Diversifying Your Portfolio

Understand the Significance of Correlation

Many investors rely on correlations to measure the diversification potential of their portfolio – whether they should expect their investments to perform similarly or differently over time. But correlations are simply a snapshot in time. They indicate how investments have performed in the past. It’s important to know how and why correlations can change, otherwise your portfolio may perform differently than you expected.

Key points

1. **Correlations are dynamic.** Simply looking at the long-term average correlation is an oversimplified way of estimating future correlation benefits.

2. **Correlations can change for many reasons.** Asset classes perform differently within varying economic environments. Understanding economic and market conditions is necessary to place an asset class’s correlation into context.

3. **Volatility can override correlation.** Many investors believe that as long as asset classes have historically low correlations, they’ll provide diversification benefits in the future. But during times of extreme volatility, correlations have historically converged, and that benefit potential disappears.

4. **Next steps.** Diversifying by risk factors, not just return sources, may be one way to help protect portfolios from the uncertainties of shifting correlations. Talk with your advisor to make sure that the diversification of your portfolio hasn’t changed over time.

The story of real estate

These key points can be illustrated by examining the historical correlation of the real estate sector and the stock market. This illustration is neither meant to advocate nor discourage an investment in the real estate sector. It’s intended to illustrate some key points about the nature of correlations, keeping in mind past performance is no guarantee of future results.

Diversification does not guarantee a profit or eliminate the risk of loss.
1 Correlations are dynamic

Chart 1 clearly shows that correlations are dynamic. From 1982 through 2012, the average correlation of real estate and the S&P 500 Index was 0.54, but correlations have rarely been at that point. They have often been either far above or far below. The highlighted area indicates the years we will focus on in the next two charts, from 2001 to 2012.

Historical correlations are no guarantee of future correlations.

2 Correlations can change for many reasons

During the late 1990s and early 2000s, investors were attracted to technology and telecommunications stocks, rather than slower growth, income-oriented securities such as real estate investment trusts (REITs). This demand began to drive up the price of equities, while lack of demand for REITs led to depressed prices for these securities. The result: reduced correlation between the two assets, as seen in Chart 2.

Chart 2: 2001-2006 — Real estate has a low correlation with the market

From August 2001 to December 2006, the correlation between the FTSE NAREIT Equity REITs Index and the S&P 500 Index ranged from a historical low of -0.02 to around 0.55, right around the long term average.

But in 2003, at the same time that equity prices were rising, interest rates hit record low levels. Investors began seeking yield opportunities and increased their allocations to REITs, which offered higher relative yields. Because real estate and equities had a recent history of low correlations, investors felt that in addition to performance, they were gaining diversification benefits. But, as the prices of both REITs and equities rose in tandem, that led to heightened correlation and reduced diversification benefits.

Correlation indicates the degree to which two investments have historically moved in the same direction and magnitude. A greater positive correlation (+1.00 maximum) means the two investments have behaved more similarly; a greater negative correlation (-1.00 maximum) means the two have performed less similarly.
Understanding economic and market conditions is necessary to place an asset class’s correlation into context and develop more appropriate expectations.

3 Volatility can override correlation

Later in the 2000s, the real estate market became overheated, driven by leverage and easy credit. During times of extreme volatility correlations of all types of asset classes have historically surged toward 1.0. Chart 3 shows this was true for real estate and equities.

![Chart 3: 2007-2012 — Real estate has a high correlation with the market](image)

From 2007 to 2012, the FTSE NAREIT Equity REITs Index became closely correlated with the S&P 500 Index – correlations soared to above 0.8. This meant that as the market was plunging, so too was real estate. The result was that investors got less diversification benefit from their real estate allocation.


Correlations tend to move during times of extreme volatility.

When the US entered a deflationary recession in late 2007, many investors’ portfolios were filled with asset classes that tended to perform well during the type of low-inflationary growth cycle we had been experiencing since 2003. What many investors didn’t realize is that real estate and equities are both subject to downward price movement during some forms of economic turmoil. Investors thought they were gaining a measure of protection by increasing their real estate allocation, but in reality, they were still vulnerable to the effects of a recession.

4 Next steps

It is important to think carefully about the potential effects of changing correlations – and to understand that those changes can be quick and dramatic during times of market volatility.

To use correlations more intentionally, be aware of the following:

- The long-term average
- Where the figure has recently been
- How economic and market conditions might affect the correlation going forward

While past performance cannot guarantee future results, we believe investors should consider diversifying among asset classes that have historically performed well in each of the three major economic environments – low-inflationary growth, inflation and recession. During recessions, currency-hedged government bonds and cash have typically provided some defense against market downturns. During inflationary periods, commodities have historically provided meaningful returns.

Exposure to asset classes with varying risk factors will not eliminate losses, but it may reduce volatility and overall drawdowns. Talk to your advisor about your portfolio’s diversification and whether you are fully prepared for shifting economic environments.
Your challenge as an investor is to create a financial plan that’s built to meet your needs no matter what the markets are doing. Meeting that challenge requires thoughtful planning, deliberate action and a financial partner who’s dedicated to your success — that’s what Intentional Investing is all about.

Diversification does not guarantee a profit or eliminate the risk of loss.
In general, stock and other equity securities values fluctuate in response to activities specific to the company as well as general market, economic and political conditions.
Real estate related instruments may be affected by economic, legal, or environmental factors that affect property values, rents or occupancies of real estate. Real estate companies, including REITs or similar structures, tend to be small and mid-cap companies and their shares may be more volatile and less liquid. Investments concentrated in any one sector or industry is subject to increased volatility if conditions adversely affect that sector or industry.
The S&P 500® Index is an unmanaged index considered representative of the US stock market. The FTSE NAREIT Equity REITs Index is an unmanaged index considered representative of US REITs.
An investment cannot be made in an index.