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# Managing Correlation Creates Portfolio Agility

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## Key Takeaways

- ▶ Current market turmoil is emblematic of a market and regime change, highlighting the need for a systematic but dynamic approach to portfolio construction.
- ▶ The Russell 1000 Value Index is currently trading at the top quintile of historic valuation, which is why an absolute valuation discipline is critical right now.
- ▶ A focus on diversification through low correlations results in a portfolio that is often highly differentiated and, we think, more robust to constantly changing market environments.

## Seeking to Be Truly Active Versus the Index

When stock market valuations are at extreme highs, volatility and correlations at historic lows and global capital concentrated in a few favored stocks, the last thing investors are positioned for is change and uncertainty. Yet these are turning out to be hallmarks of 2025. We think that this is emblematic of the beginning of a market and regime change, highlighting the need for value investors to employ a systematic but dynamic approach to portfolio construction.

While value stocks continue to trade at a historic discount to growth stocks, the Russell 1000 Value Index's (RLV) forward P/E ratio of approximately 17x 2025 earnings puts it at the top quintile of its market history on an absolute basis (Exhibit 1). This makes an absolute valuation discipline critical.

Exhibit 1: Even Value is Expensive



As of Dec. 31, 2024. Source: FactSet, ClearBridge Investments.

The key for value managers is to be truly active versus the index and go where your investment process takes you. This typically leads to higher tracking error versus peers but creates an environment where managers are getting paid for this relative risk while managing absolute risks through portfolio diversification. We believe this relative risk is worth it, as it allows us to capitalize on market inefficiencies to generate superior returns.

## Low Correlation Fuels Good Portfolio Construction

One of the key components of our active management process is seeking stocks with low pairwise correlations. These are securities with weak or minimal correlation in their price movements. Even if they have high individual volatility, this helps maximize compounded returns by minimizing the drag from volatility — often referred to as the volatility tax. These high-volatility but low-correlation assets are incredible diversifiers and help to reduce the risk of sustained volatility accompanied by rising correlations — reducing the need for quick and dynamic adjustments to overall portfolio construction to avoid a direct hit from changing market conditions. Such was the case with Vistra in 2024; the merchant power producer’s high volatility and relatively low correlation with the overall portfolio helped it to generate significant alpha as a part of the ClearBridge Value Strategy’s overall performance.

Exhibit 2: High Volatility, Low Correlation Spurs Alpha Generation

	Annualized Standard Deviation	Correlation	Alpha
Vistra Corp.	61.64%	0.73	8.41%
ClearBridge Value Strategy	14.00%	1.00	0.00%

As of Dec. 31, 2024. Source: ClearBridge Investments.

The key point is that if you have a good upside to our estimate of business value (which usually comes with higher volatility), then the compound return rate of the portfolio skews higher if it also has low correlation. The alternative is normally a lower geometric average than the stated upside — a less-than-optimal outcome for long-term return generation.

Pairwise stock correlations across the market are currently low, which is another reason to maximize diversification across sectors and industries. By doing this we can achieve attractive downside capture relative to our index — critical in driving the compounded returns we are after, while also positioning us to take advantage of any negative surprises that spike volatility, correlations and valuation spreads. By aiming for this, we often end up with a portfolio that is highly differentiated and, we think, more robust to constantly changing market environments.

## Conclusion

The main challenge of portfolio construction is that it is an inherently dynamic process as underlying correlations and volatility are constantly changing — sometimes dramatically. However, we believe that our process, driven by disciplined approach of combining attractive absolute valuation with strong fundamentals in a truly diversified portfolio, sets us apart and allows us to embrace the uncertainty and volatility of the current market with confidence.

## About the Author



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- 32 years of investment industry experience
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