How Closely Correlated Is Your Portfolio?

Asset allocation is a concept many investors are familiar with, but less familiar is the concept of correlation. Find out what correlation is and how it can impact your portfolio.

Callout:

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How closely correlated is your portfolio? The answer could surprise you.

Investors hear a lot about the benefits of asset allocation, that is, spreading your assets among different types of investments to help reduce risk.[1] But less discussed is an equally important measurement: correlation, which is a way to measure how closely related two types of investments are. In theory, you could be invested in multiple securities of differing types and classes, but if they are all closely correlated, your portfolio may not be as diverse as you think -- and could open you up to more risk than you intended.

Correlation is expressed as a number between 1.00 and -1.00.

- A "1.00" indicates an absolute positive correlation (that is, the assets under comparison always move together in the same direction).
- A "0" correlation indicates there is no relationship between the assets.
- A "-1.00" indicates an absolute negative correlation (the assets always move together in opposite directions of each other).

Very few assets have a pure 1.00 to 1.00 or -1.00 to -1.00 relationship. Generally, most experts consider a correlation value between 0 and 0.50 as a weak correlation, while a value of 0.50 and higher is progressively stronger. The farther from a 1.00 correlation two investments are, the more diversification you may realize.

If you'd like to determine the correlation of your portfolio, the easiest way may be to contact your financial professional. You can also search the Web for an investment correlation calculator -- a number of brokerage firms and other financial sites have tools, but few are free to use.

The Markets March in Unison

One important consideration for investors to keep in mind is that the financial markets are increasingly marching in unison, making correlating your investments increasingly difficult. A variety of factors are causing this trend, including:

- Globalized economies: The growth of global trade and the proliferation of worldwide investment firms mean that the fortunes of both large corporations and the investors who own their stock are tied together as never before.
- Reliance on U.S. dollars: Many foreign governments and global financial institutions rely on U.S. dollars as a reserve currency to pay debts or to influence exchange rates. Given this situation, the health of the U.S. economy and the actions of the Federal Reserve reverberate globally, as do events in Europe and beyond.

What Investors Can Do

If climbing correlations concern you, consider the strategies that may help you balance risk and return, including:

- Combining stocks with other types of assets. Adding exposure to bonds, real estate, and commodities may help you to balance returns over the long term.[2]
- Considering investments that generate income. Dividend-paying stocks, bonds, and REITs are popular with investors searching for income. When stock returns are uncertain, dividends provide something in the way of a return. Dividends are not guaranteed.

Be sure to remember that alternative investments and commodities are risky, too. REITs are subject to the ups and downs of the real estate market, and the volatility of gold during the past 10 years is close to that of stocks. The returns of these investments do not always track the U.S. stock market.[3]

Source/Disclaimer:

[1]*Asset allocation does not ensure a profit or protect against a loss in a declining market.*
[2]*Investing in stocks involves risk, including loss of principal. Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and are subject to availability and change in price. Exposure to the commodities market may subject investors to greater volatility as commodity-linked investments may be affected by changes in overall market movements, commodity index volatility, changes in interest rates, or factors affecting a particular industry or commodity.*

[3]*Sources: Standard & Poor's; 4 p.m. closing spot price of gold on the London fix. Returns are for the 10-year period ending December 31, 2010. Volatility is measured by standard deviation.*

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