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How Investing in Uncorrelated Strategies Can Hurt Portfolio Performance

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Long-established investment doctrine calls for risk management through diversification, and the pursuit of uncorrelated return streams is central to this doctrine. *All else equal*, portfolio return volatility, a key measure of risk, falls as the correlation between assets decreases. Therefore, *all else equal*, including investments that are uncorrelated with one another can potentially provide a reduction in portfolio risk without sacrificing returns.

If expected returns and return volatility across new investment opportunities are similar, the investments with the lowest correlation to existing portfolio assets will dominate. However, if expected returns and volatility differ substantially, this will not necessarily be the case. If the asset with greater correlation has a higher expected return, lower volatility, or a lower "beta", the more correlated asset may be the better option for the portfolio. Even in situations in which the expected returns are similar, the correlation is greater, but the "beta" is lower, the more highly correlated asset may be preferable.

Consider a simple hypothetical investment example to illustrate this point. The hypothetical investment is an asset with 10% invested in the S&P 500 Index and 90% invested in a fixed return strategy generating a 1.5% per month fixed return (perhaps one of the popular "private credit" strategies that seem too good to be true). Here are the statistics for the hypothetical investment versus the S&P 500 Index:

10 Years: Metrics (as of 12/31/2023)	S&P 500 Index	Hypothetical Investment
Annualized return	12.0%	18.9%
Standard deviation	15.1%	1.5%
Sharpe Ratio with 3% risk free rate	0.6	10.5
Beta of hypothetical investment to S&P 500 Index	--	0.1
Correlation of hypothetical investment to S&P 500 Index	--	1.0

In this example, the hypothetical investment would offer substantial benefit to a 60/40 portfolio by both raising return and lowering volatility, even though the correlation with the S&P 500 is 1.0. Low correlation is a benefit, but it must be considered alongside the expected return, expected volatility, and expected beta of the new investment under consideration.

A weakness of many "uncorrelated" strategies is the lack of risk premium capture. Expected return comes from the combination of risk premium and "alpha", a measure of manager skill. Risk premiums associated with equities and debt are usually linked to the broad economy. Assets exposed to the broad economy will have some degree of positive correlation, even in the case of assets that are not fundamentally impacted by a weak economy but suffer in periods of liquidity contraction. At the same time, "pure alpha" strategies,

such as a balanced long/short equity portfolio, will have little or no correlation to broad markets, but will be entirely dependent on manager skill or “alpha” for excess return capture. Given that “alpha” is often a scarce commodity, this leaves the investor with a return very close to the risk-free rate if positive “alpha” is not generated, as there is no risk premium return component. This was particularly painful when the risk-free rate was very close to zero and explains the poor returns of many uncorrelated “pure alpha” strategies.

While it’s true that, *all else equal*, little or no correlation across assets in a portfolio can provide the benefit of reduced risk, it is essential to look at correlation alongside the key variables of expected return, volatility, beta, risk premium capture, and realistic expectations for manager alpha. Failure to do so goes a long way in explaining some of the disappointing outcomes investors in uncorrelated assets and strategies have experienced.

Notes/Sources:

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