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Related Content
The Whole is Greater than the Sum of the Parts

Diversify and Conquer

Enhancing Portfolio Returns through Non-Correlated Strategies

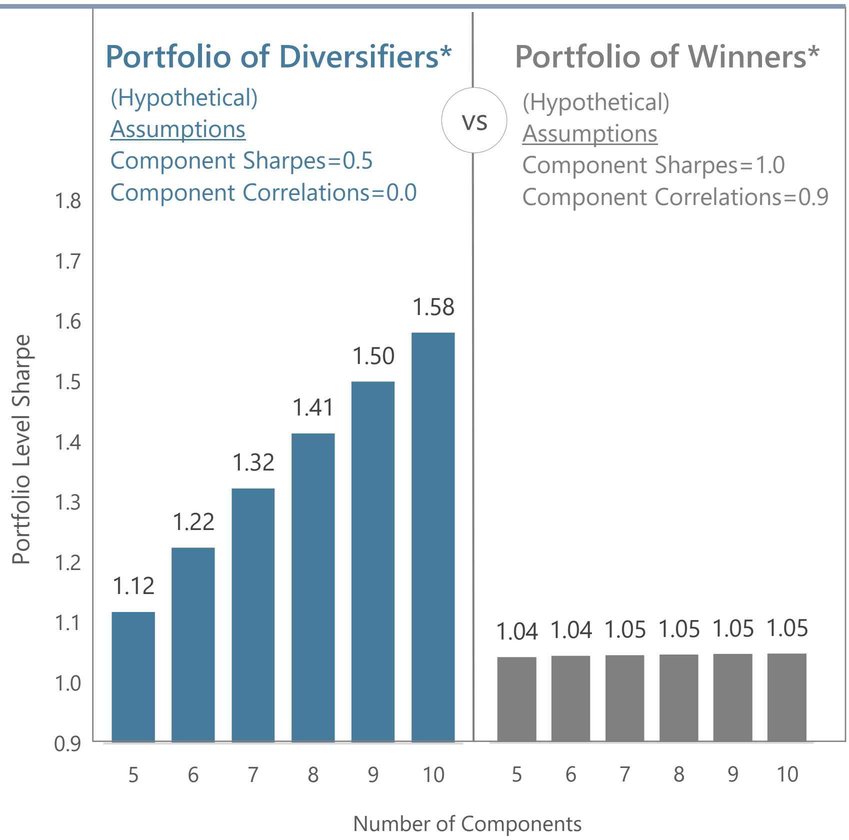
For some investors, it is tempting to construct a portfolio consisting only of high Sharpe, high-performing strategies. However, focusing solely on the return characteristics and Sharpe ratios of individual strategies, without considering their role within a broader portfolio, can increase the risk of amplified losses in volatile markets. Rather than trading in-and-out of “winners,” investors are generally better served by constructing a well-diversified portfolio of low-correlated strategies. With thoughtful portfolio construction, investors can potentially achieve significantly better returns at the portfolio level than can be expected from the individual component strategies. By prioritizing diversification over the pursuit of individual winners, investors can strengthen their chances of preserving capital and achieve more consistent returns.

In this chart, we see that a hypothetical portfolio consisting of uncorrelated "diversifiers" outperforms a hypothetical portfolio comprised of highly correlated "winners," despite the component strategies of the latter having a Sharpe ratio that is twice as high. By integrating diversifying strategies alongside more traditional investments, investors can build a portfolio that not only demonstrates resilience in challenging times but also capitalizes on the consistent growth potential that comes from careful diversification.

*There is a closed form for the Sharpe ratio of a portfolio as follows: If all assets have the same Sharpe ratio s, and pairwise correlation p, then a portfolio of n assets has Sharpe ratio :

$$S = \frac{ns}{\sqrt{n + (n^2 - n)p}}$$

If $p = 0$, S *scales with* $\sqrt{n}$
If $p > 0$, S *is capped at* $\frac{s}{\sqrt{p}}$ *as* $n \to \infty$



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Source of data: Graham Capital Management (“Graham”), unless otherwise stated

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