FIRST QUADRANT

MARKET INSIGHT

When Correlations Collapse

April 2020

March has been another painful reminder that correlations can collapse when investors most need diversification. Equities and commodities declined in lockstep as markets priced in both a supply and demand shock from the escalating pandemic. Yet despite the steep drop in risk appetite, many assets traditionally treated as havens failed to provide a meaningful hedge. During the second week of the month, as equities were entering a bear market, gold and developed market bonds also depreciated. Cash became too precious to pour into havens as investors scrambled to meet margin requirements and fund collateral calls.

When all the major asset classes are declining, active long-short strategies can potentially be an elusive source of diversifying return. Unfortunately, even some of those strategies can exacerbate the drawdown if managers were relying on market beta for return, either directly or indirectly. For many, there is still an all-too-fresh memory of the total collapse in correlations during the Great Financial Crisis in the late 2000s. Strategies that were promised to provide relief during market stress tanked alongside equities, exacerbating a problem that they were advertised to help address.

So how can an allocator determine if a strategy will provide a truly diversifying, uncorrelated return stream when it is most needed?

We believe managers owe their clients and prospects as much guidance in terms of correlation expectations as they typically provide for absolute return. As managers, it is our responsibility to hold ourselves to certain standards, to help allocators make genuinely informed decisions and avoid the kind of correlation uncertainty that has plagued portfolios in the past. The following are several principles that we believe managers should uphold, so that allocators can prepare their portfolios for sudden shifts in the market environment.

1) Managers should help you evaluate their expected correlation to different asset classes.

For an allocator considering a potential mandate, the primary concern when evaluating a new strategy is its marginal contribution to their existing portfolio, not its standalone contribution. As managers, it is tempting to talk about our strategies as if they stood in isolation, but it is important for us to have some humility and remember that we are one small piece of a very large pie.

2) As a corollary, managers should do their very best to continue to deliver on their stated product objectives.

This statement might seem painfully obvious, but staying true to stated objectives involves

Past performance is no guarantee of future results. Potential for profit is accompanied by possibility of loss.

a tremendous amount of discipline. Over the past several years, for example, global equity markets delivered standout returns. Despite ongoing weakness in economic fundamentals, risk appetite was quite healthy.

For managers whose strategies aim to deliver outsized returns when equity markets are under siege, this environment has limited opportunity. It can be quite tempting for those managers to modify their process to try to participate in the up market, and forget why they were hired in the first place. Unfortunately, attempts to participate in the upside can result in reduced effectiveness should market volatility abruptly increase (as it did in late February). We believe a systematic process can assist with this kind of discipline, as a model-driven approach can help slow style drift, or at least make it more obvious.

3) Managers should help you develop a deep understanding of the underlying drivers of their intellectual property. (Beware of hidden beta.)

We feel strongly that managers should be willing to discuss the types of return they are attempting to capture. This may be inherently harder for firms that are heavily reliant on black box techniques, though we believe stakeholders still deserve a deep understanding of where potential returns are sourced. Indirect exposures can be just as problematic for an allocator's portfolio as direct exposures. As everyone is well aware, you can experience significant equity exposure through your positioning in other asset classes. For example, a currency manager who is heavily reliant on the carry trade for performance could introduce significant equity market beta to your portfolio.

4) Managers should continually evaluate the correlation expectations surrounding their approaches, as well as evolutions in investors' needs.

A shift in trends in the marketplace can create shifts in underlying correlations. If an asset (Asset A) was once a niche investment, but has since garnered broad appeal, there is a possibility that it is now far more correlated to global equity markets. Why? During bear markets, investors are forced to make withdrawals to meet heightened liquidity needs. As a result, demand for Asset A could fall with the equity market, even if it has nothing to do with public stocks and was years ago totally uncorrelated. Active managers should actively consider their investment universe, and continually assess whether their investments are still expected to deliver the same return and correlation objectives given marketplace dynamics.

We believe that adherence to these basic principles can help managers do a better job of fulfilling their fiduciary duties to clients, who have the unenviable job of assembling a broadly diversified portfolio with limited information.

At First Quadrant, we have several strategies that target low correlations to most major asset classes. These strategies are designed to provide downside protection when you need it most, while providing meaningful return targets throughout the various market cycles. If you are interested in deeper discussions about diversifying solutions, and whether they might be a good fit for your existing portfolios, we are more than happy to have those conversations.

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