MARKET INTELLIGENCE

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The Correlation Bubble

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Close attention to correlations can help you manage your investment risk.

One of the primary ways investors attempt to reduce risk and volatility within their portfolio is by combining different asset classes and sector exposure. Portfolio theory would dictate that investors strategically incorporate asset classes with low correlations to reduce portfolio volatility as measured by standard deviation. Examples of asset classes would be Large Cap Canadian Equities, Commodities, Real Estate, Government Bonds, High Yield Bonds, Emerging Market Equities, Hedge Funds and so on. Since the "Great Recession" of 2008, macro volatility has increased significantly, and combined with the globalization of economies, correlations among asset classes, stock markets and sectors, is on the rise.

Correlations among asset classes and different stock markets have never been higher, and this reality is increasing portfolio volatility and making it very challenging for investors to achieve diversification with their investment strategies.

Figure 1 shows the average correlation between 45 different stock markets in the world.

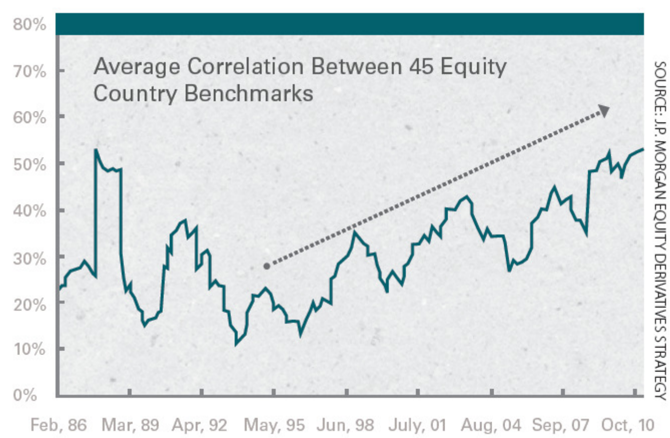

Figure 1

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Figure 2 shows correlations among the sectors and stocks that make up the S&P 500 Index in the United States.

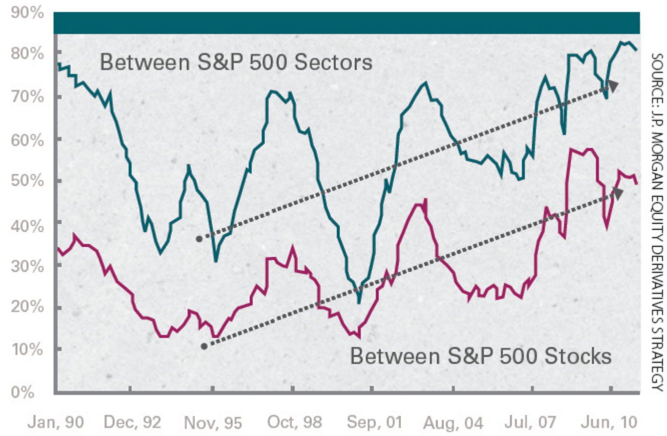

Figure 2

One asset class that has proven to dampen portfolio volatility when equity correlations are high are market-alternative strategies, sometimes known as hedge-fund strategies. As equity correlations rise above 50 per cent, market-alternative strategies have experienced correlations to equities in the 20 per cent to 40 per cent range, which has acted to reduce portfolio volatility. It is very important to fully investigate which market-alternative strategy you should employ, as there are a large number of different funds and strategies in this asset class that can produce dramatically different results with varying degrees of risk.

Prior to 2008, commodities were essentially uncorrelated to equities and bonds, and generally had weak correlations among themselves.

The correlation between the price of oil and the stock market ranged from -20 per cent to +10 per cent for the 15 years prior to 2008, but since 2008 it has climbed steadily to today's current reading of around +60 per cent. Oil has now become one of the most highly correlated commodities with equity markets.

When it comes to the oil and gas sector, a good number of people in this province can end up with an overweight position in this sector over time. Oil and gas exposure has created large amounts of wealth for investors and business owners, but with global correlations on the rise, how can energy entrepreneurs or investors diversify and protect their portfolios?

Table 1 shows various correlations on a one- and three-year basis for a number of asset classes and sectors versus oil and gas equities. Some clear themes emerge from the data. Firstly, over the last year, some strong negative correlations have existed between fixed income and energy equities. What this means is that as bond prices have risen in value, energy equities have fallen in value. Among the equity sectors generally, the conservative sectors of consumer staples and utilities tend to demonstrate the lowest correlations to energy equities. So what does all this mean for portfolio construction?

CORRELATIONS OF ENERGY EQUITIES WITH OTHER ASSETS

	1 Year	3 Year
Long-Term Government Bonds	-0.79	0.20
Real Return Bonds	-0.68	0.73
Corporate Bonds	-0.29	0.71
Utility Stocks	-0.30	0.80
Consumer Staple Stocks	0.13	0.89

Table 1

Reflecting on the data and relationships of Table 1, if we exclude shorting energy stocks and investing in inverse energy exchange traded funds, a well-managed portfolio of fixed income can work quite well to dampen volatility and protect capital when you are overweight in energy equities.

We have a number of clients at our firm who are overweight in energy because of where they work, and we have developed customized solutions made up of government bonds, corporate bonds and actively managed preferred shares to provide a "stable low- risk bucket" within a client's overall portfolio. Today may not be the time for overweight long-term government bonds, but the world of fixed income has many options and needs to be actively managed. In addition to fixed income, an investor can layer in exposure to low-correlation sectors like utilities, telecoms and consumer staples to increase the overall portfolio growth and yield potential. Relative to bond yields, dividend yields in a number of sectors remain very attractive.

Two other equity sectors that have at times proven to be very good diversification tools within an overweight energy portfolio are technology and health care. The technology sector makes up about one per cent of the entire Canadian stock market and we believe that owning a select number of high-quality U.S. technology companies can add growth and diversification to a Canadian-oriented resource portfolio.

So as you diversify your energy portfolio, consider the dynamics of correlations and risk when it comes time for reinvesting those hard-earned profits.

At McLean & Partners, we believe diversification is an important strategy to employ in every portfolio. In this specific report, we outline how it will decrease your sector risk.

Year-to-date, our pools are outperforming the market- our Global Balanced Pool is up 6.3%, our Global Dividend Pool is up 9.9%, and our International Equities Pool is up 11.1%.

If you are interested in discussing how to diversify your portfolio, we extend an invitation to you to consult with one of our Portfolio Managers, at no obligation. We would be happy to assist you at 403-234-6118 or ctsang@mcleanpartners.com.

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