



Anchor Capital
NAVIGATE WHAT'S NEXT™

Dynamic Correlation Management: Revolutionizing Portfolio Diversification in Modern Investing

Discover Anchor Capital's Risk-Managed Funds — Helping to solve the correlation dilemma.



When assembling a diversified portfolio, an advisor faces the risk of excessive correlation when all assets begin moving together during periods of high stress or systemic risk. The challenge of developing an efficient, diversified portfolio is twofold: firstly, it involves achieving the optimal mix of non-correlated assets to minimize risk and maximize potential gains; secondly, it requires managing those shifting correlations and adjusting portfolios as the market evolves.

As a financial advisor, it is important to diversify your client's portfolio both for guarding against loss and for staying nimble enough to maximize gains as the market shifts.

Traditional diversification tactics can help maximize gains in a bull market, but what happens when extreme market stress reduces the benefits of diversification? To maintain the level of diversification needed to minimize risk and potentially capture gains in all market conditions, correlation management forms the core of all diversification strategies.

Correlation and MPT

Correlation of assets is a key consideration of **Modern Portfolio Theory** (MPT). While MPT is the basis for most common investing strategies, the theory still leaves open the opportunity for argument as it does not necessarily solve for the challenges presented by correlation breakdown (the phenomenon where the correlation between the returns of different assets would suddenly move close to the extremes¹) during times of high stress within the market.

Correlation is a statistical measure that indicates how strongly two securities/investments are related. It ranges from -1 (strong negative relationship), through 0 (no relationship), to 1 (strong positive relationship)

Systemic risk or systemic stress refers to the potential for a significant disruption in the entire financial system due to interconnected dependencies. It's essentially a risk that can lead to a collapse of an entire financial system or market, as opposed to the risk associated with any one individual entity.

Modern Portfolio Theory

Introduced in 1952 by economist Harry Markowitz, Modern Portfolio Theory is a widely known investing model. MPT is a method for portfolio management that aims to reduce risk.

The theory states that, given a desired level of risk, an investor can optimize the expected returns of a portfolio through diversification. This is accomplished by investing in less correlated assets and grouping correlated assets together with those that move in opposite directions to each other, so as to reduce the risk for a given return.²

1. *Correlation Breakdowns, Spread Positions, and CCP Margin Models*, www.eachccp.eu/wp-content/uploads/2021/02/Correlation-Breakdowns-Spread-Positions-and-CCP-Margin-Models-20210131.pdf.
2. "Modern Portfolio Theory Definition." *Risk.Net*, www.risk.net/definition/modern-portfolio-theory#:~:text=Modern%20portfolio%20theory%20is%20a,Of%20a%20portfolio%20through%20diversification.

Correlation Breakdown Leads to Diversification Breakdown

When systemic stress impacts the markets, a phenomenon often observed is an increase in correlations between different asset classes. This happens because, in times of heightened uncertainty or stress, all market participants tend to react to the same set of news or events, causing various asset classes, whether they be stocks, bonds, or commodities, to move in concert. This simultaneous movement may challenge the effectiveness of a diversified portfolio, as the principle of diversification relies on different assets responding differently to market conditions.

In such situations, the perceived safety net of diversification can diminish significantly, underlining the need for active correlation management and stress testing within portfolio strategies.

See the table to the right: 2008, 2018, and 2022 can be considered periods of high stress or systemic stress. In 2008 all but the top 3 asset classes produced losses, in 2018 you had all but 2 asset classes produce losses, and in 2022 only the Cash Equivalent was positive.

What does this show? Since 2008, traditional asset classes have become highly correlated to one another, thus hampering the ability to build diversified portfolios.

Thinking Outside the Traditional In Portfolio Construction

As traditional asset classes become more correlated, non-traditional asset classes may provide a more effective form of diversification.

A nontraditional approach that strives to achieve the desired level of non-correlated diversification is a risk-managed strategy.

Asset Class Returns 2008, 2018, and 2022

2008	2018	2022
U.S Fixed Income 5.24%	Cash Equivalent 1.87%	Cash Equivalent 1.46%
Gbl ex-U.S. Fixed 4.39%	U.S. Fixed Income 0.01%	High Yield -11.19%
Cash Equivalent 2.06%	High Yield -2.08%	U.S. Fixed Income -13.01%
High Yield -26.16%	Gbl ex-U.S. Fixed -2.15%	Dev ex-U.S. Equity -14.29%
Small Cap Equity -33.79%	Large Cap Equity -4.38%	Large Cap Equity -18.11%
Large Cap Equity -37.00%	Real Estate -5.63%	Gbl ex-U.S. Fixed -18.70%
Dev ex-U.S. Equity -43.56%	Small Cap Equity -11.01%	Emerging Market Equity -20.09%
Real Estate -48.21%	Dev ex-U.S. Equity -14.09%	Small Cap Equity -20.44%
Emerging Market Equity -53.33%	Emerging Market Equity -14.57%	Real Estate -25.10%

Callan Periodic Table of Investment Returns,
callan.com/periodic-table/

A risk-managed approach involves a fund manager analyzing and quantifying the potential for losses in an investment, and then taking the appropriate action to achieve the funds investment objectives (gains) and risk tolerance³, ie. maintaining the balance between risk and return even as correlations shift. While risk-managed investing may be more common and accessible for large institutions, advisors are increasingly adding risk-management to their client's portfolios and strategies.

Why Anchor Capital

When seeking a nontraditional solution that prioritizes correlation management, advisors can look to asset managers, such as Anchor Capital, for dynamically managing correlations that can complement traditional asset allocations and help solve the diversification/correlation issue.

The Anchor Capital investment process is driven by a multi-factor, multi-timeframe approach. The proprietary, quantitative investment decision models examine long term index price trends, intermediate-term momentum index price trends, and short-term extreme market volatility to manage overall portfolio exposures.

This multi-timeframe approach drives overall strategy exposures seeking high correlation to market indexes during rising market trends and reduced or inverse correlation during highly volatile falling market trends. Changes in market volatility drive the frequency of portfolio changes. For example: during low volatility, rising price trends the long-term and intermediate-term trend following strategies remain fully invested with little change.

Since it's not always true that uncorrelated assets will remain uncorrelated in all conditions. The existence of correlation breakdown calls for a dynamic approach to managing risk within investment portfolios.

Anchor Capital uses a proprietary multi-factor, multi-duration (long, intermediate, and short-term) process to:

- Provide Dynamic Correlation: We seek high correlation in rising markets, reduced or inverse correlation to highly volatile, falling markets to help deliver better (and smoother) overall portfolio performance.
- Maintain Liquidity: We offer total transparency and daily access to your money: no commitments or fund lockups like other alternatives.
- Improve Diversification: For investors seeking to improve diversification and reduce risk, we cover three core asset classes: core fixed income, equity, and global equity.

This approach allows Anchor to map risk and opportunity across multiple factors and time periods to seek better, risk-adjusted returns.

3. Kenton, Will. "What Is Risk Management in Finance, and Why Is It Important?" *Investopedia*, 20 Jan. 2023, www.investopedia.com/terms/r/riskmanagement.asp#:~:text=Essentially%2C%20risk%20management%20occurs%20when.Risk%20is%20inseparable%20from%20return.

Leveraging industry leading asset managers like Anchor Capital to provide risk-managed solutions may allow you to simplify portfolios, reduce volatility, and achieve more sustainable returns over time.

At Anchor, we believe that if you get the risk right, you'll get the return right.



Anchor Capital

For more than two decades, Anchor Capital has been at the forefront of risk-managed investment strategies that seek to deliver:

- Positive long-term returns in a variety of up and down markets
- Lower than market index volatility/risk
- High correlation in rising markets, low or negative in declining markets

And we're here to help you make the most of this relationship. Anchor Capital offers a range of resources for advisors, including portfolio reviews, risk identification, portfolio construction help, and more.

Reach out to our asset management team for personalized support.

[Get in Touch](#)

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