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Janus Advisor Guide: Beware of Correlations, and Other Investment Tips

Janus Funds' 2017 Wealth Advisor's Guide identifies the intended and unintended risks of advisors' asset allocations in their model portfolios

Janus Funds has just issued its 2017 Wealth Advisor's Guide, which includes some key investment tips for financial advisors working to diversify the potential risks and rewards of their clients' portfolios.

One key to achieving that diversification is to limit the correlation among asset classes as well as individual funds and ETFs, which sounds simple but often is not as easy as advisors might assume.

Janus analyzed more than 1,700 asset allocations of financial advisors to help them better understand the intended and unintended risks of their portfolios, looking for themes and trends in the advisors' models.

What they found, says Matt Sommer, director of retirement, were many advisor models that employed two or three large-cap growth managers whose funds were highly correlated not only to the S&P 500 but also to each other.

"If you have three active managers and they are all are doing the same thing you basically have a very expensive index fund," says Sommer.

The Janus analysis found that the average correlation of the 50 large-cap growth funds to the S&P 500, as of Aug. 31, 2016, was 0.94. If two such funds were paired, the correlation among 91% of those pairs, was 0.90 or higher, meaning that only 9% of the pairs had a correlation below 0.90. In more than half of those pairings, the correlation was 0.95 or higher.

Sommer suggests that advisors look at the correlations not only among asset classes but also among the funds and ETFs a client owns.

If the investment goal is to have an experience similar to the S&P 500, then an advisor should use an S&P 500 index fund. But if the objective is different from the index, then the advisor should choose an active manager with a highly concentrated portfolio, low-volatility portfolio or some other focus unlike the index. "Make it intentional," says Sommer.

The Janus analysis, based on its asset allocation service called Portfolio Construction Services, which uses MPI Stylus software, also found that liquid alts don't necessarily achieve the diversification that advisors are seeking.

While the 5-year correlation to the S&P 500 was -0.03 for an alternative managed futures fund and 0.04 for a market neutral fund, it was 0.91 for long-short funds and 0.86 for total return funds.

"Liquid alternatives are not necessarily a portfolio diversification investment, especially if they are highly correlated with the S&P 500," says Sommer.

He suggests that before investing in such a strategy, advisors first decide its primary objective — whether it's to drive returns or to diversify risk, for example — and then select the most appropriate subclass of liquid alternatives. "These investments can be expensive so getting S&P 500-like returns is building a pricey index fund."

Strategic income bond funds, also known as unconstrained bond funds, constitute another investment category that, like liquid alternatives, covers a wide range of investments. Moreover, such funds can change their compositions "quite radically," says Sommer. "They're all over the place. The question becomes, is your strategic income fund more correlated with other parts of your portfolio?"

Overall, the liquid alt and strategic income/unconstrained bond fund categories performed relatively poorly in 2016, though some individual funds did not.

Beyond checking for correlations between asset classes and funds and ETFs in a client's portfolio, Sommer offered some investment types that advisors should consider including in client portfolios:

- **ESG Funds.** These funds, which choose stocks based on their ratings for environmental, social and governance criteria, are becoming more popular among investors, especially millennials, and can boost performance, according to Sommer. He cited a 2015 Oxford University report "From The Stockholder to the Stakeholder" which found that about 90% of the research shows that sustainability standards and practices can lower a company's cost of capital and result in better operational performance, while 80% of studies show such practices positively influence a company's stock price.
- **Foreign Equities.** Janus Capital's analysis of advisors' models found that among moderate model portfolios, the average allocation was 11% for international stocks and 1.8% for emerging markets while about 15% had no exposure to international stocks. These allocations are low given the fact that international stocks, including emerging markets, account for almost half the global equity market. They "have a place in most aggressive and moderate model portfolios and will reward investors with a long-term outlook," says Sommer.
- **Stock Protection Funds.** These funds, which offer downside protection to individual investors with a large percentage of their net worth tied to a single security, such as corporate executives, are becoming increasingly popular, says Sommer. A group of such investors, owning different stocks, get together, contributing cash that's equivalent to 10% of each one's equity position. The cash is then used to buy Treasuries. At the end of say, five years, the money from the Treasury bonds is used to reimburse those who have suffered the largest losses. If there are no losses, everyone gets their money back plus interest.