Is There a New Level of Diversification For Extraordinary Times?

By: Joe the Investor

The typical definition of diversification in financial circles is choosing investments among the major asset classes (equities and fixed income being the 2 major categories). The second layer of diversification branched out into sectors and countries, with more emphasis on international securities to take advantage of different business cycles around the world. This worked from the 1970s until the 1990s when the world economies began to converge. After that time, the definition was expanded to include hybrid securities such as real estate investment trusts, preferred shares, high yield bonds and other equity/bond hybrid type securities. These securities were designed to allow for more nuances in the securities spectrum and allow for more income generation to smooth out cash flows and provide consistent income. The other factor in including these securities is the search for yield which is a result of low interest rates in the developed world where most of the capital is.

The next layer of diversification is using derivatives to protect against sudden market moves and enhance the risk / return profile of an existing security. Examples of this strategy include using options to increase yield on government bonds, covered calls to increase yield on equities, convertible preferred shares to allow a "bond like security" to behave like an equity security in certain situations. There are also derivatives to hedge currency risk, or going long and short at the same time.

Beyond the derivatives is the allocation to more physical and illiquid assets such as infrastructure, private equity and physical assets like land that can generate income. Access to these securities is available directly for large pools of capital, or through ETFs or mutual funds for retail investors.

These methods of diversification are all being used in the present but there is a new layer of diversification that can now be utilized. The 2 central questions that are key to this diversification expansion are: "What if the system breaks down?" and "What is a currency?". The first question refers to the banking network, securities exchanges, the government, the regulators and all of the other pieces that allow for the status quo to function and to continue. The system revolves around using the Canadian dollar as a unit of currency (or another country fiat currency). This leads to the second question: Is there another way to pay for things aside from using dollars?

Where do these 2 questions lead us? There is a layer of diversification that protects against systemic risks or failures (bank runs, excessive government debt, credit freezes as well as social issues like riots, pandemics or mass unemployment). This new layer of diversification address both questions at the same time: it protects against systemic risks and is a way to transact. The products that fulfil this role are physical gold, silver and cryptocurrencies. A fourth product is farmland, physical commodities or equipment that is productive and can create items for consumption, barter or trade. What do these assets protect against? They are currencies in that they can be used to transact instead of dollars. In the case of farmland, the products are produced instead of bought, which reduces the need for currencies.

Notice that these assets were not very popular until recently. Why? There is more doubt about the viability of the system now then there has been in the past. The pandemic has created volatility in the supply chain network. The huge amount of debt creation is causing volatility in asset prices. There is a lot more uncertainty in everyday life on many fronts, which is causing questioning in all levels.