

Find me some uncorrelated assets!

Tim Farrelly | farrelly's Investment Strategy | 17 September 2018

For many years, the search for uncorrelated assets has been the holy grail of investment world. It started with Markowitz in the 1950s, who showed mathematically that low or negative correlation is the secret sauce that makes diversification work. The lower the correlation, the better.

While Markowitz's maths unquestionably stacks up, the way it is often used – or, more to the point, abused – does not. Typically, we see someone producing a correlation matrix over a single time period, illustrating the remarkable low or negative correlations of their chosen asset classes.

The problem with this is that correlations change over time.

Take equities and government bonds, which have shown strong negative correlations over the past 20 years. All good – except that, for the 40 years prior to 1995, those correlations were closer to positive 0.3 rather than the great diversification implied by a negative 0.4 correlation.

Japanese equities and US equities showed strongly divergent behaviour between 1980 and 2000 - in other words, very low correlation. This was then followed by 15 years of very similar month-to-month performance. Which is the real correlation? The answer is 'it depends'. If two countries experience normal economic growth, their equity markets will generally be highly correlated. If their economic paths diverge sharply, so too will their underlying market performance. Ahead of time, investing in two markets does offer diversification benefits. The second market provides a level of insurance in case the first market fails to perform for reasons unique to that market. If, after diversifying into two markets, both perform similarly with very high correlation, that does not mean that the markets were actually very highly correlated. It simply means that the insurance was not called upon over that particular period.

Secondly, we need to know the cost of the insurance that low correlation buys. Investing in a market with genuinely low correlation is unhelpful if the expected returns on that market are so low that we could have reduced risks more simply by increasing our exposure to cash. Gold is an asset that often appears to fit the bill here.

Finally, we often see presentations promoting unlisted assets during which the speaker produces an impressive looking chart showing the very low correlations of monthly returns of their chosen asset class compared to mainstream equities and bonds. It's pure nonsense! Comparing the behaviour of listed and unlisted assets over short time horizons simply reveals that one asset is valued by the market on a daily basis, while the other is subjectively valued on a quarterly or annual basis. To get any sort of meaningful data, we need to find ways to measure returns on a like-for-like basis.

So what do we do? We need to *think*, not measure. We need to think about our own investment time horizon and about what may drive poor performance in different assets over that time horizon. Do our different asset classes largely perform the same under those scenarios or are they often different? This will provide the best guide to how different assets are correlated.



As for searching the data for low correlations? It's nuts and you can clearly see it's nuts!



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