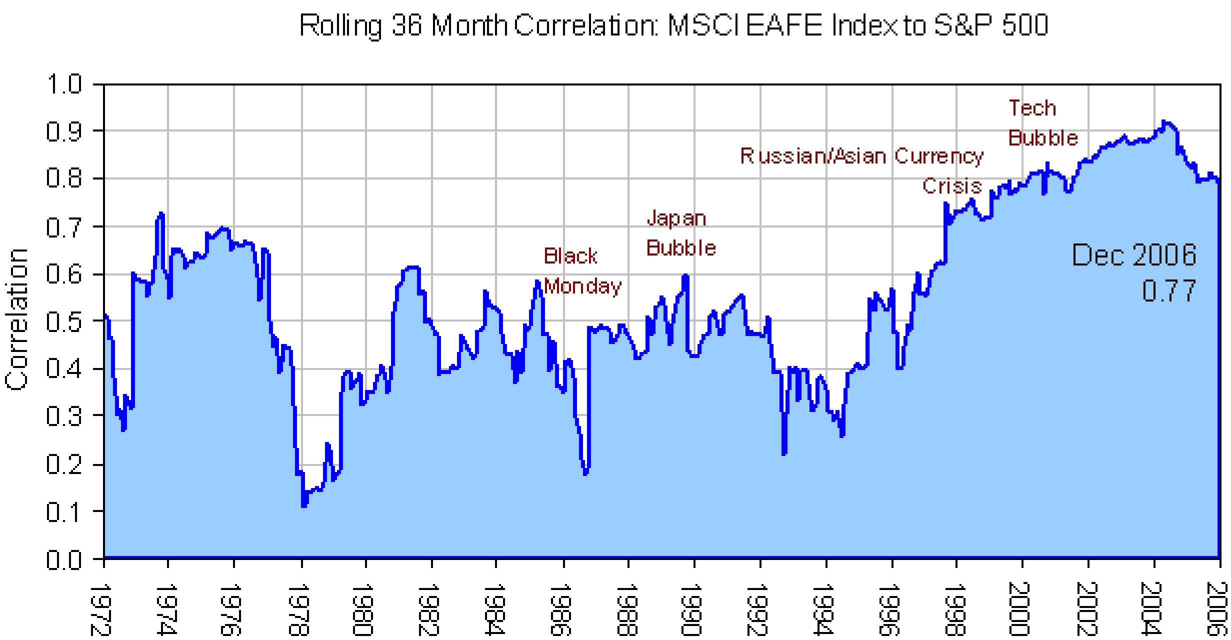
May 11, 2007 – The High Correlation of World Markets

The one clear observation to take away from the world stock market sell-offs in May, '06 and February, '07 was the rising correlations across world asset classes. It didn't matter if an investor owned stocks in the U.S., Europe, Asia, in oil & gas, REIT's or even the supposed safe haven, gold, they all took a significant hit during these two sell-offs.

The real surprise to this investor is the rising correlation of asset classes around the world. One of the advantages touted of diversification is, when one asset class is declining another is advancing. The theory is, this reduces risk and volatility of the portfolio. In the past year, this has not been happening as it was drawn up by Harry Markowitz, the Nobel Prize winner who pioneered "Modern Portfolio Theory" as a way to maximize returns for a given level of risk.

The basis of Modern Portfolio Theory states that diversification across many asset classes should maximize returns for a given level of risk if the portfolio is invested according to the Markowitz Efficient Frontier. But if asset classes all move in unison, then this investment technique may not provide the risk protection touted by the theory.

The chart below shows the correlation of the MSCI EAFE Index* to the S&P 500 from 1972 to 2006.



From 1972 to 1997, the correlation of the S&P 500 to other world markets generally ranged from 30% to 60%. Since then, the correlation of returns has been on the rise, reaching a peak in 2005 when it was 92%! Why is this important? Mass correlation could be particularly damaging for a portfolio. The extent of the damage could be dependant on how the portfolio components move together in situations of periodic crises or longer periods of time when everything is going sideways or down.

Correlation seems to be on the rise and investments may be linked more than ever before. Many traditional money managers don't have a mechanism to hedge their bets and thrive in highly correlated environments. Look for money managers who can hedge their holdings in an effort to reduce risk.

* The MSCI EAFE Index is a benchmark to measure international equity performance. It comprises 21 MSCI country indices, representing the developed markets outside of North America: Europe, Australasia and the Far East.

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