MV Capital Management Weekly Market Flash

The Vanishing Act of Low Correlations

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Hedge funds are back in the news this week. The latest Master of the Universe to be scorched by the sun and come crashing back to earth is Steven Cohen. Cohen, the sole proprietor of $15 billion hedge funds SAC, is in the crosshairs of a major insider trading scandal that has already taken down many of his closest colleagues. It seems that years of 30%-plus returns required a little extra “sauce” – yet another reminder to those who believe in free lunches and tooth fairies that if something looks too good to be true, it probably is. But while the humbled rogues are the ones who make the headlines, some real problems affect a much broader swath of hedge funds and indeed other asset classes that have long styled themselves as “alternatives” – as offering a refuge from the traditional world of stocks and bonds.

Liquidity: A Blessing and a Curse

We normally think of liquidity as a good thing. Liquid markets make it easier to buy and sell assets with confidence that the price you see is the price you get. But at the same time, the liquidity that comes from easier access – which has happened successively with historically low-correlation assets like commodities, REITs and now hedge strategies – makes it more likely that those assets will correlate more closely to traditional stocks and bonds.

Think of it this way: commodities used to be accessible only to investors with the means and the knowledge to invest directly in futures contracts – a small number of souls indeed. Now anyone with $500 can purchase a commodities ETF on eTrade. Hedge funds, too, have moved into the world of regulated mutual funds. That’s good for enabling more investors to build diversified portfolios: the catch is that those diversification benefits diminish when assets trade more on whether or not Ben Bernanke says “tapering” and less on the fundamental merits of individual assets or business cycle considerations.

More Fishermen, Fewer Fish

You can see this effect in the numbers. Over the last five years the correlation between the HFRI Fund of Funds Index and the S&P 500 has been 0.76 (where 1.0 represents perfect positive correlation). By contrast this value was 0.32 in the five years from 1991 to 1996. Even more strikingly, the correlation between the Dow UBS Commodity index and the S&P 500 was 0.02 in the 1991-96 period – basically implying no correlation at all – and had shot up to 0.81 by 2008-13. It is not a mere coincidence that the first ETF launched in 1993 and has since grown to a market worth nearly $1.5 trillion in total assets.

This makes it harder for intrepid money managers to discover untapped nooks and crannies in the global capital markets. It’s like a pond teeming with fish: a few folks stumble upon it, cast their lines and hook one fish after another. Then word gets out, the hordes descend and the fish disappear. The money managers find it increasingly hard to prove their prowess in delivering alpha. Some – like SAC – turn to more desperate measures to create the illusion of success, and fall hard when their luck runs out.

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