Quality Is More Important Than Size

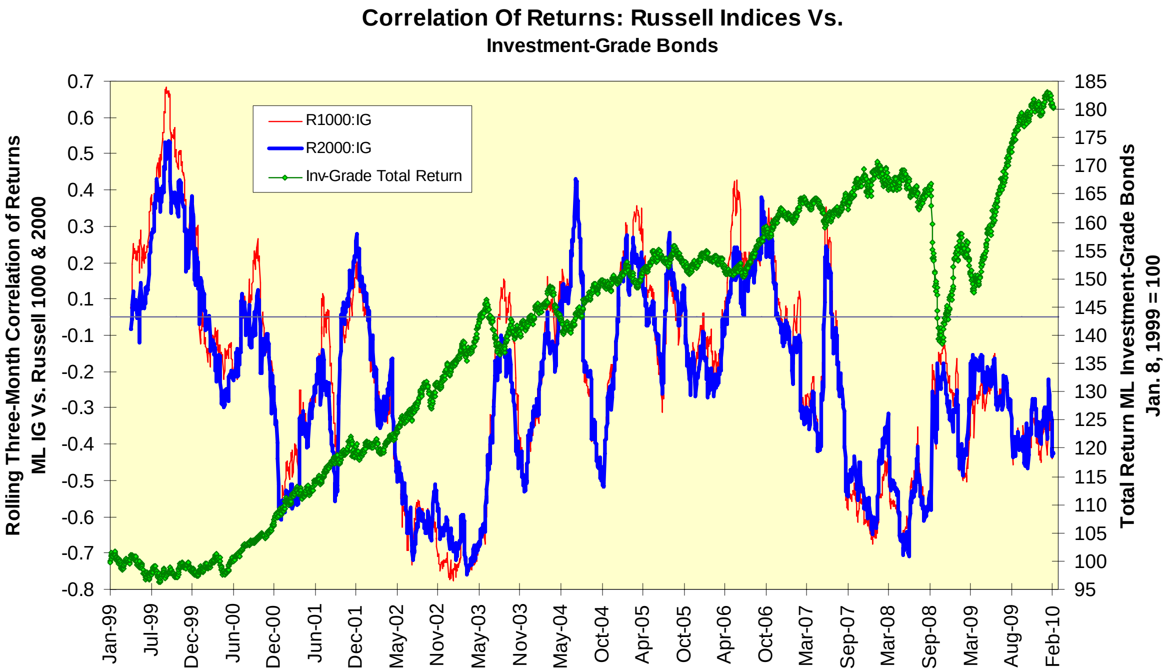
Some things you suspect; others you just know. One of the truisms in our index-besotted world is if you splice and dice the investing universe enough, you can find a bull market somewhere. Try it; even in awful years such as 2002 or 2008, you will be able to find something, somewhere that went up, which by extension means you will find someone asking you why you missed out on Mauritian stocks in 2002.

One of the simpler divisions is capitalization. We have large-caps. We have small-caps. Yes, we even have mid-caps. If we take the brightest line between large-capitalization and small-capitalization, the division between the Russell 1000 and Russell 2000 indices, we can start playing the game of whether large-caps are outperforming small caps.

Corporate Bond Quality

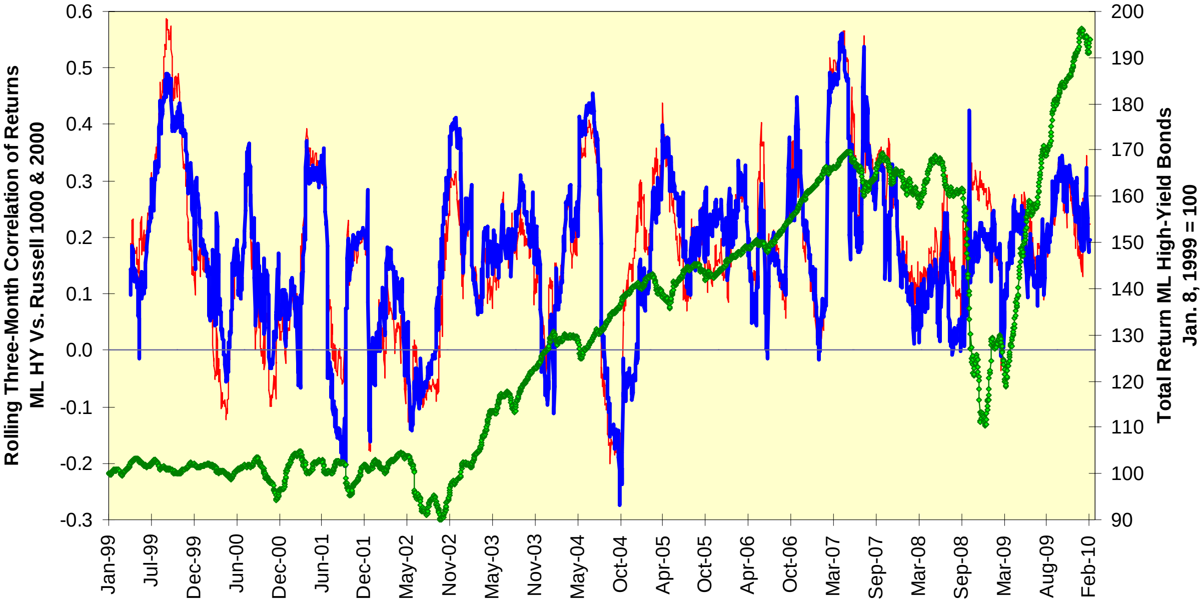
While stock investors are focused on size, bond investors divide their world up more along a quality dimension. Once again, let's split the universe along a single dimension into investment-grade and high-yield. If we map the rolling three-month correlation of returns for the Russell 1000 and Russell 2000 indices against those for the Merrill Lynch investment-grade and high-yield indices re-indexed to January 8, 1999, two conclusions emerge.

The first is how investment-grade returns have been correlated negatively to both the Russell 1000 and Russell 2000 indices continuously since the credit crisis erupted in late July 2007. This has been true even though the huge stock rally of 2009 was also a huge corporate bond rally.



The second is how high-yield returns have been correlated positively against the Russell 1000 continuously since November 2004 and have been correlated positively against the Russell 2000 with minor and mild exception since December 2004.

Correlation Of Returns: Russell Indices Vs. High-Yield Bonds



In addition, the absolute level of correlation has been greater for the Russell 1000 against both the investment-grade and high-yield indices. While high-yield bonds are correlated more closely with equities, the rolling three-month correlation has not been very high even during years such as 2003 and 2009 when free money propelled nearly all markets higher in unison. Indeed, the period of maximum correlation occurred in the three month period ending in May 2007, and that did not exceed .60 for either Russell index.

The rolling three-month correlation of returns for investment-grade bonds remained negative during 2009 and indeed for nearly all of 2003. Once again, we see periods of positive correlation during 2006-2007, especially for the Russell 1000, but these readings never exceeded .40.

This allows us to conclude the death of diversification, like the death of Mark Twain, is exaggerated. Adding investment-grade corporate bonds to stocks produces different results than adding high-yield bonds to stocks; this is the meaning of negative correlation. Conversely, adding high-yield bonds to stocks, especially when credit spreads start to narrow becomes a doubling-down bet. If investors should have learned anything in recent years, it is risk management matters most of all. Adding high-quality bonds to stocks of any size reduces risk.