

Stock Markets March Together

Successful diversification historically has required venturing outside the United States. But as the financial markets have become increasingly global, correlations are increasing, which presents challenges when mitigating volatility.

As investors in U.S. stocks watch their holdings hover around bear market territory, many are looking for alternatives. Yet many global indexes are faring worse than U.S. stocks. Year-to-date through September 30, 2011, the S&P 500's decline of 8.6% was eclipsed by the MSCI EAFE Index, a non-U.S. developed markets benchmark that swooned 14.6%, and the MSCI Emerging Markets Index that was down 21.6%.¹

A variety of factors are causing financial markets to march in unison. The growth of global trade and the proliferation of worldwide investment firms mean that the fortunes of both large corporations and the investors who own their stock are tied together as never before. Many foreign governments and global financial institutions rely on U.S. dollars as a reserve currency to pay debts or to influence exchange rates. Given this situation, the health of the U.S. economy and the actions of the Federal Reserve reverberate globally, as do events in Europe and beyond. Investors historically have attempted to diversify stock portfolios with real estate or commodities. But the proliferation of mutual funds and exchange-traded funds that track these assets and trade on stock exchanges has caused their returns to more closely resemble stocks.² As a result, when U.S. stocks are in a trough, this scenario impacts assets on a global basis.

36-Month Correlations of S&P 500 and MSCI EAFE



Sources: Standard & Poor's; Morgan Stanley Capital International (MSCI). U.S. stocks are represented by the S&P 500, developed markets by the MSCI EAFE Index. Past performance does not guarantee future results. Thirty-six-month

correlations were calculated from monthly returns for the period between September 1, 2004, and September 30, 2011.

Climbing Correlation

Because the global economy has become increasingly interconnected, returns of stocks based in non-U.S. developed markets, as measured by the MSCI EAFE Index, grew more synchronous with the United States during the past five years.

What Investors Can Do

If climbing correlations concern you, consider the following strategies that may help you balance risk and return.

- **Combine stocks with other types of assets.** Adding exposure to bonds, real estate, and commodities may help you to balance returns over the long term. The type of investment may make a difference in its correlation to U.S. stocks. For example, although mining stocks present exposure to commodities, they may come close to mirroring returns of the S&P 500.
- **Consider investments that generate income.** Dividend-paying stocks, bonds, and REITs frequently are favorites of investors searching for income. When stock returns are uncertain, dividends provide something in the way of a return. Dividends are not guaranteed.
- **Focus on blue-chip stocks.** When the global economy is under stress, large corporations with a global footprint may be better able to ride out the storm compared with smaller companies.
- **Remember that alternative investments are risky, too.** REITs are subject to the ups and downs of the real estate market, and the volatility of gold during the past 10 years is close to that of stocks. The returns of these investments do not always track the U.S. stock market.³

You may be able to smooth out returns by owning a mix of assets, focusing on income, and using alternative investments in appropriate proportions.

¹Sources: Standard & Poor's; Morgan Stanley Capital International. Domestic stocks are represented by the S&P 500, developed markets by the MSCI EAFE Index, emerging markets by the MSCI Emerging Markets Index. For the period beginning January 3, 2011, and ending September 30, 2011. Returns for developed markets and emerging markets are presented in U.S. dollars. Emerging markets are generally more volatile than the markets of more developed foreign nations, and you should consider this increased market risk carefully before investing. You cannot invest directly in an index. Past performance does not guarantee future results.

²Exposure to the commodities market may subject investors to greater volatility as commodity-linked investments may be affected by changes in overall market movements, commodity index volatility, changes in interest rates, or factors affecting a particular industry or commodity.

³Sources: Standard & Poor's; 4 p.m. closing spot price of gold on the London fix. Returns are for the 10-year period ending December 31, 2011. Volatility is measured by standard deviation.