https://www.unionleader.com/news/business/money_sense/money-ense-a-summary-of-portfolio-correlation/article_8763c697-ce6f-50da-b57d-da65c1417613.html

'Money $ense': A Summary of Portfolio Correlation

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Investors hear a good deal about the rewards of asset allocation, which is partitioning your portfolio among diverse types of investments.

One of the purposes of asset allocation is to reduce risk. This is accomplished through diversification, which is the spreading of dollars among dissimilar assets, or not putting all of your eggs in one basket, so to speak. Diversification doesn't guarantee you a profit nor ensure that you will not have losses, but it can help you manage risk.

Another asset allocation concept that is less considered but equally important is correlation, which is a way to measure how tightly linked the performance of two types of securities are. Correlation is a statistic used to quantify the degree of connection between the price movements of the various assets in a portfolio.

In theory, you could have many different securities in your portfolio, but if they are all closely correlated, your portfolio may not be as diversified as you think. When the performance of various assets closely follows one another, you could expose yourself to greater risk than you planned for.

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

A "-1.00" indicates an outright negative correlation. In this case, the assets you are comparing move in opposite ways from each other.

A "0" correlation indicates there is no link between the movement of the assets.

A “1.00” indicates an outright positive correlation. This means that the assets you have chosen to compare consistently move in sync with each other.

Very few assets have a pure 1.00 to 1.00 or -1.00 to -1.00 relationship. It is difficult to even find two assets with a perfectly neutral correlation of 0. A correlation value between 0 and .50 is considered a weak correlation, while a value of .50 and higher is considered to be increasingly correlated. The lower the correlation between two investments, the greater diversification that could be provided to the portfolio.

To put this plainly, assets whose prices move in the same direction at the same time can be positively correlated. When the price of one asset goes up and the other goes down, the assets can be negatively correlated. Thus, correlation is important for a portfolio because gains from one investment may cushion the losses on others.

When reviewing your portfolio correlation, you could consider including other types of assets in your portfolio. These could be in addition to whatever stock exposure you already have. Examples of assets that could reduce your correlation include bonds, real estate, and commodities. Examples of commodities include precious metals, such as gold and platinum, as well as agricultural products, such as wheat, coffee, and sugar. Just be sure to consider your overall risk tolerance and goals for the portfolio when including new types of assets.

Keep in mind too that correlations are dynamic and constantly change. This is a version of the “past performance doesn’t equal future returns” concept. With our world becoming increasingly connected through global trade and worldwide investment companies, assets could become more correlated, as well. On the other hand, many companies based in the United States conduct business across the globe, which decreases their dependence on the U.S. economy.

Remember that there are a wide array of factors, such as overall risk tolerance and goals for the portfolio, that should be considered when reviewing a portfolio. A financial professional, such as a Certified Financial Planner, may help you analyze these factors as well as how correlated your portfolio assets are. As with any investment decision, it pays to do your homework and understand the full picture before making any changes to your portfolio.

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