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Investors should combine asset classes with low or negative correlation

Building a diversified portfolio will protect against big drawdowns in value

Bindisha Sarang | Mumbai November 05, 2020 Last Updated at 23:55 IST

Diversification across asset classes, sub-asset classes, sectors and geographies is a time-tested method for portfolio construction and wealth preservation, according to Nitin Rao, CEO, InCred Wealth

The markets have been volatile this year. Towards the end of March, when the pandemic-led lockdown began, the equity markets took a massive beating. On March 23, the Nifty50 index was down 37.5 per cent year-to-date (YTD). Now, the YTD return of this benchmark is down 0.40 per cent, which means it is about to break into positive territory. Financial advisors say one of the biggest takeaways from the downswing and the subsequent recovery is the need for investors to build diversified portfolios using asset classes that have negative or low correlation.

Correlation shows how one asset class moves in relation to another. If two asset classes were perfectly correlated, they would have a correlation of +1. They would move in the same direction and also to the same extent. A correlation of zero means there is no correlation. A correlation of -1, on the other hand, means that the two asset classes tend to move in opposite directions: When one moves up, the other moves down to the same extent, and vice versa.

Building a portfolio with asset classes that have low or negative correlation has many advantages. Says Tarun Birani, founder and chief executive officer, TBNG Capital Advisors: “Doing so will prevent big drawdowns in your portfolio.”

Diversification across asset classes, sub-asset classes, sectors and geographies is a time-tested method for portfolio construction and wealth preservation, according to Nitin Rao, CEO, InCred Wealth. “It helps portfolios tide over economic, political, financial and other uncertainties, like the Covid-19 pandemic,” he adds.

Equities and bonds tend to have low or negative correlation. According to Rao, “Though not very pronounced, negative correlation exists between the Nifty and the Crisil India Composite Bond Index”. If your portfolio includes both these asset classes, then when the equity markets fall, bonds may decline less, or even rise, thereby providing downside risk protection.

Says Birani: “Right now, fixed deposit rates of most banks are going down, but equity market returns have been moving up since April.” Usually, when interest rates decline, the cost of debt taken by companies falls, boosting their bottom line. This in turn lends buoyancy to share prices.”

MANY OPTIONS, BUT CHOOSE WISELY

Asset classes	Correlation over past 17 years
Nifty with Crisil Composite Bond Index	-0.14
Nifty with international gold	0.27
Nifty with S&P 500	0.64
S&P 500 with US treasury	-0.56
S&P 500 with international gold	-0.06
Nasdaq with International gold	0.01
US treasuries with international gold prices	0.43

Source: InCred Wealth, *Bloomberg*

Equities and gold prices, too, are negatively correlated. Combining them in a portfolio can be very useful. Take the example of 2008. That calendar year the Nifty gave a negative return of 51.7 per cent. An investor who also had exposure to gold, however, would have suffered less badly because the yellow metal was up 26.6 per cent.

Nowadays, most financial advisors suggest that once a person has built a well-diversified domestic portfolio, she should diversify geographically. And when venturing abroad, they suggest investing in the US market first. The US and Indian equities have low correlation. US equities are not affected by many the factors that affect Indian equities, such as a border skirmish with a neighbour, inflation, etc. Also, many companies in the US are global multinationals, so a bet on US equities becomes a diversified bet on global growth.

Finally, diversify among sub-asset classes as well: In some years large-cap stocks tend to do well, and in others, mid- and small-caps.