

## De-correlating from the Equity Market Rollercoaster

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A typical defensive move in times of equity market volatility is to decrease exposure in favour of asset classes that are relatively independent of the turmoil. But which? In this first table we take a selection of indices and two IMA sectors, then compare their correlation to the FTSE All-Share index as a benchmark, over the two years to 31 July 2007.

	Ann. Alpha	Beta	Info Ratio Rel.	Ann. Jensen's Alpha	r <sup>2</sup>	Ann. Return	Sharpe	Ann. Tracking Error	Ann. Volatility
Index AFI Aggressive Index	-1.36	1.08	-0.09	-1.09	0.84	14.69	1.17	3.90	9.59
Index AFI Balanced Index	-0.28	0.83	-0.87	-0.87	0.86	12.08	1.18	2.99	7.28
Index AFI Cautious Index	0.79	0.54	-1.27	-0.80	0.80	8.78	1.08	4.32	4.89
Index FTSE All Share	0.00	1.00	0.00	0.00	1.00	15.09	1.42	0.00	8.14
Sector UK All Companies	-0.64	1.02	-0.16	-0.57	0.92	14.62	1.28	2.51	8.67
Sector UK Corporate Bond	0.70	-0.05	-1.43	-2.88	0.01	-0.08	-0.00	9.23	3.49

Source: Financial Express Analytics. Fund performance and ratio data to 31/07/2007. Bid to bid, net income reinvested – Total Return.

The striking observation here is that while four of the constituents show a degree of r-squared correlation to the FTSE, the corporate bonds have none at all. In an investment portfolio, this negative correlation to a share index should be a powerful antidote to equity market volatility, and in a moment we shall look for the optimum candidates in the sector.

Staying with this table for a moment, other noteworthy points arise:

- The UK All Companies sector is tightly correlated to the FTSE index.
- Volatility in the AFI indices progressively follows the investment stance downwards from the aggressive to the cautious. The strongish r-squared measures also allow us to pay attention to other ratios.
- This regularity is also reflected in the Alphas and Betas. The AFI Aggressive's Beta suggests its movement has been more pronounced than that of the FTSE, and this has had its impact on the AFI's negative Alpha. Again, sensitivity to the FTSE's movement reduces progressively through Balanced and Cautious, with the ameliorative effect on Alpha.

Turning to the uncorrelated corporate bond sector, we can report that not one of its 115 constituent funds has the remotest correlation to the FTSE All-Share index: the range of r-squared measures reaches just 0.17 at the most. This consistency does not carry over into an intra-sector analysis, though; arguably, we should be looking for funds that not only are uncorrelated to share markets, but also hold close to the sector's overall divergence from those markets. We can examine some potential contenders in the next table.

	Ann. Alpha	Beta	Info Ratio Rel.	Ann. Jensen's Alpha	r <sup>2</sup>	Ann. Return	Sharpe	Ann. Tracking Error	Ann. Volatility
F&C Corporate Bond	0.35	0.83	0.58	-0.23	0.99	0.28	-0.00	0.63	2.91
Legal & General (Barclays) Income Portfolio	0.82	0.59	0.58	-0.60	0.96	0.78	-0.00	1.49	2.10
New Star Sterling Bond	1.01	0.61	0.71	-0.34	0.94	0.97	-0.00	1.47	2.20
Resolution Renfield UK Corporate Bond	6.04	0.82	1.84	5.37	0.44	5.92	0.57	3.27	4.28
Threadneedle UK Corporate Bond	-0.14	1.03	-0.52	-0.05	0.99	-0.23	-0.00	0.29	3.60
Sector UK Corporate Bond	0.00	1.00	0.00	0.00	1.00	-0.09	-0.00	0.00	3.49

Source: Financial Express Analytics. Fund performance and ratio data to 31/07/2007. Bid to bid , net income reinvested – Total Return.

With the exception of Resolution's fund, which we shall come to, these candidates all have the virtue of a close r-squared correlation to their sector as a whole, and we can consider these to be strongly divergent in character from equity markets.

The inclusion of the Resolution product serves to demonstrate the kind of trade-off to be found sporadically among the sector constituents. If our principal criterion is to hold tight to the sector and its divergence from equities, the 0.44 value for r-squared fails the test. However, when we look at the return statistics – the high Alpha and, more importantly, the exceptional Information Ratio – we see evidence of some unconventional investment decisions that have paid off to a spectacular extent, especially in view of the raised volatility.

On the other hand, let us return to the main objective, and look for the best combination of correlation with performance. We have to conclude that the Threadneedle fund has not done as well as its competitors in generating positive Alpha or Information Ratio. Its volatility also sits at the top of the range of the non-Resolution funds.

F&C's Corporate Bond is moving in the right direction, with a positive Alpha outstripping the benchmark, and a respectable Information Ratio suggesting that investment skill is at work. Legal and General's fund moves us further along the path - matching F&C's Information Ratio, while turning in an enhanced Alpha outperformance and logging the lowest level of volatility in our sample.

The fund that ticks all the boxes, though, is New Star's Sterling Bond. It has the close correlation to its sector that we seek, which reinforces its strong dissimilarity from equity market investments. Its volatility is low at 2.2%, and it combines a superior Alpha with an excellent Information Ratio. If investors decide to run for the defensiveness of fixed interest funds, they could do worse than to consider our sample and the methods we have used to select it.



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