By Brian D. Colwell

Exploring Asset Class Correlations And Risk Management

CONTENTS

Forward by Occupy Wisdom	i
Preface	ii
Chapter 1: Introduction	4
Chapter 2: Mitigating Investment Risk	6
Chapter 3: Stocks	12
Chapter 4: Income Assets	45
Chapter 5: Commodities	75
Chapter 6: Cash & Equivalents	105
Chapter 7: Cryptocurrencies	116
Chapter 8: Alternative Ivestments	179
Chapter 9: Final Portfolio	203
Chapter 10: Conclusion	206
Sources	ccvii
About the Author	ccxviii
Acknowledgements	ccxx
Glossary	ccxxi

FORWARD

There is a well known story from the Weimar Republic during the hyper-inflationary period of the 1920s where a man who was indebted to his neighbor, was able to satisfy his home's mortgage loan by trading him a single live chicken. While the book you are about to read concerns investing, and not monetary history, there is an important lesson to be learned from the story.

The man who made the loan and held the mortgage, the creditor, had made a valuable investment in receiving the debtor's principal and interest payments years before. After the hyperinflation of the German Papiermark, the future debt payments and property became worth less than a single chicken. How would anyone have forecasted a situation where owning a chicken was more valuable than owning a house? It would have been impossible to foresee. While this may sound far-fetched in the modern day, episodes similar to this are occurring in Venezuela and in other countries around the world, where stability and predictability in currencies, and assets, vanish quickly.

So what does this story mean for your investments?

It means that investing capital is not as predictable as some people may make it sound; circumstances change and much of the future is unknowable. "One investment fits all" strategies rarely (if ever) work as many asset classes are cyclical and positively or negatively correlated to each other. Why place all your eggs in one basket? There are countless investments you can make, across many asset classes.

In the following book you will learn the many different asset classes: equities, bonds, precious metals, cryptocurrencies etc. and you will be able to understand why diversification is absolutely essential.

@OccupyWisdom

PREFACE

GENESIS

Risk management and portfolio diversification are not clout seeking activities, are not exciting adventures, and do not require expensive certifications or money managers. Born from a desire to educate the masses on what proper portfolio diversification is and how it can be easily achieved, *What Is Investment Diversification?* is a never-to-be-completed resource for investors of all skill levels.

PURPOSE

This book was created not only as a resource for **CryptoTwitter** and investors of all types, but also as a reminder to the author as to what risk management entails (it's easy to get drawn into hype around technologies or investment opportunities perceived as "special"). Proper risk management and portfolio diversification are not difficult to achieve. This book is intended for those with a special interest in stable portfolio growth against all economic conditions, without the need to chase yields, momentum, or even hot traders and investment "gurus". *What is Investment Diversification?* serves not only as an educational resource, but also as a means to an end - financial sovereignty and stress-free living.

LIMITATIONS

What Is Investment Diversification? is limited by time. At some point, the author has to push the publish button. However, this book will never be considered as done and updates are planned including but not limited to: worksheets, the tracking of an actual portfolio, more on emerging markets, and a deep dive into high-yield bonds. In addition, this book is intended to showcase a diversified portfolio, with speculative investments moved to a separate portfolio and separate conversation.

SCOPE OF THE BOOK

From a topical standpoint, this book introduces the concept of diversification, defines the importance of risk management, identifies investable asset classes, and then digs into each asset class in some depth. Sectors and sub-sectors are discussed, as are potential investments to represent each theme or economic condition. Finally, a diversified portfolio is built using few assets with low fees and requiring low levels of personal management.

HOW TO USE THIS BOOK

There is an exhaustive amount of information in this book. For most of CryptoTwitter, the first two chapters on diversification amongst asset classes will be of value. In addition, this author believes the altcoin sections to be robust with many resources provided. Of personal interest is the section on privacy tech, which starts with the Cypherpunk movement, although it should be noted that the privacy tech project profiles need more work.

Those new to Bitcoin and cryptocurrencies should start with Bitcoin for beginners. Investors familiar with asset classes and investable assets therein will find the final portfolio chapter to be a clear resource against which to check one's own portfolio. The chapter on alternative investments will be of value for most investors, whom have probably not considered this asset class for investment.

CHAPTER 1

INTRODUCTION

“The purpose of diversification is to preserve wealth, while the purpose of investment concentration is to grow wealth.”

The word "**diversification**" is used frequently in the cryptocurrency industry by people that do not seem to understand the word. No, owning a bunch of different **altcoins** does not yield investment diversification. Neither does owning a bunch of stocks or ETFs yield diversification. Diversification comes from spreading investment into different asset classes, not just different assets.

According to the SEC, "diversification" is:

"One of the most important ways to lessen the risks of investing is to diversify your investments. It's common sense: don't put all your eggs in one basket. If you buy a mix of different types of stocks, bonds, or mutual funds, your overall holdings will not be wiped out if one investment fails. If you had just one investment and it went down in value, then you would lose money. But if you had ten different investments and one went down in value, you could still come out ahead."

The purpose of diversification is to preserve wealth, while the purpose of investment concentration is to grow wealth. This is important to understand. Investment diversification spreads risk, so a common side effect is reduced volatility and portfolio returns relative to an index (in most cases, the index chosen for performance and volatility comparison is the S&P500).

This makes sense… a portfolio with 100% investment in Bitcoin has been very volatile over the last 10 years, but has also resulted in more capital growth than would be seen in a portfolio diversified into the primary investment asset classes over the same period. Were an investor to have high risk-tolerance, investment concentration becomes an option to consider.

To recap, the benefits of portfolio diversification include minimizing the risk of loss, preserving capital, and producing stable returns.

CHAPTER 2

MITIGATING INVESTMENT RISK

"Allocating capital across many asset classes is essential for capital preservation."

Objectives
1. Define the Permanent Portfolio
2. Define asset classes
3. Assess economic conditions

Now that we have a working definition of what diversification is and why it is important, how can we achieve portfolio diversification?

Investing in assets whose returns are not correlated to one another is key to reducing risk and **portfolio drawdown** while producing stable returns. Harry Browne's long-term investment strategy was referred to as the "**Permanent Portfolio**" and serves as a great base upon which to build the conversation on risk mitigation and asset correlation.

SECTION 1

THE PERMANENT PORTFOLIO

According to Browne, a permanent portfolio should provide safety and stability, protecting an investor against an unknown economic future while also providing steady returns. To achieve these goals, Browne finally boiled-down the strategy to 25% U.S. stocks, 25% long-term U.S. Treasury bonds, 25% cash, and 25% gold.

While the approach may appear simple, it is far from simplistic, reflecting a sophisticated understanding of economics and financial history. For example, in this portfolio stocks were meant to provide strong returns during times of economic prosperity, Treasuries were selected for their strong performance during prosperity and deflation (and poor performance during other economic cycles), cash was meant as a hedge against periods of recession and tight money, and precious metals (gold) were meant to provide protection against high levels of inflation.

"The portfolio's safety is assured by the contrasting qualities of the four investments - which ensure that any event that damages one investment should be good for one or more of the others. And no investment, even at its worst, can devastate the portfolio - no matter what surprises lurk around the corner - because no investment has more than 25% of your capital." - Harry Browne

---

"Unlike some investment strategies that seek to minimize volatility in each asset class, the Permanent Portfolio seeks to increase volatility in each asset class in order to achieve stability across the whole portfolio. While at least one of the Permanent Portfolio's assets is normally in the doghouse, one of more of the other assets are usually doing quite well ... one of the easiest ways to destroy the safety and stability offered by the Permanent Portfolio is to replace one of the assets with something less volatile because it appears safer.

The Permanent Portfolio depends on volatility in its individual asset classes." - Craig Rowland, The Permanent Portfolio, Wiley, 2012.

This portfolio strategy works because capital is spread to various assets, each with their own risks and with price performance not totally correlated to one-another. Not only that, but this portfolio strategy followed an important but often neglected philosophy, "cash is not trash."

With markets looking heated and many suggesting recession is on the way, "cash is king" could be the mantra soon enough.

SECTION 2

WHAT ARE ASSET CLASSES?

In brief, an **asset class** is a grouping of assets based on similarities in financial structure, markets traded, geopolitical risks, and/or price movement correlation. While the Permanent Portfolio referred to four primary assets (stocks, bonds, cash, gold), it is also a slightly dated model. For example, at the time this portfolio strategy was created, Swiss Francs were still backed by real assets and cryptocurrencies did not yet exist.

For our modern, diversified portfolio, there are six classes of investable assets:

- Stocks
- Income Assets
- Commodities
- Cash & Equivalents
- Cryptocurrencies
- Alternative Investments

"But divide your investments among many places, for you do not know what risks might lie ahead." - the Bible, Book of Ecclesiastes

---

SECTION 3

AGAINST ECONOMIC CONDITIONS

There are four primary **economic conditions** with which a diversified investment portfolio must be able to contend. This is why diversification across asset classes is of key importance.

These economic conditions are:

- Prosperity
- Deflation
- Recession
- Inflation

For example, during times of **prosperity**, stocks and bonds outperform. **Deflation** tends to produce outperformance for bonds and cash assets. **Recession** is great for cash (and picking up depressed assets), and **inflation** produces capital growth for precious metals assets, especially gold.

The safest way to approach diversification against adverse economic conditions is to take a neutral stance, with the potential for any economic condition materializing equally weighted. This way our portfolio can achieve real returns in any market without relying on market timing or trading picks.

SECTION 4

SO, WHAT'S THE POINT?

The point is that most investors take on too much risk without considering the opportunities that come from stable returns and steady income. Proper portfolio diversification provides risk management. To reiterate: no - a bunch of altcoins does not diversify one's portfolio.

Portfolio diversification comes from allocating capital across asset classes, not into asset classes.

Taking an approach similar to the Permanent Portfolio would suggest that we allocate 16.6% of our capital to each of the six asset classes in order to achieve proper portfolio diversification.

Now, let's take a look at each of the asset classes mentioned earlier. What are they? What research is needed to understand each asset class? What investment opportunities are available in each asset class?

Finally, how can the average investor take advantage of this knowledge to create a low-fee, simple-to-manage, diversified portfolio designed for capital preservation, stable income, and steady growth?

Is it even possible to create a "risk-management" portfolio with few assets?