Correlation, Diversification and Investment Success

Suppose you owned a baseball team and decided to fill the roster exclusively with pitchers.

Needless to say, you wouldn't be very successful. While pitchers are trained to foil batters, most don't hit or field very well. Any baseball fan knows that a team must have a diversity of skills in order to win.

Diversification is just as essential in investing. A strong investment portfolio features different asset classes, each with a role as distinct as those on a baseball team. Together, these asset classes can be greater than the sum of their parts.

Instead of baseball players, let's look at stocks and bonds. The long-term average annual return of U.S. stocks has been 11%, while bonds have returned 7%. Should we invest 100% in stocks then?

The answer, of course, is no—and the reason is risk. On their path to superior long-term performance, stocks may swing sharply upward and downward. Bonds, on the other hand, may achieve their more moderate long-term performance with less volatility (as determined through a measurement known as standard deviation).

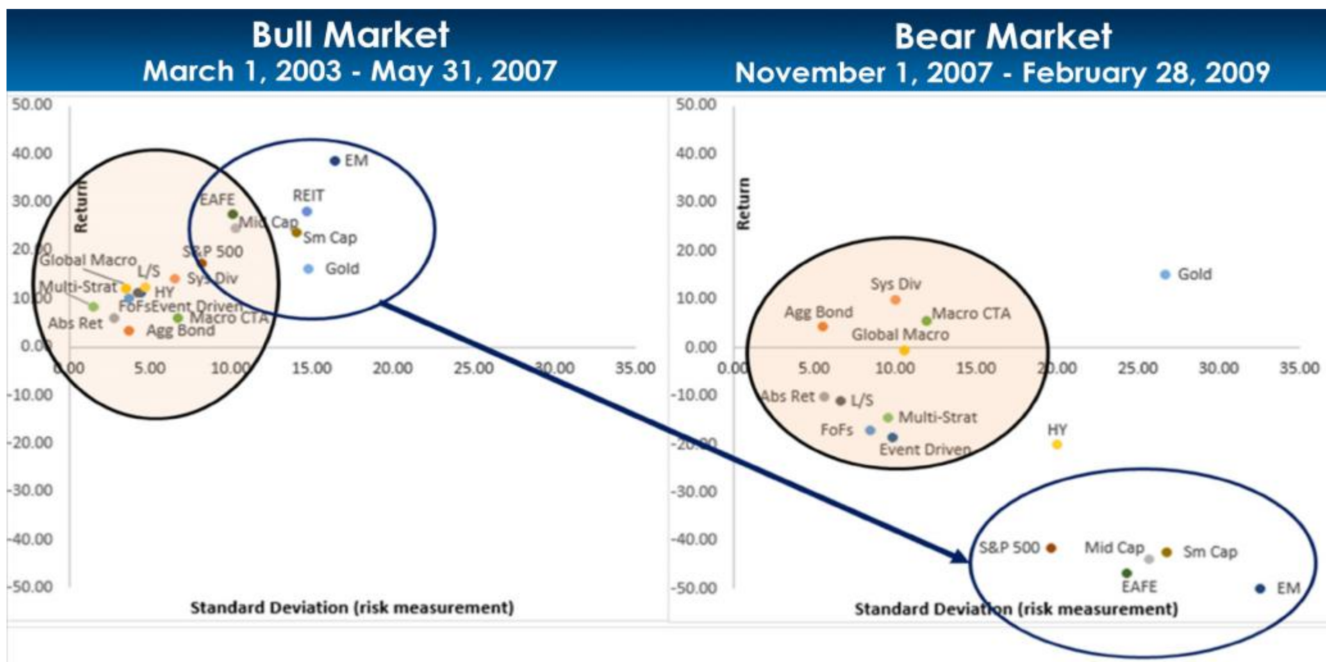
Indeed, from January 1976 through February 2015, the S&P 500 returned an average annualized return of 11.64%, with a standard deviation of 15.01%. The Barclays Aggregate Bond Index averaged a 7.86% return, with a lower standard deviation—just 5.46%. On average, stocks outperformed bonds, but with greater volatility.

Lower volatility may mean not only more peace of mind for the investor, but also better results. Why? It's because of the mathematics of compound interest. Let's say one $100,000 portfolio rises 10% each year, while another $100,000 portfolio rises 30% in the first year and falls 10% in the next. Both portfolios average returns of 10% per year. But after the two years, the first investment is worth $121,000, while the second is worth $117,000, $4,000 less. The forces of compounding favor smoother portfolios and especially those that avoid steep losses.

Combining stocks, bonds and other asset classes creates the best balance of risk and return. To choose which to combine, investment professionals rely on a measurement known as correlation.

Correlation shows how different investments behave under the same circumstances. Investments that rise and fall in tandem have a positive correlation; those that move in opposite directions have a negative correlation.

This is why stocks and bonds, which typically have a low correlation, are frequently combined to provide the diversification benefits of low risk and high return.



How might you achieve even greater diversification benefits? One way is by finding “alternative” asset classes—such as commodities, gold and tactical strategies—that have low correlations to both stocks and bonds.

Historical data confirms this argument. In the bull markets ending in March 2000 and May 2007, alternative and traditional asset classes had similar returns, but traditional assets were more volatile. Meanwhile, in two bear markets ending September 2002 and February 2009, traditional asset classes suffered large losses, while alternative asset classes did much better. The bottom line: By combining the traditional stock and bond investments with alternatives, investors can reduce overall portfolio risk and enjoy better returns.

To review, diversification—combining asset classes with low correlations—is the key to successful long-term investing. While stocks and bonds provide a strong foundation for diversification, the addition of alternative assets can result in even stronger portfolios.

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