CORRELATION: HOW INVESTORS CAN PUT THEMSELVES AT RISK WITHOUT REALIZING IT

A Google search for correlation states it is the relationship between two or more variables that indicates the extent to which those variables fluctuate together. In other words, from an investment perspective, it indicates how one security or asset class moves relative to another, either up or down.

When assets are highly correlated, the value of those assets have a tendency to move up and down at the same time. Perfectly correlated markets have correlation of 100%. Conversely when the value of securities moves in opposite directions, they are negatively correlated having a negative correlation of 100%. For general discussion, a correlation higher than .7 or 70% is considered a strong correlation.

So why is it important? In constructing portfolios, one of the goals is to improve the consistency of the return stream. To accomplish this goal, risk (as measured by the up and down price movement of the total portfolio) can be reduced by combining investments with a lower correlation to each other. This statistical measure can be applied not only to asset classes but also investment strategies within the same asset class, manager styles, sectors of asset classes and even securities within sectors. In this way, the highs won't be as high, but the lows won't be as low, resulting in a more consistent risk adjust return.

Simple as it sounds, it is anything but simple in today's investment environment. The calculation of correlation uses historic return data, and therefore, correlation is subject to change depending on the market influences. Recently, we have witnessed correlation convergence between markets which historically had a low correlation. Before the global economy, international stocks used to have low correlation to U.S. equities, as did bonds. Today the correlation has risen to 90%. Even small-cap stocks and emerging markets have significantly higher correlations than in past periods. In periods of market stress, it is not unusual to hear market analysts state there is no place to hide, meaning correlations have converged.

Recently there has been a lot of talk of alternatives (meaning alternative strategies), which can include hedge funds, private equity, and private debt to mention a few. These strategies traditionally have experienced a low correlation to long-only equities and bonds and are strategies long-used by pensions, endowments, and accredited wealthy individuals to diversify their portfolios. With the introduction of liquid alternatives, all investors now have the access to low-correlated strategies to diversify their portfolios.

In constructing the Smart Money Portfolios, we use correlation to measure the diversification between the individual strategies within the portfolio. For example, in long-only equities, we match a value manager with a growth manager. Additionally, on the equity side we add merger arbitrage. In fixed income, we have introduced alternative debt strategies to reduce the impact of rising rates. Other strategies will be added from time to time as the environment shifts.
In summary, correlation matters when constructing portfolios. It is just one of the tools used to create and monitor portfolio diversification to achieve the best risk-adjusted return within the confines of a client's risk tolerance.

IMPORTANT INFORMATION

Sightline Wealth Management LP ("Sightline") is an investment dealer and is a member of the Investment Industry Regulatory Organization of Canada (IIROC) and the Canadian Investor Protection Fund (CIPF). Sightline provides management and investment advisory services to high-net-worth individuals and institutional investors primarily through fee-based accounts.

Sightline Wealth Management LP is a wholly owned subsidiary of Ninepoint Financial Group Inc. ("NFG Inc."). NFG Inc. is also the parents company of Ninepoint Partners LP, it is an investment fund manager and advisor and exempt market dealer. By virtue of the same parent company, Sightline is affiliated with Ninepoint Partners LP. Information and/or materials contained herein is for information purposes only and does not constitute an offer to sell or solicitation to purchase securities of any issuer or any portfolio managed by Sightline Wealth Management or Ninepoint Partners, including Ninepoint managed funds.

The opinions and information contained in this article are those of Sightline Wealth Management ("Sightline") as of the date of this article and are subject to change without notice. Sightline endeavors to ensure that the content has been compiled from sources that we believe to be reliable. The information is not meant to be used as the primary basis of investment decisions and should not be constructed as advice. Each investor should obtain independent advice before making any investment decisions.

Royal Bank Plaza, South Tower
200 Bay Street, Suite 2700
Toronto, Ontario
M5J 2J1