Edison Wealth Management

Why correlation matters

17th November 2022

Barring a miraculous turnaround, 2022 is on course to be one of the worst years on record for investors. While headline falls for stock markets may not be on a par with the crashes of 2000 or 2008, the real pain has been felt elsewhere in portfolios; every single major asset class is in negative territory, exposing the established merits of diversification.

Diversification is widely accepted as a key risk-mitigation tool. To most people, the idea of putting your eggs in different baskets makes intuitive sense. For portfolios, these 'baskets' have broadly been stocks (equities) and bonds since their prices largely did not move together.

But this year, both equities and bonds have sold off, largely because of increased uncertainty in global markets and rapidly rising interest rates. Whereas historically these assets have counterbalanced each other, this simultaneous downward move indicates they have become highly correlated. Correlations are an important term in understanding why and how diversification is supposed to work.

What are correlations

Correlations measure the relationship between any two variables. It could be between the weather and umbrella sales, or between two investments. They are an indication of how likely two things are to move in tandem. Correlations typically fall into three brackets.

A positive correlation means the movements of one asset are closely tied to the movements of another. If one asset performs well, data suggests that the other will do well too – and vice versa.

Assets with negative correlations move in different directions to each other. When one asset tends to do well, the other tends to do badly.

When there is no discernible relationship between two assets, they are considered non-correlated, or in other words, the correlation is zero.

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Insight: How recessions impact returns

Therefore, any two financial assets with the required return history will have a correlation that is either positive, negative or zero.

Why are correlations important

There are lots of types of risk associated with investing. But one, diversification risk, arises when the assets in the portfolio all behave in a similar way.

Correlation information helps to understand how the component parts of a portfolio might behave when combined. A portfolio containing only positively correlated assets would carry higher risk, since there is nothing in it to offset market movements. While this would benefit returns in an up-market, it would likely lead to greater drawdowns when markets turn.

Because cautious investors tend to require a more risk-averse strategy, negative correlations and effective diversification arguably play a bigger role at the lower end of the risk spectrum.

Therefore, quantifying inter-asset relationships at the portfolio construction stage can indicate ways to diversify and reduce the overall risk.

Historic correlations

For the past two decades the equity/bond correlation has been consistently negative, and investors have mostly been able to rely on their bond holdings for protection when equities sell off.

Go back a bit further and history tells a slightly different story, showing that correlations are not static. They can spend years at a time in negative or (mildly) positive territory. This is largely due to a complex and dynamic interaction between macroeconomic factors.

A slightly clearer trend emerges if we consider periods of market weakness. Looking at the US S&P 500 index, there have been 20 instances of 10%+ declines since 1927. US bonds delivered a positive return in 17 of them. Meanwhile the average bond loss during the three negative equity drawdowns was a palatable -2.3%.

What happened this year

Unlike the 2020 Covid-led sell-off, where a steep decline in equities was offset by soaring bond prices, 2022 has seen a synchronised correction in almost every asset class. Correlations have turned positive.

Indeed, the end of the third quarter saw parallel bear markets (a fall of greater than 20%) in three entirely different assets; the S&P 500 (-25%), the yen/US dollar rate (-20%) and the copper price (-23%).

It's hard to remember a global market downturn with so few places to hide. When looking at annual returns, there have been only two calendar years when US equities and bonds both suffered losses, 1931 and 1969. Are we on course for a third?

What we are doing about it

Statistics tells us that a rise in equity/bond correlations increases portfolio volatility and expected drawdowns. What they don't tell us is whether we are entering a new era of positively correlated assets, or if 2022 is a one-off.

Attempting to anticipate future changes in correlation is an exercise in forecasting both policy decisions and how economic factors might respond to them. Positive correlation regimes are generally characterised by high and variable interest rates and inflation rates, accompanied by monetary surprises.

We think it's worth looking outside of the traditional equity and bond asset classes to protect against the possibility of reduced diversification.

That's why this year we have increased our exposure to alternative and uncorrelated investments to make up the 'diversification deficit' if correlations remain higher for longer.

We look to areas such as commodities, infrastructure, long/short equity, and dynamic trading strategies to outperform when traditional asset classes are weak. The aim of reallocating to alternative assets is ultimately to maintain an optimal balance of portfolio risk and return – regardless of where correlations go.

If you have any questions on the above or to find out more about our investment service, please call 020 7287 2225 or email hello@edisonwm.com.

You can read more about us by visiting our website www.edisonwm.com.

Important Information

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This document does not constitute advice.

The value of investments and the income arising from them can go down as well as up and is not guaranteed, which means that you may not get back what you invested. Past performance is not necessarily a guide to the future.

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