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The curious case of correlations

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Investors face a trade-off between return and stability – the more they seek of one, the less they get of the other. By investing in multiple asset classes, investors can tilt the balance of this trade-off in their favour by reducing volatility while preserving total return potential. Suppose you own an all-equity portfolio and a sudden change in personal circumstances requires you to seek more stability and forgo some growth. You could reallocate one-half of the portfolio into cash, which would cut the volatility and return potential roughly in half. Alternatively, if you invest some of that cash into bonds (the positive-yielding kind, not the negative-yielding Swiss kind), which typically rise when stocks decline, you can further reduce volatility and improve return expectations at the same time – this is clearly the preferable route. When a portfolio combines asset classes that exhibit negative or weak correlations with each other, it has greater opportunities for improving risk-adjusted returns. This is why we diversify.

This notion has been challenged in recent years as the typical correlations between equities and bonds have broken down on several occasions. During the "taper tantrum" in the summer of 2013, equities and bonds sold off in tandem in response to comments by Ben Bernanke, then the chairman of the U.S. Federal Reserve, about reducing asset purchases through its quantitative easing program. We witnessed similar patterns in the spring and in August of this year when equities sold off and bonds did not come to the rescue. In each case, bonds were out of favour amid expectations of central bank tightening. This led anxious equity investors to invest in cash rather than bonds. The breakdown in correlations naturally poses a challenge for investors who rely on diversification.

The good news is that the normal inverse relationship between stocks and bonds is making a comeback. In September, the Fed reaffirmed its zero interest rate policy and lowered its interest rate projections for the near and long term by 25 basis points. This dovish positioning provided reassurance to the bond market that the central bank is sensitive to slowing global growth and is not rigidly following a pre-set path to tightening. With future rate hikes pushed back, some of the pressure on bonds has been relieved and they are more likely to act as a safe alternative to stocks in periods of stress. Indeed, in recent weeks government bonds have performed well when investors have been fearful.

Global monetary policy is still in an easing mode given subdued global growth, as most major economies continue to recover from the great recession. Lifting rates in this environment is difficult for any nation and current Fed Chair Janet Yellen can attest to that. Meanwhile, investors continue to grow more nervous about China and the possible spillover effects to the rest of the world. With the threat of quickly rising rates now put aside, investors who want stability will feel more comfortable owning bonds as insurance in their portfolio. Alone, bonds may disappoint but when paired with other assets like equities, the combination can produce attractive risk-adjusted returns.

It is very encouraging to see a return to normal correlations but we know that stocks and bonds do not always behave normally. Buying assets at the right price and occasionally holding cash and foreign currencies is the best defence against abnormal correlations, providing a smoother ride toward your financial goals.

Combined top 15 equity holdings as of September 30, 2015 of a representative balanced United Financial portfolio with alpha-style equity exposure:*

1. Manitoba Telecom Services	6. Loblaw Companies	11. Alphabet Inc.
2. Altagas	7. Suncor Energy	12. Empire
3. Atco	8. CIBC	13. Industrial Alliance
4. E-L Financial	9. Toronto-Dominion Bank	14. Canadian Tire
5. Resorttrust	10. Deutsche Wohnen	15. Citigroup

Combined top 15 equity holdings as of September 30, 2015 of a representative balanced United Financial portfolio with value-style equity exposure:*

1. Toronto-Dominion Bank	6. American International	11. Citigroup
2. Apple	7. Manulife Financial	12. Boeing
3. Royal Bank of Canada	8. UnitedHealth Group	13. Visa
4. Microsoft	9. CIBC	14. Diageo
5. Bank of Nova Scotia	10. Alphabet Inc.	15. GlaxoSmithKline

*Approximately 37% fixed-income, 7% enhanced income, 49% equities and 7% global real estate.

To see the top 15 holdings of the individual United Pools or of the United equity Alpha mandates, please visit the United Financial web page by right clicking on this link and selecting “open web link in browser”: http://www.assante.com/wp/optima/financials.jsp#united15.