# Preparing Portfolios for Future Rebalancing: Why Correlation Matters

**One of the most concentrated equity and corporate-credit market declines on record occurred from late February into March, only to be followed by just as swift a recovery when the Federal Reserve proclaimed its broad support within the capital markets. Looking at year-to-date returns through June, one may never know that the first quarter drawdown ever took place. So why should investors care about the correlation of their equity and fixed income portfolios if both recovered from their previous losses?**

This is a question that many investors have asked their advisors, particularly since the end of the financial crisis where, despite multiple periods of high volatility and drawdown, many asset classes have increased in value. Since the end of the financial crisis, corporate bond investors in particular have enjoyed low average volatility, declining interest rates, and declining credit spreads. This combination has led to historically competitive bond returns, especially in the lower credit quality segments of the corporate bond market.

The stated historical returns for any investment strategy can only be achieved in a real-life portfolio if there are no portfolio cashflows. For the buy-and-hold investor, the stated returns on the individual investment strategy are generally close to what the investor actually achieves. For the opportunistic investor, portfolio returns can sometimes be *higher* than what the weighted average investment strategy returns might suggest due to rebalancing (i.e. buying low, selling high). For the investor with liquidity needs, however, returns can be a lot lower due to the portfolio's need for liquidity when, and if, asset prices decline.

Portfolio liquidity is one of the main reasons why investors hold bonds. They are generally one of the less volatile segments of a portfolio from which to source cash and can also serve as a potential return-enhancer because of their ability to perform differently than equities. When equities decline and an investor is rebalancing, their fixed income holdings can serve as an immediate source of liquidity.

## Protecting Capital for Future Rebalancing

### What happens when a portfolio's bonds decline alongside a drop in equities?

Even if bonds hold up *better* than equities, the simultaneous drawdown can *limit* participation in the benefits of rebalancing. If the portfolio has a liquidity need, it also faces the prospect of a capital loss because both equities and fixed income holdings in the portfolio have declined. Looking at stated returns in **Figure 1**, we see in the far-right column that our flagship core fixed income mutual fund provided better portfolio protection during the period when equities declined by almost 34 percent, contributing to its first quarter performance. Looking at year-to-date returns in the second column, we see that the recovery in the second quarter resulted in the Fund lagging the Morningstar categories and the corporate segment of the Bloomberg Barclays Aggregate Index.

These returns were only achievable if the portfolio did nothing but stay the course; however, actively rebalanced portfolios are not meant to stay the course. In **Figure 2** we illustrate what would have happened to year-to-date portfolio returns if the very realistic need for portfolio liquidity *and* opportunistic rebalancing had taken place.

The four portfolios shown in **Figure 2** are comprised of 60 percent equities and 40 percent bonds. All used the S&P 500 as the proxy for the equity segment of the portfolio, and for the bond proxy, the return streams of those listed in the table were used. Each portfolio was rebalanced to take advantage of the massive decline in equities.

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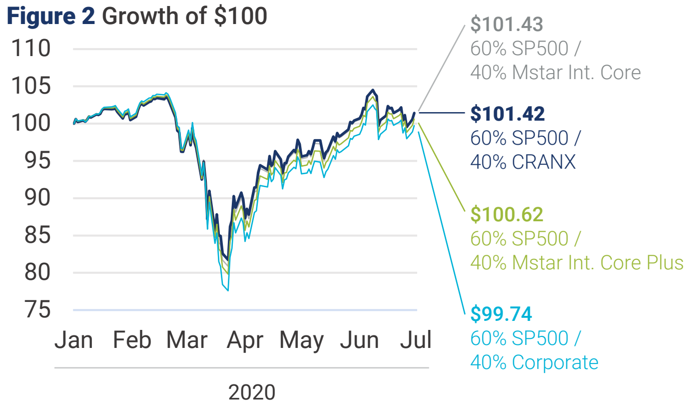
| **Figure 1** | YTD (as of 6/30/20) | Q1 | Q2 | Performance during the stock decline of 2/20/20 - 3/23/20 |
|---|---|---|---|---|
| CRANX | 3.70% | 2.15% | 1.51% | -.82% |
| Morningstar Intermediate Core | 5.55% | 1.60% | 3.89% | -3.52% |
| Morningstar Intermediate Core Plus | 4.37% | -1.11% | 5.54% | -6.16% |
| Corporate Bonds* | 5.02% | -3.63% | 8.99% | -12.24% |

**As measured by the corporate segment of the Bloomberg Barclays Aggregate Index*

**Figure 2** Growth of $100



While **Figure 1** shows that the Fund lagged the others year-to-date, **Figure 2** above shows that the portfolio that *included* the Fund actually performed better-than or in-line-with the others when considering the effects of portfolio liquidity and rebalancing. This is because the Fund performed better than the others in the first quarter when equities declined, so there was more money to be moved from bonds into equities during the rebalance. As a result, the portfolio that included the Fund was positioned better to participate in the massive rebound in the equity markets.

## Optimizing Portfolios for Future Rebalancing

Not all bond strategies are alike, nor are they all structured to maximize the benefits of a balanced portfolio. As such, it is important to look at the bond strategy's return and liquidity performance during times where larger rebalancing is likely to occur. By doing so, an investor's ability to achieve a balanced portfolio's objectives can be greatly enhanced.

## About CCM

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