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Dangers and opportunities in a highly correlated world

The past few years have borne witness to some of the most volatile market conditions in a generation. What started out as a credit crisis has now become a sovereign debt crisis. This is because governments which supported failing institutions have themselves become overly indebted as a result. Furthermore, the need to reduce government debt through austerity budgets is now hampering economic output in western economies and reducing their ability to grow out of the problem.

Markets continue to lurch from extreme pessimism around the resulting outlook for global demand to naïve hope for a political “silver bullet”. A defining feature of these volatile market conditions has been extremely high correlations within and across investment markets. High correlations are the product of extreme uncertainty, which in itself has real world and financial implications and presents both opportunities and dangers for investors.

Implications for the real world

One of the key consequences of today's economic uncertainty is that companies are inevitably strengthening their balance sheets relative to history. This is not only to help insulate businesses from any future economic shocks, but is also a direct consequence of their own uncertainty about the outlook and consequent reluctance to invest for future growth. This in itself then, is unhelpful for the economy as it further subdues corporate expansion and employment. From a more positive standpoint, however, their low levels of debt mean that companies will have plenty

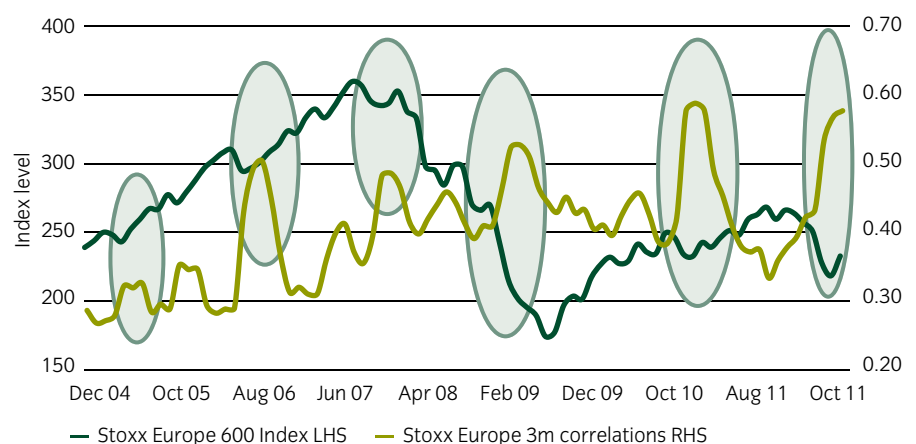
of firepower to invest once the economy improves. What we also see is that economic uncertainty impacts consumers. The relentless stream of worrying headlines, news stories and resulting job uncertainty leads to belt tightening and consumers trying to pay down debt, fearing worse times ahead.

Implications for stock markets

From a stock market perspective, the main consequence of extreme investor uncertainty is that correlations rise within

equity markets. This comes about as all stocks and sectors are sold down together, regardless of their underlying fundamental strength. Investors wanting to reduce or hedge exposure to a deteriorating market outlook look for liquidity as fear increases. This process has occurred in sharp sell-offs in each of 2008, 2009, 2010 and 2011 as liquidity in markets fell and investors redeemed stocks indiscriminately.

The chart below shows how correlations have risen at the same time as sharp market falls over the past 5 years.



Source: Credit Suisse and Datastream.

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The benefits of diversification from different stocks and sectors are therefore dramatically lower during these episodes. However, periods of indiscriminate selling can provide significant opportunities for active long/short equity managers to benefit from subsequent differentiation between winners and losers. Ultimately these periods of highly-correlated stock performance are short-lived, as fundamental company results and performance play out.

Implications for asset classes

What we have seen more recently is that correlations also rise across different asset markets, with asset performance being driven by which side one is of the risk-on / risk-off trade. Investors have had very few options as they look for uncorrelated performance to help genuinely diversify and improve the efficiency of their portfolios.

Only cash, gold, selective government bonds and safe-haven currencies such as the yen have proved to offer such attributes which in itself represent a paradox: one could argue that none of these assets look fundamentally attractive from a valuation or yield perspective. As a result the benefits of a traditional diversified portfolio have been dramatically reduced and investors are faced with an unenviable choice: opt for a traditional spread of assets and accept that the resulting portfolio will not be as diversified as

one might like, or chose to have a high weighting in true safe-haven assets and accept that you run the risk of sacrificing near term return potential for capital preservation.

The uncertain economic and market environment highlights therefore the importance of having a significant part of a portfolio dedicated to uncorrelated investments. Genuine absolute return funds should be able to fulfil this role. These funds have the potential to provide investors with the best of both worlds, as they can help protect capital as markets fall and also be well-placed to benefit from the resulting fundamental opportunities that arrive between stocks and sectors.

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