GLOBAL FINANCIAL
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COMPREHENSIVE WEALTH MANAGEMENT

Thought for the Week: Monday, June 11th, 2012

Risk On/Risk Off: Volatility & Correlation

Three expressions have dominated the media's description of investment phenomena since 2008: Volatility, Correlation and Risk On/Risk Off. This week we will look at what these terms have meant for general investing and our portfolios.

Volatility and Risk On/Risk Off

"Risk On/Risk Off" generally refers to an investment environment in which asset price behavior is primarily driven by seemingly bi-polar swings in investor sentiment. Rather than delicately and selectively "pricing" new information into the prices of each asset class and security, each piece of macro-economic news causes investors to ask: "will this lead to recovery or recession?"

This process results in sharp, rapid market movements (both up and down) with little regard to prior information. Investor capital quickly flows between asset classes perceived to be "Risky" (Risk On) to those perceived as "Safe" (Risk Off) and vice versa.

"Safe assets" are generally considered to be U.S. and German government issued debt as well as as Gold; just about the only asset classes wherein investors feel their capital will be returned. "Risky" tends to mean everything and anything else.

As a result, we have paraphrased Risk On/Risk Off as "Recovery On/Recession On."

It might be said that during periods of Risk On, investors run to assets that provide a return ON their principal. During Risk Off, they move into assets that provide a return OF their principal.

Correlation

Currently, investors have polarized all asset classes into two broad categories, as described above. They view everything as either risky or safe; paying less attention to the unique characteristics of each investment or asset class. This means that asset classes which previously moved in opposite directions now move in similar directions. This is what we call Correlation.

If two securities move in exactly the same way, they are said to have a correlation of one. In reality, a perfect correlation of one rarely occurs. However, last year, Joseph Mezrich wrote "Stock correlation is now at the highest level since January 1987[1]" illustrating that many investments are moving in the same direction when they used to move differently.

One obvious example is the way in which corporate bonds normally correlate with stocks. Historically, they tend to move at very low values of correlation. Recently, this trend has changed and they have both followed the Risk On/Risk Off principle. When Risk is On, investors are willing to invest in both of these asset classes and values rise. When Risk is Off, investors sell both asset classes and the prices fall.

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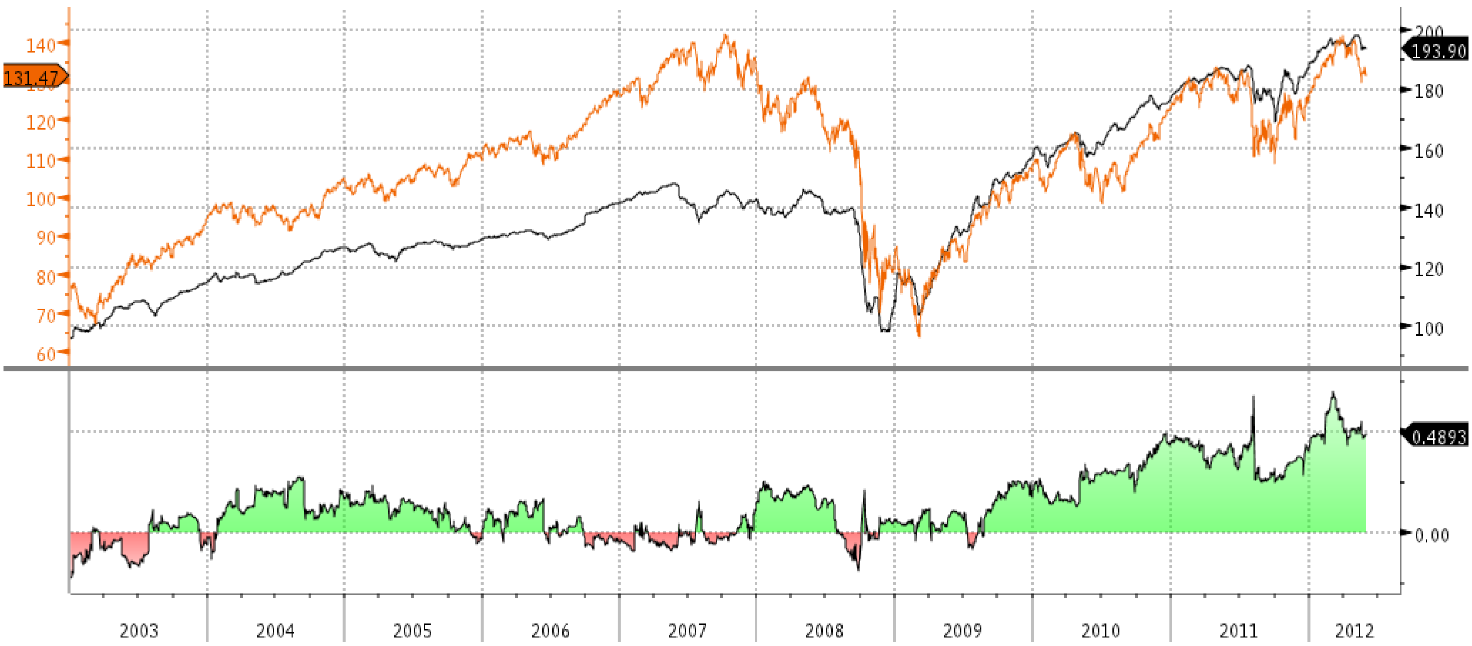
[1] Joseph Mezrich, Nomura—Global Quantitative Investment Strategies, August 11, 2011.

These price movements seemingly ignore the basic fact that the bonds have a greater guarantee and less historical volatility than stocks.

The chart below[2] shows this change in correlation for equities and corporate bonds. The green area shows how the correlation between these assets has increased significantly since mid-2007. It is telling us that bonds are no longer performing as the much safer asset class compared to stocks in similar companies.



Asset Management Goals and DIAS Portfolios

Given that a general goal of many investors is the outperformance of a specific market index, professional investors often comment that there are few opportunities to add alpha (outperformance) when stocks are highly correlated. "It's a macro-driven market" is a common reason for investors failing to beat indices recently.

To quote Mezrich again: "U.S. stocks are moving together in lockstep fashion with other asset classes, rendering stock selection (alpha generation) extremely difficult." Although it's only one example, the chart above typifies what is occurring across most market sectors.

One of the ways Global Financial aims to outperform indices is by researching and developing investment themes which potentially give us a medium to long-term advantage over the market. When markets closely correlate, as recently, these investment themes take a back seat for a time and Risk On/Risk Off dominates.

In the medium to long-term, economic fundamentals determine asset prices. In the short-term however, this Risk On/Risk Off behavior does make most non-U.S. Treasury asset classes look and perform in a similar manner (correlate).

[2] Chart courtesy Bloomberg LP.

These can be frustrating times for those who invest in the belief that some asset classes are less volatile than others, or for those who follow the rule that for every asset class that falls in value there are others that rise.

Value Fundamentals

As Value-based managers, we believe Bull Markets are born out of investor uncertainty and temporary bad news. Bear markets start when complacency sets in and there is an unsustainable abundance of good news.

The frustration of Risk On/Risk Off periods can be mitigated by a collecting a steady stream of income; coupons, dividends and the like.

For income investors, the panoply of yield available, sometimes at reduced prices, can help to reduce the magnitude of market volatility. The income generated from an investment can act as a cushion for short-term price drops.

Although it is difficult to avoid the daily volatility of this Risk On/Risk Off behavior, over the long-term we increasingly see companies improving their balance sheets and cash flows. We see them hoarding financial strength to ensure they don't have to rely on capricious credit markets for capital.

A final observation supporting our overall long-term view is the increase in stock and debt "Buy-backs" we are seeing. Companies are taking advantage of their own discounted stock price by purchasing it with available cash.

What is Global's Approach in this Environment?

Our strategy does not involve us jumping between the two stools of Risk On or Risk Off. Our approach falls in-between the two stools.

When Risk is Off, investors are primarily interested in U.S. Govt. debt. At the same time, the market looks at the companies *we* invest in, who in most cases have better balance sheets than the U.S. Govt., and ignores their fundamentals. In their opinion, the world is coming to an end and only the U.S. Govt. (and maybe Gold) will survive. All companies are put into broadly the same category with respect to the risk of default. This is evidenced by the aforementioned increased correlation.

When Risk is On, investors are primarily interested in high growth, high risk assets. For these periods, the market favors high octane investments above the type of companies *we* like – companies that in our opinion are very stable, solid and provide consistent growth opportunities.

Therefore, at times, our portfolios can miss much of the fall in price but also not participate in much of the rebound.

Investing is a marathon and those who chase short-term fixes tend to end up in the same disappointing place. We have our track shoes on.