AT THE HEART OF INVESTMENT SINCE 1995

INVESTMENT WEEK

investmentweek.co.uk

15 May 2017

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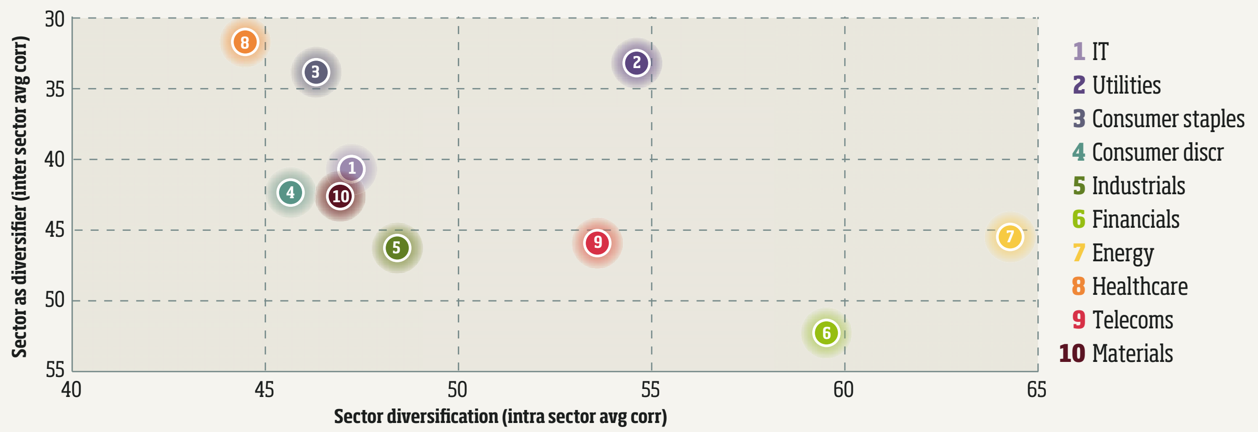
Inter vs intra sector average correlations (%)



Source: TOBAM; Correlations computed using one year daily data as at 31 December 2016.

Do financials pose risks for investors as sector correlations leap to 2008 levels?

Intra-sector correlations within financials, as well as its correlation to other areas, have risen to levels last seen at the peak of the financial crisis in 2008, leading to diversification concerns for investors.

The rise in correlations has been driven by the strong performance of the sector, with the MSCI World Financials index up 31% over the second half of 2016 versus a 14% rise for the MSCI World.

This was driven primarily by an upward move in US treasury yields, as well as the election of Donald Trump as US President in November, which boosted investor expectations of more relaxed banking regulations, rising inflation and rates.

According to research from smart-beta provider TOBAM, the financial sector's performance over the period on a relative basis versus cap-weighted benchmarks was the best since 2009, but this has had a negative impact on its diversification characteristics, with intra- and inter-sector correlations rising to levels last seen at the height of the financial crisis.

Intra-sector correlations measure the average correlation of the stocks within a given sector, with an equally-weighted proxy composed of all the stocks of the same sector. Meanwhile, inter-sector correlations measure the correlation of an equally-weighted proxy of the sector, with an equally-weighted proxy for all the stocks belonging to a given universe, in this case the MSCI World.

TOBAM's analysis found that, at the end of 2016, the financials sector offered the poorest diversification potential relative to all other sectors of the MSCI World index, with only energy stocks having a higher inter-sector correlation (see graph).

Reminiscent of 2008

The divergence between the intra- and inter-sector correlations of financials relative to other sectors in the index has reached levels last seen in 2008, according to TOBAM, with the sharp move resembling the leaps of 2009.

Yves Choueifaty, co-founder of TOBAM, said: "Based on [this], the financials sector became increasingly correlated to the rest of the market, providing fewer diversifying opportunities when combined with other sectors."

The research has also shown the weighting of financials in the MSCI World index has steadily increased over the second half of 2016 as a result of the rally in these stocks, which presents a "large concentration risk".

Chris Rice, manager of the £300m TM Sanditon European fund, agrees the current market environment is comparable to 1999 and 2007. He has been holding on to his allocation in financials due to low valuations, but has begun selling down some exposure.

He said: "We are underweight financials, as is quite common for European fund managers, but we have held on to them more than we normally would at this point in the cycle as they have been so cheap.

"But now we are starting to gently sell. We will get one more leg up in financials as bond yields in Germany and France pick up, and we will be selling in to that. I think you will see our weighting come down by about 4 to 5 percentage points [it was 16.1% as at 30 April]."

Active approach

However, other active managers have said they are still able to find diversification within the sector by looking across sub-sectors and geographies and focusing on bottom-up stock selection.

The financials sector became increasingly correlated to the rest of the market, providing fewer diversifying opportunities – Yves Choueifaty

Guy de Blonay, manager of the £490m Jupiter Financial Opportunities fund, agreed the MSCI ACWI Financials index had lost some diversification potential after REITs were removed last August, but believes opportunities remain.

He explained: "Different parts of the index respond differently depending on where you are in the cycle. Back when passive investments were not as important as they are now you had more rational behaviour within the index, but this is still valid today.

"If you have a strong dollar and a rising rate environment, US financials will outperform the EM and European components of the index, and vice versa if the dollar is weak and there are delays in interest rate rises."

Within his fund, de Blonay achieves diversification by looking not only across geographies and sub-sectors, but also across a range of investment styles, such as growth, value and restructuring stocks. For example, he said growth stocks could be emerging market financials or financial technology, which have different characteristics and drivers.

James Sym, manager of the £973m Schroder European Alpha Income fund, prefers to remain stock specific: "My response is to buy only the highest quality banks which operate in consolidated markets that, as a consequence, are seeing improving margins. They will protect the portfolio better in the downturn as the cycle continues to extend in length," he said.

Macron victory not 'all clear' signal for Europe: Leader page 20