INVESTING SPECIALISTS

What's the Best Diversifier for Stocks?

Treasuries have been effective ballast, but that's not certain to continue.

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As of early July 2020, the 10-year Treasury yield was bouncing between 0.60% and 0.70%. That skimpy yield has sparked discussions among investment cognoscenti about whether Treasuries are even worth owning at this juncture. Their payouts may not even keep up with inflation over time, let alone provide a livable stream of income for even wealthy retirees. In addition, Treasury bonds also court duration risk--essentially, the risk of losses in an environment in which interest rates head up. Because of their lower yields and lack of credit risk, Treasury bonds and the funds that own them tend to be incredibly sensitive to interest-rate changes, both for better and for worse.

But even as Treasuries court risks that are well worth considering, they've brought something to the table that other most assets have been hard-pressed to duplicate: the ability to hold their ground--and even gain a bit--in equity market shocks. During the first-quarter 2020 bear market, for example, Treasury bonds and the S&P 500 exhibited a nearly opposite return pattern. Even as the S&P 500 lost about 20% between the beginning of the year and the end of March, long-term Treasury funds gained 20% during that same stretch.

That pattern is consistent with my previous examinations of asset-class correlations. Of the major asset classes, Treasury bonds have historically exhibited some of the lowest correlations with equities. The Bloomberg Barclays U.S. Aggregate Bond Index, which total bond market index funds track, has also been a serviceable equity diversifier, albeit not as robust as pure Treasuries. That owes to the Aggregate Index's heavy weighting in Treasuries and other government-issued bonds.

Yet there were a few new wrinkles in this latest run of correlations data. Thanks in no small part to the violence of the first quarter's downturn--the biggest market shock since the global financial crisis of 2007-09--correlations moved around a bit. A handful of categories that had heretofore appeared to be underwhelming as diversifiers proved their mettle recently, while other categories' diversifying ability slid. It's too soon to say whether those trends will be persistent, but they're worth keeping an eye on, especially because the pandemic and related economic weakness have the potential to exacerbate some of the underlying problems.

Digging Into the Data

To examine whether correlations among asset classes have changed since I last examined the data in 2019, I turned to Morningstar Direct's software, which is geared toward institutional investors. I examined correlations among an assortment of equity, bond, and alternative investments over various time periods. My first choice was to use indexes to examine correlations, because they're a pure play on a given asset class. However, I used mutual fund categories and even some individual funds when I couldn't find an index with a sufficiently long track record.

Morningstar uses a statistic called "correlation coefficient" to measure the relationships among asset classes. A correlation coefficient of 1 indicates that two assets are perfectly correlated, whereas a correlation coefficient of negative 1 indicates a perfect inverse relationship; if one asset goes up, the other goes down. Finally, a correlation coefficient of 0 indicates no correlation at all.

In Morningstar Direct, you can assemble what are called "correlation matrixes" that depict various assets' interrelationships. Here's a look at the one-, three-, five-, 10-, and 15-year correlation data.

To see the correlation between two assets, focus on the square on the grid where they intersect. Gold shading reflects two assets with a negative correlation, whereas blue points to two assets being highly correlated. On the charts, for example, bear-market funds have the highest negative correlations with the four stock indexes examined: the S&P 500, the Russell 2000 (small caps), the FTSE Global All Cap ex US, and the MSCI Emerging Markets.

Key Findings

Intuitively and in keeping with previous correlation analyses, various equity categories provide limited diversification with one another: While there are ample good reasons to add small caps and international stocks to a portfolio, diversification away from the S&P 500 doesn't appear to be one of them. Ditto for the various bond categories: While they provided decent to so-so diversification away from equities, they provided little diversification with one another.

As noted above, the Treasury indexes were the best equity diversifiers among various bond-fund types. But while there's the widespread perception that long-term Treasuries are the most attractive diversifiers, the recent data don't

bear this out. In fact, the shorter-term Treasury index had an even lower correlation with the S&P 500 than the long-term index. That's a useful finding, from a portfolio livability standpoint, in that long-term Treasuries are incredibly volatile whereas the shorter-term products are much less so.

It's also worth noting that the attractiveness of cash as a diversifier has risen a bit since my last data run. That's likely because the first quarter featured an extreme flight to safety and liquidity, burnishing cash's appeal. Meanwhile, municipal bonds' diversification ability appears to have waned a bit, thanks to munis' rough showing in the first quarter, when pandemic-related worries over municipal finances roiled the muni market. Those concerns haven't gone away during the pandemic, which could weigh on their diversification benefit during this period.

Funds in the intermediate-term core bond and intermediate-term core-plus bond Morningstar Categories have also been less beneficial as diversifiers than Treasuries. Both groups exhibited a higher correlation with equities in the most recent data run than they did at this time a year ago. They also exhibited a substantially higher correlation with equities than did the Treasury indexes or the Aggregate Index. Core-plus bond funds, in particular, have looked less than great as diversifiers for equities for a while now, and that was exacerbated by their performance during the first-quarter downdraft. Owing to their higher weightings in riskier areas of the bond market, which struggled in the "risk-off" market environment that prevailed earlier this year, the typical intermediate-term core-plus bond fund posted a small loss in the first quarter. Meanwhile, the typical intermediate-term core bond fund managed a small gain during that same period. Core-plus bond funds certainly have a yield and long-term return advantage over core bond funds as well as intermediate-term government-focused funds, but the trade-off is higher volatility and higher equity correlations for core-plus.

And while most alternative investments have underwhelmed on the diversification front, managed-futures funds have made a decent showing of late, reducing their near-term correlations with equities. Bear-market funds, which use a variety of strategies in an effort to deliver the inverse of the market's return over usually short periods, have also delivered on the diversification front. However, their long-term results have generally been abysmal, so they rarely make sense for investors' portfolios.

Is It Repeatable?

As with all backward-looking statistics, correlations data won't necessarily foretell the future: A relationship that has held in the past--high-quality bonds zigging while stocks are zagging--may not hold up. Indeed, in a recent outlook report, BlackRock Investment Institute argued that Treasuries may be less reliable as equity ballast in the future. The researchers pointed to lower starting yields as the explanation, noting that German and Japanese bonds performed less well during those countries' recent stock-market sell-offs for this very reason.

Yet, historic correlations, while imperfect, are the most reliable gauge we have when aiming to build diversified portfolios. Moreover, even as categories like intermediate-term core and core-plus bond funds and municipals appear to be

less valuable diversifiers for equities than Treasuries, it's safe to assume that their losses in equity-market shocks will be substantially lower than stock investments. That underscores the value of considering not just the direction that an asset class moves in, but how much it loses or gains over the period examined.

Common sense and these investments' actual utility in your portfolio should also factor into the equation. Despite Treasuries' low yields, it's reasonable to assume that they'll continue to be perceived as a safe haven in times of extreme stock-market duress. And while the diversifying ability of cash appears to be lower than Treasuries, portfolio diversification isn't the main reason investors hold cash in the first place--liquidity and safety are. In 2018, for example, both stocks and most bond funds were in the red, but cash held its ground.

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