Correlation - the key to investment success

- Genuine diversification can only be achieved with asset classes that are largely uncorrelated
- Four different categories of fixed income allow optimum diversification in a risk parity model

Hamburg, 12. April 2014. Effective diversification is the cornerstone of every successful investment. Today, most investment strategies are based on this insight. In our opinion, though, there is more to successful investing than that, particularly in these times of extremely low interest rates. As a pioneer of risk-weighted investment concepts, we make sure that different risk contributions are taken into account when diversifying across asset classes. To apply a risk parity strategy, we need asset classes that offer risk premia, that are as uncorrelated as possible with one another and that can be implemented with liquid instruments.

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Many bond investors are currently faced with the problem of how best to invest in the asset class going forward. Will government bonds perform well? Has the potential of corporate bonds already been exhausted? Will emerging market bonds bounce back again? There is no point in consulting a crystal ball for advice. It makes more sense to rely on facts. In our strategy, which invests in the sub-asset classes of government bonds, corporate bonds, inflation-linked bonds and emerging market currencies, we prefer to focus on correlations which are permanently changing in relation to each other. The important thing is to seek out the asset classes which behave differently in certain economic and capital market conditions. That's why the four fixed income segments listed above, which display very different characteristics throughout the economic cycle, were selected.

Figure 1: Low correlation - the key to efficient diversification

	Corporate Bonds	Emerging Markets	Inflation	Government Bonds
Corporate Bonds	1.00	0.10	0.45	0.54
Emerging Markets	0.10	1.00	0.35	-0.28
Inflation	0.45	0.35	1.00	0.44
Government Bonds	0.54	-0.28	0.44	1.00

Source: Aquila Capital Concepts GmbH, proprietary calculations

Government bonds with top ratings serve as a safe haven, especially in downswing phases and in crises. They represent a highly liquid asset class which contains virtually no credit risk but only duration risk.

Corporate bonds, by contrast, are available for a wide spectrum of sectors, countries and currencies. They still offer a higher average return than safe government bonds, even if their yields have fallen noticeably in recent years, and perform well especially in upswing phases.

Inflation-linked bonds offer protection against a sudden rise in inflation but have limited credit risk since their issuers are primarily industrialised nations. They also display a low correlation to other asset classes, especially in phases of rising interest rates.

Finally, **emerging markets** in which our strategy invests via currencies from eleven different countries certainly offer greater potential than investments in industrialised countries thanks to their more dynamic growth. On top of this, these markets are becoming increasingly more liquid, and the emerging markets *per se* form a less homogeneous asset class than the markets of the industrialized nations. They can thus contribute additionally to the diversification of the portfolio. Furthermore, they tend to perform well especially in economic boom phases.

As a result, these four asset classes generally develop differently in the various phases of the business cycle. This means that attractive returns can be generated in virtually all market conditions.

Figure 2: Performance contributions of asset classes in the ACQ - Risk Parity Bond Fund

Source: Aquila Capital Concepts GmbH, proprietary calculations

The graph shows that in January and February of this year government bonds accounted for a considerable part of the good performance of our ACQ - Risk Parity Bond Fund and that at a time when most experts were taking a negative view towards government bonds. Shortly afterwards the advocates of forecast-based models were in for their next surprise: since the beginning of February the emerging markets, which had been written off, have turned into the strongest return drivers by far.

Examining the correlations and aligning the portfolio on the basis of this is clearly more advisable than asking a crystal ball for advice.

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