KIEGER

Kieger’s “unique” portfolio and why it works

Going back more than 20 years, Kieger’s legacy has been built in healthcare and small companies.

Over these decades we have developed our own “unique” asset allocation which has some outstanding and attractive portfolio characteristics, especially in recent turbulent times.

It’s a good time to be in healthcare. Out in the real world, healthcare companies are scrambling to research, innovate and even collaborate like never before to find a solution to the biggest crisis of our time. But this is not surprising: companies in this sector are continually innovating to find solutions to critical challenges.

This year in the investment world – not surprisingly, given the environment – the healthcare sector has not suffered as badly as others and is one of the strongest-performing groups year-to-date (roughly flat). In any investment portfolio, healthcare has proven to be a diversifier and protector of performance. But this, also, is not new - for decades Kieger has known that healthcare investments provide something unique: enormous return potential through innovation (similar to tech stocks) but defensive characteristics in a downturn due to the fact that there will always be demand for such a basic human need.

The Kieger model

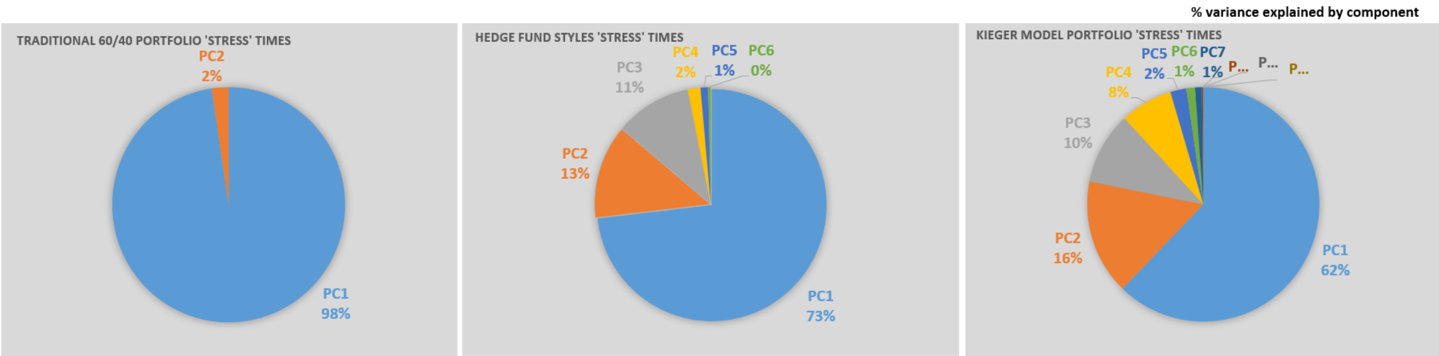
Going back more than 20 years, Kieger's legacy has been focused on supporting the entrepreneurship, innovation and flexibility of small companies, together with a focus in healthcare. Over the decades we have developed a "unique" asset allocation with three pillars: a core "endowment fund" allocation to benefit from diversification across many global asset classes and strategies; a long-term allocation (up to 25% of the portfolio) to private equity to support entrepreneurship; and a major bias (25% allocation) to healthcare stocks. This was originally driven by our history and expertise, but over the years we have found that this allocation has some outstanding and attractive portfolio characteristics, especially in recent turbulent times.

Diversification is key

In the current environment of high market volatility and liquidity pressure, traditional balanced portfolios have been tested by sudden increases in correlation. In March 2020 the standard 60/40 equity/bond portfolio experienced one of the largest drawdowns in several decades due to its inherent fragility and left tail risks. While diversified in theory, these portfolios still have concentrated risk exposures resulting in the reduction of portfolio diversification benefit exactly when it is needed the most.

Our model has performed better in this environment because our approach provides *real diversification*: the behaviour of the portfolio is driven by diverse uncorrelated sources of return. Principle Component Analysis, a machine-learning technique that decomposes performance, indicates this as shown in Figure 1 below. Here, we compare the common risk factors impacting the performance of a standard 60/40 portfolio, a broad hedge fund portfolio (often cited as an example of "better" diversification) and Kieger's model portfolio. We focus specifically on "stressed" periods since 1994 as this is exactly when the benefits of diversification are most important.

Figure 1: Common Risk Factors Across Traditional Beta, Hedge Fund Styles and Kieger Model Portfolio (January 1994 - March 2020)



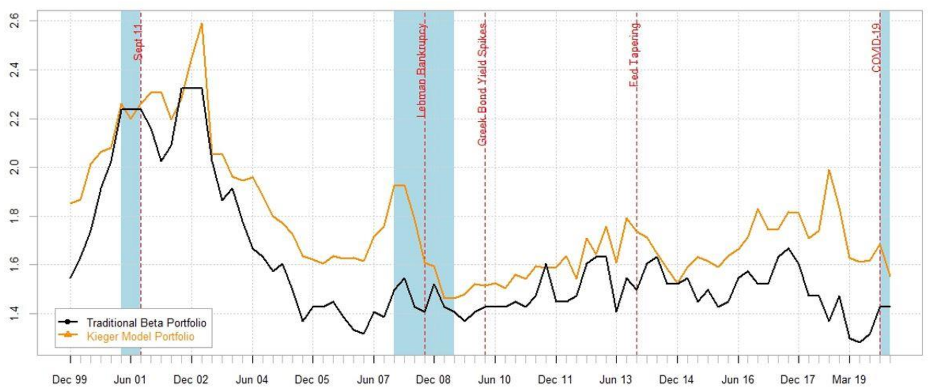
Each component/driver of risk (and return) is labelled PC1, PC2 etc. in order of importance. Clearly PC1 dominates; this usually represents the returns driven by the equity market and the appearance of this factor is not too surprising. What is surprising, however, is that in stressed periods as much as 98% of the performance of the 60/40 portfolio is driven by one factor. Where is the diversification?

In contrast, the same level of risk concentration in our portfolio mix is spread over five unique factors – an outstanding reduction of risk, even better than the hedge fund portfolio. This provides a unique source of diversification in times of stress, while improving the risk-adjusted return potential.

Long-term consistency

Another popular measure of strategy crowding and portfolio efficacy is the diversification ratio, defined as the ratio of the weighted average asset volatility to overall portfolio volatility. The higher the diversification ratio, the lower the portfolio risk is relative to the weighted average volatilities, i.e. the diversification is better.

Figure 2: 3Y Rolling Diversification Ratios

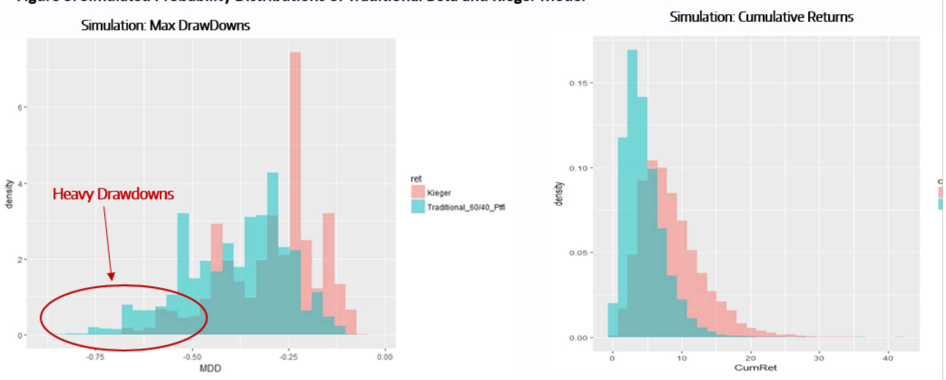


In Figure 2, the diversification advantage of our model portfolio over many years is evident. It is also interesting that over time there appears to have been a structural change which has made it more difficult to achieve real diversification.

Real Long-term Diversification = Efficient Risk Management

But how does better diversification lead to better performance? In Figure 3 below, we show the results of statistical simulations showing the range of maximum drawdown possibilities (left) and possible cumulative returns (right) of our model portfolio vs. the 60/40 example.

Figure 3: Simulated Probability Distributions of Traditional Beta and Kieger Model



As expected, it is clear that better diversification leads to smaller losses. But it does not necessarily follow that lower risk leads to lower returns – the simulations above demonstrate that our model portfolio offers the potential of considerable improvement both in terms of risk and return. By minimizing the impact of tail events, the portfolio compounds higher returns over time – disciplined risk management generates greater long-term growth!

Looking forward, we remain more convinced than ever in our portfolio model, which is positioned to benefit from global innovation and entrepreneurship and make optimum use of diversification. In particular, healthcare remains incredibly attractive due to its central position in human health and wellbeing, continued innovation, and supportive megatrends (e.g. demographics, genomics, chronic diseases, rising expenditure in emerging markets, and increased awareness and preparedness for the next pandemic).

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