

Perpetual knowledge bank series: Correlation

By Perpetual Asset Management

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Correlation has several meanings and applications within investment and financial services but here we are looking at the concept in terms of basic portfolio management. The degree to which two securities move in relation to each other is called correlation and should be a fundamental consideration when creating a diversified investment portfolio. A common

misconception among investors is that they are broadly diversified across multiple asset classes when they have merely invested in multiple sectors of the equities asset class, which are likely to rise and fall with that market's movements. However, it is only when positions are held across multiple uncorrelated asset classes that a portfolio is genuinely diversified and better able to handle market volatility, as the high-performing asset classes can balance out the underperforming classes.

Both equity and fixed income products are financial instruments that can help investors achieve their financial goals. Each of these and other asset classes have distinct risk-and-return profiles and investors, in consultation with their financial adviser, should choose an optimal mix to achieve the desired risk-and-return combinations for their portfolio. However, whether an investor thinks fixed income presents an attractive opportunity for growth or not, it is vital they understand the asymmetric nature of credit investing means avoiding the downside is as (or even more) important than capturing the upside. This means looking for providers that take a measured approach to risk, have experience across multiple market cycles and the discipline not to push further into riskier segments to pick up yield. The value of defensive assets should after all be measured by their ability to protect investors against significant losses from major market downturns. Delivering modest growth should be a secondary consideration.

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