

CFS Financial Roundtable

Correlation & Diversification

Hello this is Stephen Cross, a Financial Consultant, with today's Financial Roundtable

In today's segment, I'm going to discuss the term Correlation as it relates to Diversification. Diversification can be approached on lots of different levels, so today I'm going to talk about the concept of asset correlation. Consider this an advanced lesson in portfolio construction.

First, everyone knows Diversification means you don't put all your eggs in one basket, right? Well, it's a lot more complicated than that when it comes to investing.

You diversify in order to spread the risk around in our portfolio. Meaning, you don't buy just one stock because if that stock goes down, your whole portfolio goes down. So if you own two stocks, hopefully they both go up, but maybe one goes down and the other goes up.

But there's another important idea behind how to diversify. It's called Correlation. This idea and statistic measures how your securities move in relation to each other. There are three types of Correlation in investing. They are Perfect Correlation, Negative Correlation, and Non-Correlation.

Let's examine each one.

First there is Perfect Correlation. That's when one security moves up or down, the other security moves up or down in the same direction. They move in tandem, they are Perfectly Correlated. Now most securities are not "Perfectly Correlated". So we're talking about being Highly Correlated. An example would be if the Home Building industry goes through a deep industry wide slow down, then most likely, all of the Home Building stocks will go down in value. And likewise, if business is great, then all of the stocks would probably go up in value. So they are highly correlated.

Next, there is a Negative Correlation; this is when a security moves in the opposite direction of the other. An example of this might be that when the economy is weak and therefore the stock market is weak, most of your stocks will go down in value but your US government bonds might go up in value, since people will sell the risky stocks and buy the safety of US Government bonds. Or if the economy is only mildly weak, Industrial stocks might go down in value but Consumer Staple stocks go up because they are assumed to be a bit more stable.

Lastly, there is non-correlation. This is when securities move in a random fashion. There's no discernible pattern to how they move. They may go up or down when the other security goes up or down.

What does all this mean as it relates to diversification? The key, and it is tricky, is to invest in a basket of securities that do not move in perfect correlation, nor move in total negative correlation. I like to use the expression "Are you Diversified or Just Duplicating?"

I review quite a few statements where the investor thinks they are properly diversified but they are not because most of the securities are positively correlated.

So, it's not just the number of securities you own, it's the type of security you own.

I'm Stephen Cross and this has been the Financial Roundtable.

There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not ensure against market risk.