The world around us in dynamic, and windows of opportunities can show up from time to time. In this instalment of the HLB-exclusive 'Total Portfolio Management' series, let's get into 'satellite diversification'. It's a means by which you may seek and benefit from short-term opportunities.

WHAT IS SATELLITE DIVERSIFICATION

HLB model portfolios can make up the core of your long-term investment holdings. They play a role in generating sustainable and consistent returns over the long term. However, every portfolio can be improved.

Here's how: The dynamic nature of markets tends to provide shorter term opportunities. A satellite portfolio approach can potentially help generate additional returns without excessive risk. It is where a portion of your portfolio takes on a more active approach to take advantage of trends — without risking your entire portfolio.

HOW DOES THE SATELLITE APPROACH WORK?

Think of your portfolio as a sun, where a bulk of your investments reside. Many planets orbit this sun, and they all have unique environments and wealth opportunities. By carefully selecting and investing in a few planets, you can potentially capture the extra gain when the planet thrives.

Here are four examples of the various investment instruments that may be part of a satellite approach:

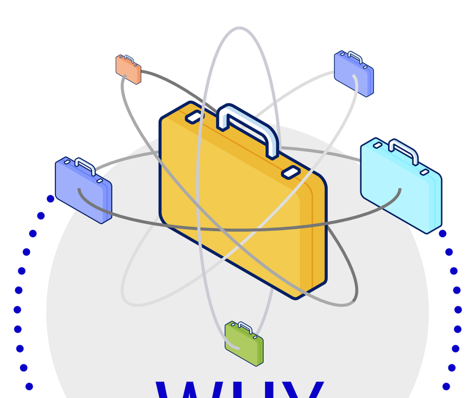
1. FOREIGN EXCHANGE
Some foreign currencies may appreciate against our local currency over time. Be aware, the risk is that the foreign currency may also depreciate.

2. THEMATIC UNIT TRUST
These are used to target certain countries or sectors that may present an extraordinary opportunity.

3. BONDS
Generally, they provide fixed and predictable income. While high-yield bonds can be more risky than standard investment grade bonds, bonds that are sold at a discount can be a good tactical buy provided the bond issuer does not default.

4. STRUCTURED INVESTMENTS
Their performance is linked to an underlying asset or index. They also feature an option providing a specific pay-off. Structured investments like equity-linked structured products allow investors to earn fixed interest, while waiting for the right time to own stocks at a discounted price.

> *A general rule of thumb: Your core investments should form the bulk of your portfolio. Only risk a small portion (perhaps 25%-30%) in this satellite approach.*



WHY CONSIDER A SATELLITE APPROACH

After your core portfolio is capable of managing downside risks, a satellite approach can be considered. It can help you boost returns in good times, which becomes an additional buffer against downside risks.

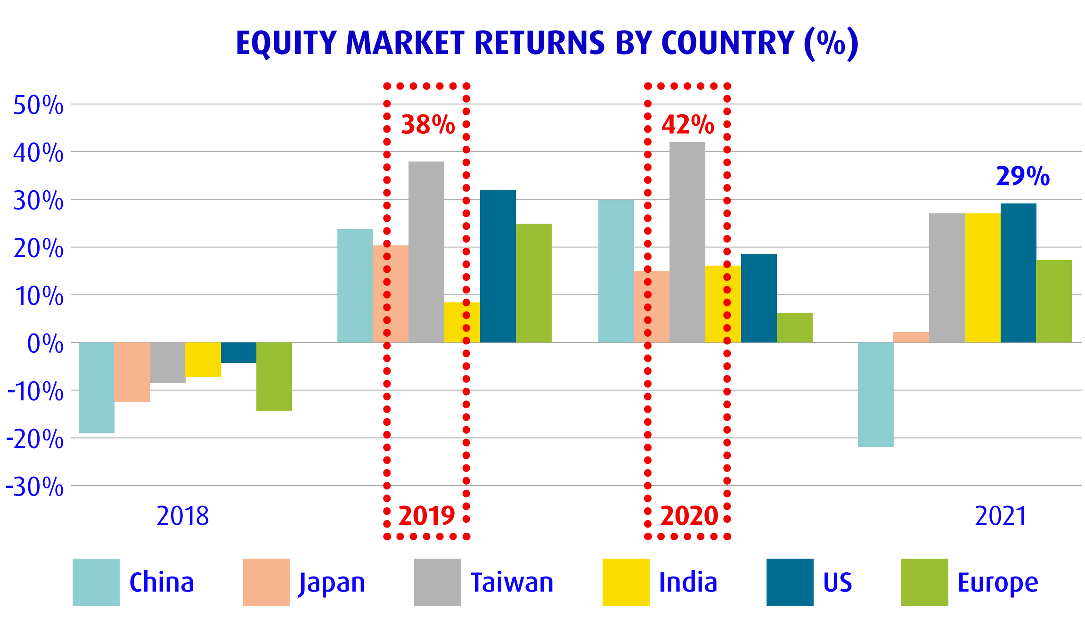
Below are two examples of the thought process that helps you target viable satellites:

1. TARGETING EQUITY MARKETS BY COUNTRY

Markets are unpredictable, but proper analysis can lead you to a calculated bet — such as targeting the semiconductor industry during the pandemic and the global chip shortage. Taiwan (a semiconductor giant), saw two consecutive years of solid gains in 2019 & 2020 (refer to the chart below), eclipsing China, Japan and Europe.

Even if it wasn't the biggest overall gainer, profits would have been healthy, amplified by bull market conditions. As a growth bet made on top of an existing core portfolio, it would have helped raise overall gains. While riskier, the risk is somewhat limited to that specific sector.

EQUITY MARKET RETURNS BY COUNTRY (%)



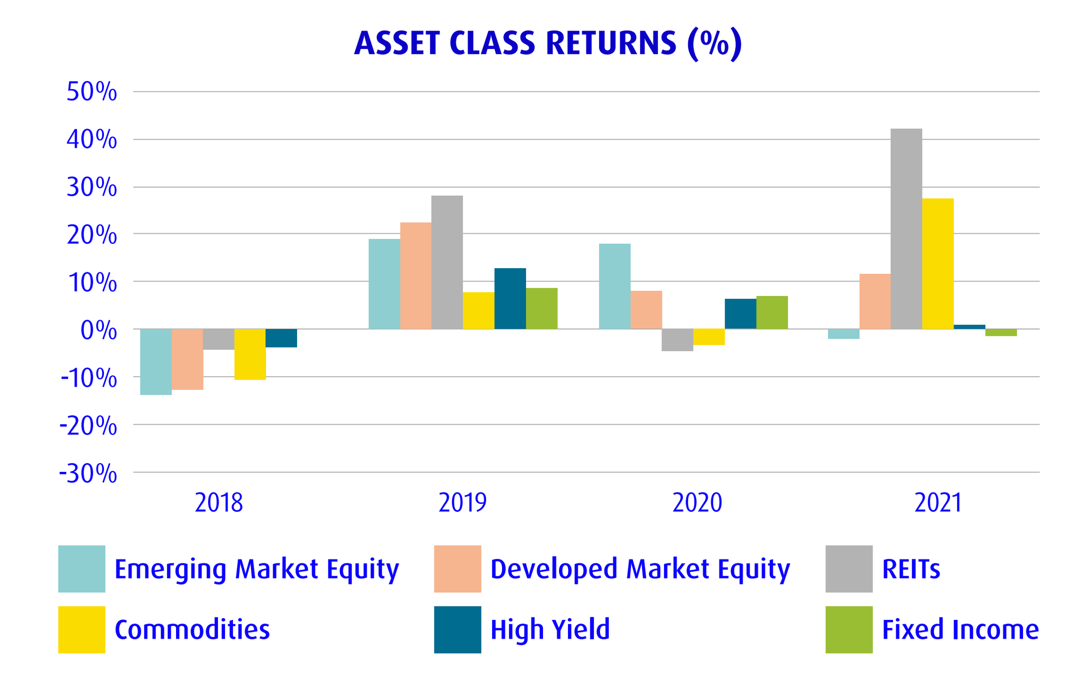
Source: Morningstar

2. TARGETING ASSET CLASSES

Are return profiles of asset classes random? Not entirely. Asset classes do respond differently in varying economic environments. In 2021, inflation rose to a decade-high and was a bullish signal for hard assets such as REITs and commodities which indeed outperformed.

Historically, emerging market equities tend to do better as economies emerge from recession — a pattern that repeated in 2020, where riskier and higher growth assets performed best during the onset of a recovery. The satellite approach targets these kinds of movements and can help improve one's chances of achieving profitability. Always consider your risk appetite and knowing how and when to utilise it is key.

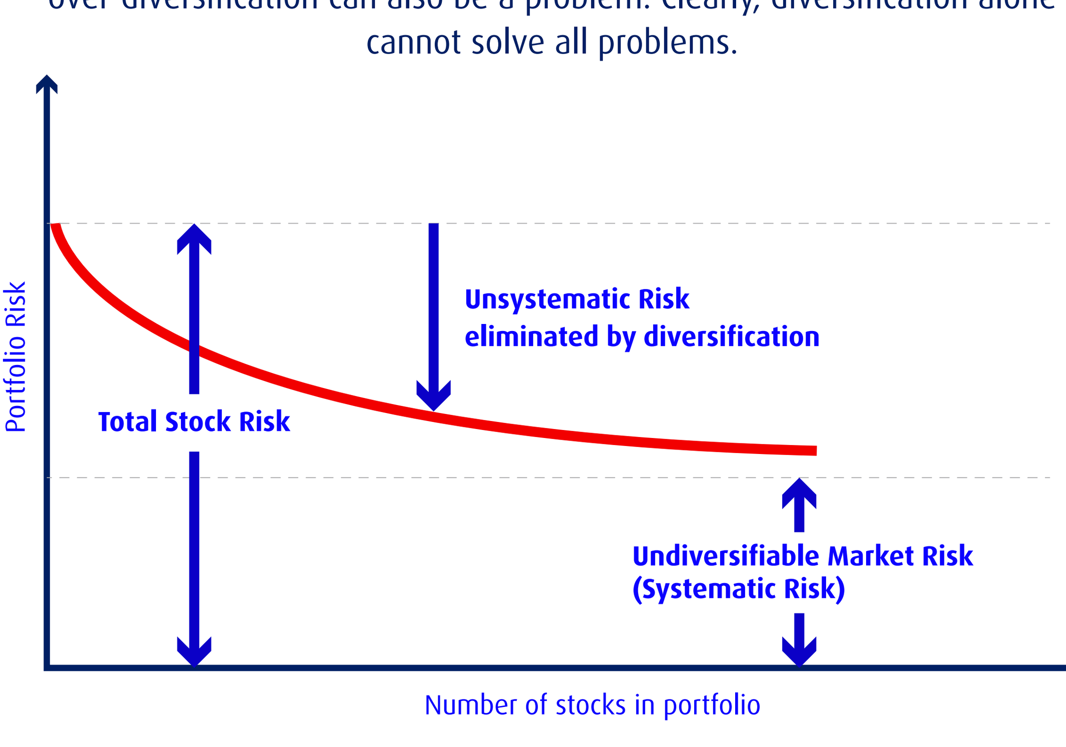
ASSET CLASS RETURNS (%)



Source: Morningstar

IS DIVERSIFICATION A MYTH?

Referring to the chart, diversification does appear to reduce risk. However, some risks cannot be diversified. Furthermore, studies have shown that over-diversification can also be a problem. Clearly, diversification alone cannot solve all problems.



Some things to keep in mind:

A one-stock portfolio, carries stock-specific risks & market risks. A bad quarter, lower earnings or competitive pressures can be dangerous.

Certain types of risks (from interest rates for example), cannot be diversified.

Even the most 'perfect' group of stocks will still drop if the overall economy heads into recession.

CONSIDER ALTERNATIVE STRATEGIES

1. Principal Protected Investments

For risk-averse investors who worry about their initial investment value (principal). Similar to bonds, they are fixed income securities that return your principal if held to maturity. They may also have a step-up feature that provides a buffer from rising interest rates via a pay-out (coupon rate) that increases annually. You should always determine the strength of the bank guaranteeing the principal, the underlying assets and any associated fees.

2. Equity-Linked Structured Investments

These derivatives are a financial instrument with a specific stock as the underlying asset. It mimics the movement of the actual stock and can help provide earnings during sideways market movement. Typically, you would be earning interest while waiting to make a favourable entry into your chosen stock. It's attractive when markets are very volatile and are selling-off.

Constructing a satellite portfolio takes time, knowledge and skill. Don't worry, you're not alone. At HLB, our team of investment specialists apply a rigorous and thorough analytical framework to identify market opportunities. They are at your service, and always happy to advise you.

HELP IS HERE!

LET'S TALK