from broad equity market declines over the past few weeks. For example, while most regional markets sold off over January, Italian equities had a positive month, benefiting the fund's meaningful exposure. Elsewhere, losses in US equities were largely avoided as Juan and Tony had taken profits in the fund's position in the S&P 500 Index last year. However, they maintained exposure to select cheaper parts of the US market through baskets of technology and bank stocks, which held up better than the broad US market during January, as did the basket of mining stocks.

Government bonds

Over the second half of last year, Juan and Tony fairly aggressively added to long-dated mainstream government bond holdings, particularly in terms of 30-year US Treasuries. This was in response to what they believed to be a largely emotionally driven sell-off that brought these assets to far more attractive levels of yield than they have been at for some time, also improving their diversification properties.

'Safe-haven' demand in recent weeks has proved beneficial for these holdings, helping to offset losses from the equity portion of the portfolio (along with gains from holdings in some peripheral European bonds).

US 30-year Treasury yields

Source: Bloomberg as at 4 February 2014

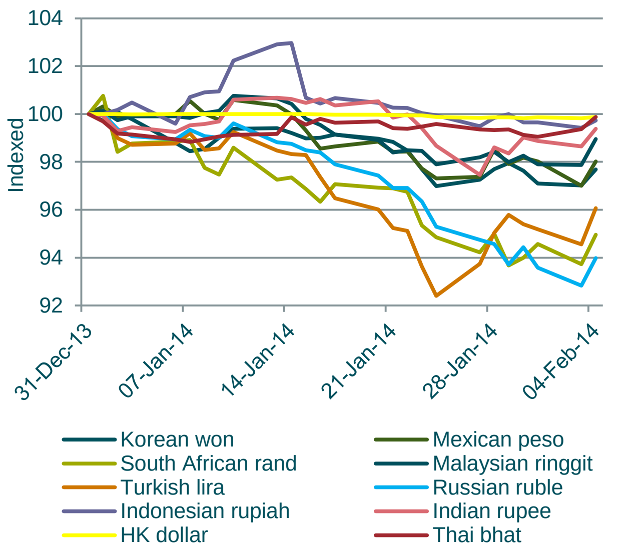
Given this strong performance, it may be tempting to now sell these bonds. However, maintaining a longer term perspective, Juan and Tony observe that even at current levels of yield, these assets remain significantly more attractively priced than for much of the past two years (see previous chart). Furthermore, other investors' availability bias may cause them to read too much into these recent moves and begin anticipating an interest rate rise sooner than Juan and Tony feel is likely, given the longer term picture.

Emerging market currencies

Another interesting example of availability bias at work at the moment is movements in emerging market currencies. A few weeks ago, there was a lot of 'noise' around declines in several emerging market currencies, such as the Turkish lira. This created some potentially interesting opportunities in these very 'cheap' currencies. However, investors seem to have already moved on from this topic, with global equity market declines grabbing headlines now. Investors may have expected that these currencies would share the same risk properties as equities. In fact, as shown below, several of the emerging market currencies to which the fund had modest exposure have held up better more recently, if this persists they may provide some useful diversification for equity exposure.

Elsewhere, the fund's modest exposure to property and convertibles also continue to provide some useful potential diversification properties.

Emerging market currencies versus US dollar



Source: Bloomberg as at 4 February 2014, rebased to 100 as at 31 December 2013

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