Sionna Investment Managers®

INSIGHT

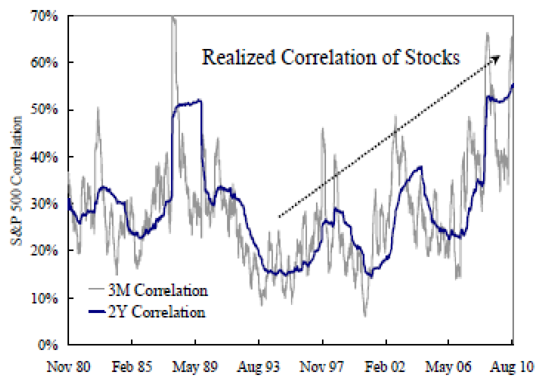
January 2011

High Correlation In Equity Markets

Correlations between most equity sectors and individual stocks are all well above historical norms. In the short term, this is reducing the benefits that have typically come from individual stock selection and causing returns for all investors to be connected.

CORRELATION OF S&P 500 STOCKS

The realized correlation of S&P 500 stocks was recently more than 60%, meaning that stocks are more likely to move together as a pack rather than individually, based on their own fundamentals. In fact, the correlation level "recorded over the last two years was never realized in the recent history of the U.S. markets" (see charts from J.P. Morgan Oct 2010). As a result, all stocks – including both quality and risk stocks – are moving more in lockstep. J.P. Morgan's Global Equity Derivatives team concluded that this high level of correlation indicated a "bubble" and forecast a significant decline of correlation over a one- to two-year horizon.



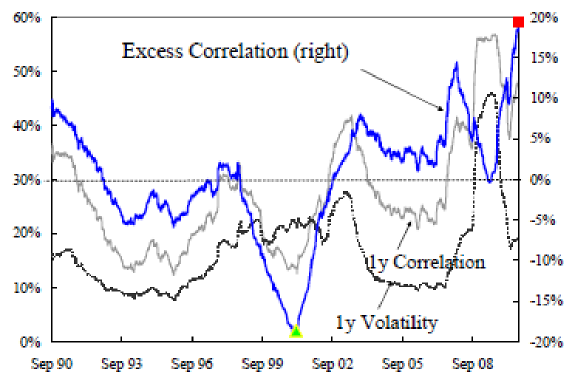
Source: J.P. Morgan Oct 2010

What might be driving this phenomenon and how may it have an impact on stock-picking equity managers?

CAUSE AND IMPACT OF HIGH CORRELATION

Over the past 10 years, there has been significant growth in index-based products such as index futures and broad-index ETFs. When investors purchase or sell these products, they effectively place an order for all of the underlying stocks in the index at the same time, leading to higher correlation. Today, approximately 60% of all equity volume is index futures and ETFs and observers believe that this and high-frequency trading may be major contributors to the increased correlation of stocks.

This current high correlation means that individual company fundamentals are less material at the moment. Stocks are tending to move together – passively – in response to macroeconomic factors such as the current “risk on, risk off ” days. The result is the narrowing of the return potential for stock-selecting managers, leading many to struggle to outperform their benchmarks.

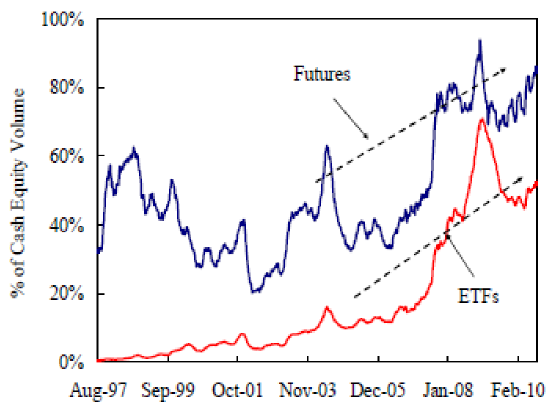


Source: J.P. Morgan Oct 2010

LIMITATIONS TO PASSIVE INVESTING

We agree there is a natural limit to the amount of passive investing. Intellectually, it is rational that if enough investors buy the index as it is composed and too few investors are actively differentiating between quality and risk in individual securities, the index itself will no longer be efficient. Economic equilibrium forces will eventually create the means to enforce rational behaviour again.

Historically in sideways markets like the one we believe we find ourselves in today, capital gains have been less than 1% and total returns have been approximately 6%. A massive approach to investing promises investors less than market returns after fees and expenses.



Source: J.P. Morgan Oct 2010

THE ROLE OF INTELLIGENT CONTRARIAN STOCK PICKING

Many investors knew the dot.com mania and the real estate crisis were bubbles, but it was not possible to know how or when those markets would break. Like all market occurrences that aren't sustained by fundamentals, they eventually broke, creating financial pain for those left dancing.

Sionna's relative value approach was able to handily gain significant excess returns in the aftermath of the explosion of these two bubbles. We are cautiously optimistic that once the market gets past "risk on, risk off" market correlation trading and reverts back to a rational focus on individual company fundamentals, stock picking will prove to be the intelligent approach for investors to earn true wealth over the long term once again.

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