



## Letters to the Editor

March 10, 2009

*The following two letters are in response to our article, [Why Diversification is Failing](#), which appeared last week.*

Dear Editor,

As usual, people who do mean variance analysis and don't think about the inputs come out with the wrong answer. It has nothing to do with upside versus downside correlation asymmetry. It has to do with asset class valuations going into a correction. Like Jeremy Grantham said 18 months ago: bubbles, bubbles everywhere. Every asset class was overvalued. No wonder they all came down at the same time. If you are looking to diversify, don't look at trailing correlations. Look for valuation disparities. Unfortunately, that would not have helped last year, when only cash worked. Too many people feel comfortable when they run models and do the math. People should think first.

Thanks for listening.

Phil Appel  
Merrill Lynch  
Bloomfield Hills, MI

Dear Editor,

Only the CFA Institute could come up with the following reason for why diversification is failing: "In short: diversification is failing because of correlation asymmetry." They might consider a much simpler answer: Diversification is failing because correlations are greatly impacted by the underlying valuation of the securities involved. In bear markets, investors will sell overvalued assets in favor of less overvalued assets. The historical correlation of the assets will have little to do with it. After a five year run where the valuation of U.S. stocks, international stocks, commodities, and real estate, all went vertical due to the coordinated and determined efforts of global policy makers to reflate assets after the 2000-2002 bear market, it should have been obvious that the historical correlations of these asset classes could and should have been thrown out the window. Unless advisors learn that there are two methods of managing risk,



diversification AND valuation, they will continually be bedeviled by “correlation asymmetry.”

Kenneth R. Solow  
CFP, Chief Investment Officer  
Pinnacle Advisory Group, Inc.  
Columbia, MD

*Sebastien Page provides the following response to these two letters:*

We thank Kenneth R. Solow and Philip Appel for their interest in our research. We would like to take this opportunity to clarify a few points. First, our research was not produced on behalf of the CFA Institute except that it was presented at their European Investment Conference last year. Second, we do not advocate that advisors should blindly rely on historical correlations. Our research merely points out empirical observations on correlation asymmetries and suggests a new portfolio optimization method – called full-scale optimization – that controls for this feature of investment returns. Advisors must indeed formulate expectations about the future before they use portfolio optimization. These forecasts might differ from historical correlations. This concept goes back to the first article on portfolio selection written by Harry Markowitz in 1952 in which he states: the first step of portfolio selection begins with judgment and experience and ends with expectations about the future; the second step starts with expectation about the future and ends with the choice of a portfolio. Kenneth R. Solow and Philip Appel provide an argument why correlation asymmetries might persist into the future. When assets valuation rise over a long period of time they all become overvalued. At that time it becomes evident that they will fall together when risk aversion increases and de-leveraging takes place.

Our research shows that as during a plague outbreak, in times of crises assets fall together rapidly and unexpectedly; while in normal times they diversify each other a lot more. Explanations for why this empirical observation is to be repeated in the future include Mr. Solow’s and Mr. Appel’s valuation build-up argument. Investor behavior also plays an important role: in financial markets fear is more contagious than optimism. Liquidity also matters. In their thirst for liquidity, investors will sell assets that normally would not be correlated. Other explanations include the proliferation of portfolio insurance strategies; quantitative equity investors using the same Barra factors; the short-put-option positions embedded in many investment strategies and credit-linked assets that become in-the-money simultaneously; hedge funds chasing the same sources of alpha; and the list goes on. For all these reasons, the full sample correlation coefficient belies and asset’s diversification properties in markets when it is most



needed. Hence the myth of diversification. We agree with Mr. Appel's observation that people using mean-variance optimization without thinking about the inputs get the wrong answer. In fact that's the point of our research. The full sample correlation coefficient is the wrong input because it over-estimates diversification's ability to reduce exposure to loss. We thank Mr. Solow and Mr. Appel for giving us the opportunity to address this important question.

"No longer were there individual destinies; only a collective destiny, made of plague and emotions shared by all." –Albert Camus, "The Plague"

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