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When Diverse Markets Act as One - A Look at Current Asset Class Correlations

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Throughout most of our financial history, every investment has performed to its own tempo. Losses in one area of a portfolio were typically offset by gains in another. But in the wake of the credit crisis and the Great Recession of the past few years, this tendency appears to have changed, at least temporarily. Investment performance has become more synchronized. Gains in any one type of investment are frequently mirrored across the portfolio; losses, too.

The technical term for this type of behavior in investment returns is correlation. Assets whose returns march together perfectly like troops on parade are said to have a correlation of 1.00 with each other. Those that move at exactly the same pace but in precisely the opposite direction are said to have a correlation of -1.00. Assets whose returns vary randomly - those moving more like children running willy-nilly than like coordinated soldiers - would have a correlation approaching zero.

The Current Situation

As of the middle of September, the trailing three-year correlations among most principal asset classes were well above their long-term averages. Between small-cap stocks and the S&P 500, for example, the correlation was 0.93; between developed foreign markets and the S&P 500, it was 0.91. Bonds (0.46) and commodities (0.58) were less correlated than the stock style variations, but non-equity classes also have become much more correlated than they had been previously. (Keep in mind that higher correlations don't necessarily increase the likelihood that a portfolio will lose money over the long run. Higher correlations do, however, signal that the value of that portfolio could be more variable from week to week and month to month in the meantime.)

S&P 500 Sector Correlations with the S&P 500

	Rolling 36-Month Correlations with S&P 500: 12/31/89-9/17/10					
S&P 500 Sector	Low Value & Date		Average	High Value & Date		Current
Consumer Discretionary	0.70	12/94	0.85	0.93	9/10	0.93
Consumer Staples	(0.01)	2/02	0.63	0.88	12/92	0.87
Energy	0.30	9/05	0.56	0.74	9/10	0.74
Financials	0.63	12/01	0.82	0.95	8/98	0.88
Health Care	0.15	3/02	0.63	0.87	12/92	0.80
Industrials	0.70	8/07	0.87	0.96	9/10	0.96
Information Technology	0.49	6/96	0.79	0.92	9/10	0.92
Materials	0.50	8/01	0.74	0.93	9/10	0.93
Telecom Services	0.44	4/07	0.66	0.84	3/05	0.69
Utilities	(0.04)	3/01	0.42	0.73	7/10	0.72

Source: Standard & Poor's Equity Research; MetaStock. Past performance is no guarantee of future results.

Unusual synchronicity can also be seen among the industry categories within the S&P 500. Since 1989, which is as far back as S&P 500 sector data extends, the average rolling

36-month price correlations with the S&P 500 for cyclical sectors - Consumer Discretionary, Financials, Industrials, Information Technology, and Materials - have ranged from a low of 0.74 for Materials to a high of 0.87 for Industrials. What's more, the traditionally defensive sectors - Consumer Staples, Health Care, and Utilities, and to a lesser extent, Energy and Telecommunications Services - have seen their correlations average from a low of 0.42 for Utilities to a high of 0.66 for Telecom Services.

Today, however, a large majority of sector groups within the S&P 500 are sporting correlations that are at or near their all-time highs. Most are 20 to 30 points higher than their long-term averages. Even those sectors not at the extremes of their range are typically correlating at levels 10 to 15 points higher than average.

Implications for Investors

For the past few years, it has often appeared that investors were trading whole portfolios en masse, shifting large sums from one type of asset to another across the board. This has in effect created all-pervading up-and-down cycles. Those cycles, combined with a range-bound market, have helped to breed an on-again, off-again approach that works as if investors were pulling pedals from a daisy. The ultimate effect is seen in the elevated asset class and sector correlations.

Some observers have argued that this kind of behavior is becoming the "new normal" for substantial numbers of individual investors. But while current correlations among asset classes are higher than historical averages, they are not likely to remain as outsized as they are today.

For one thing, earnings forecasts and demand projections are not identical for all asset classes. And, despite the high correlations of recent years, there is ample evidence to suggest that investors who stayed diversified through the ups and downs still could have outperformed investors focused solely on equities. For example, although the stocks represented by the S&P 500 returned -37% in 2008, long-term Treasury bonds gained nearly 23% during the same period. Thus, staying the course with an appropriately diversified portfolio could be seen as a workable strategy, even in these synchronized times.

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