COLUMBIA THREADNEEDLE INVESTMENTS

It's time to change the way we look at diversification: 2024 asset allocation outlook

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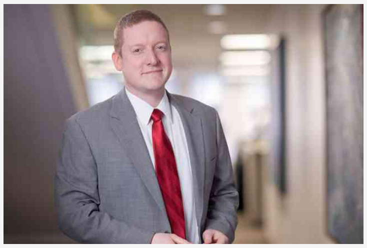
Correlation between stocks and bonds remains elevated, creating challenges for multi-asset investors.

At the start of 2023, we had one important high-conviction asset allocation view: As inflation declined, correlations between equities and fixed income would revert to historical norms. But as 2023 came to a close, correlations hit multi-decade highs, despite that steady decline in inflation. Here's what we think this means for asset allocation in 2024:

There's more to diversification than correlation

Diversification — a core tenet of multi-asset portfolio construction — suggests that combining different asset classes that do not move in the same direction could help reduce overall portfolio volatility and generate more consistent returns. Traditionally, diversification has been closely tied to correlation, which measures how closely the returns of two asset classes move in relation to each other. But with correlations still strongly positive — meaning stocks and bonds move in the same direction — we believe other measures can help identify opportunities for diversification.



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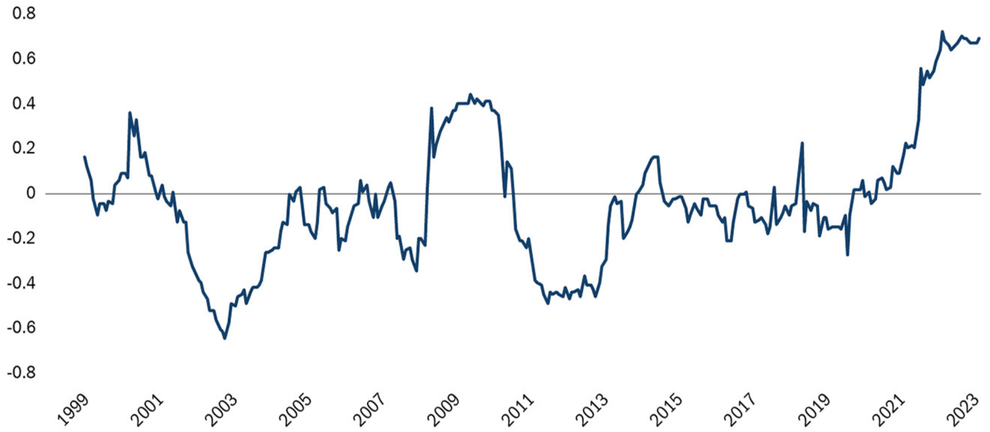
Correlations between stocks and bonds are still at record highs

(24-month rolling correlation)



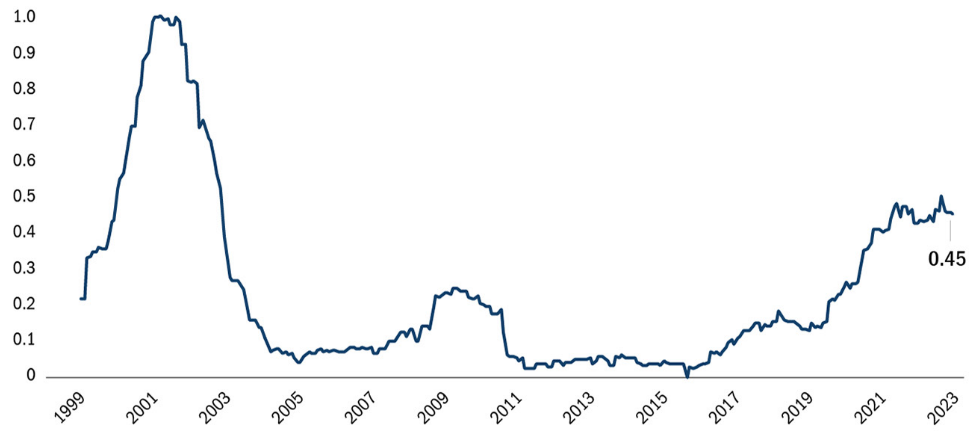
Source: Bloomberg L.P., Columbia Threadneedle Investments Global Asset Allocation team based on monthly data. Stocks are represented by the S&P 500 Index. Bonds are represented by the Bloomberg U.S. Aggregate Bond Index. An investment cannot be made in an index.

Pivoting from correlation to differentiation

An additional measure we use to identify diversification opportunities in multi-asset portfolios is differentiation, which measures the volatility of the difference in returns between a pair of asset classes (over a rolling two-year period). The higher the volatility of that difference — higher differentiation — the more we can identify specific opportunities with the potential to add alpha to portfolios.

Pursuing asset class diversification with differentiation

(Difference in volatility of returns between growth and value stocks, indexed)



Source: Bloomberg L.P., Columbia Threadneedle Investments Global Asset Allocation team based on monthly data. Growth stocks are represented by the Russell 1000 Growth Index. Value stocks are represented by the Russell 1000 Value Index. An investment cannot be made in an index.

The concept of differentiation also underscores the importance of research and security selection. For example, if we hold a more neutral view on stocks versus bonds, employing security selection in our portfolios and identifying pockets of opportunity becomes even more critical.

Bottom line: It's time to dig deeper into multi-asset portfolios

The conventional approach to diversification has relied heavily on correlation to help smooth out the investment journey. As we begin 2024 with this notion in question, we must explore other aspects of the market, like relative value trades, to identify opportunities for multi-asset portfolios to thrive.

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