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INVESTMENT MANAGERS

Investment viewpoint

Equity-bond correlations: was 2022 an outlier?

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Should we be shocked? Negative equity and bond returns in 2022 provided further evidence that annual performance by the asset classes is not as uncorrelated as commonly believed. How frequently do these so-called 'outlier' years occur, and how can investors with long-beta portfolios be better prepared?

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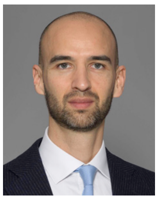

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Need to know

- We challenge two common beliefs: that equity and bond returns are often negatively correlated and long-beta portfolios with exposure to both show strong risk management
- On a daily basis, equity and bond returns are often negatively correlated. But in more than two of every three years since the 1980s, annual returns have moved in the same direction
- On a real-return basis, equities and bonds delivered negative total returns in 15 of the 95 years since 1928, including last year. How can investors better prepare for the not-so-unlikely experience of falling stock and bond markets?

An exceptional year?

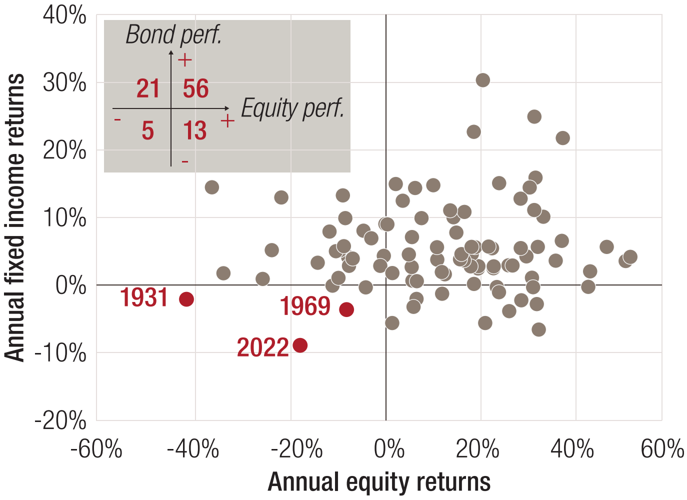
For passive investors, 2022 was a difficult year. Both equity and bond markets delivered negative total returns: a scenario often categorised as the exception to the norm. Figure 1 illustrates this presumed abnormality.

Analyses like this are often used to conclude that 2022 was an outlier year for two reasons:

1. The correlation between fixed income and equity returns was positive, while conventional knowledge assumes it should be negative.
2. Long-beta portfolios with considerable bond and equity holdings rarely lose money because having exposure to both asset classes is key to robust risk management.

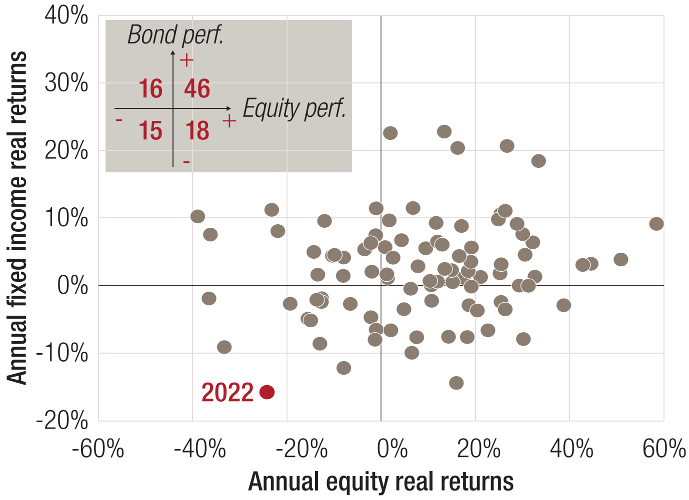
Both conclusions need further investigation, in our opinion.

FIG. 1 EQUITIES AND BONDS: ANNUAL NOMINAL RETURNS, 1928-2022



Source: Bloomberg LOIM as at December 2022. Number of yearly occurence in each quadrant.

FIG 2. EQUITIES AND BONDS: ANNUAL REAL RETURNS, 1928-2022



Source: Bloomberg LOIM as at December 2022. Number of yearly occurence in each quadrant.

Challenging convention

To begin, let's challenge the first conclusion: that fixed income and equity returns are persistently negatively correlated. The belief that holding bonds and stocks in a portfolio creates real diversification is the cornerstone of traditional asset allocation and its posterchild, the 60/40 portfolio.

The daily returns of bonds and equities often show a negative correlation. However, plotting annual returns proves that anything but a negative correlation exists between the asset classes, as shown in Figure 1. When making investment decisions it is critical to measure correlations on both a high-frequency (such as daily) and low-frequency (such as annually) basis. Because most investors and asset allocators have an investment horizon closer to one year than one day, we argue that the **latter metric** is far more relevant to proper portfolio construction and risk management.

Furthermore, since the 1980s, equities and bonds have moved in the same direction (up or down) in more than two of every three years. Notably, investors voiced fewer concerns about the asset classes being positively correlated during risk-on moves.

To address the second conclusion, we allow that 2022 looks like a rare occurrence according to Figure 1. In fact, of the 95 years of history we sample, only five – including 2022 – show bonds and equities delivering negative returns. However, if we look at real (inflation-adjusted) returns instead of nominal, we observe 15 years in which bonds and equities delivered negative total returns (see Figure 2). This implies a 15.8% probability that bonds and equity will both decline in the same year.

Was 2022 an outlier? It was not exactly a tail event.

True diversification is not so simple

We do not dispute the fact that 2022 was a particularly challenging year for beta, and inflation-adjusted returns paint an even bleaker picture. But we do make the following assertions:

1. Assuming a solid and permanent negative correlation between bonds and equities is treacherous.
2. Any year in which bonds and equities deliver negative real returns in the same year is not an outlier, tail or black swan event. It might not occur regularly, but should not be completely unexpected.

With that in mind, we reiterate our conviction in investment solutions that provide genuine diversification. We believe that niche strategies which can deliver alpha with almost zero correlation to the market play an important role in an asset allocator's risk-management and portfolio-construction strategies. They include hedge-fund strategies exhibiting no directional bias, such as multi-strategy, quantitative, macro and relative-value solutions.

IMPORTANT INFORMATION