How To Make Big Money Trading In All Financial Conditions

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SAMPLE

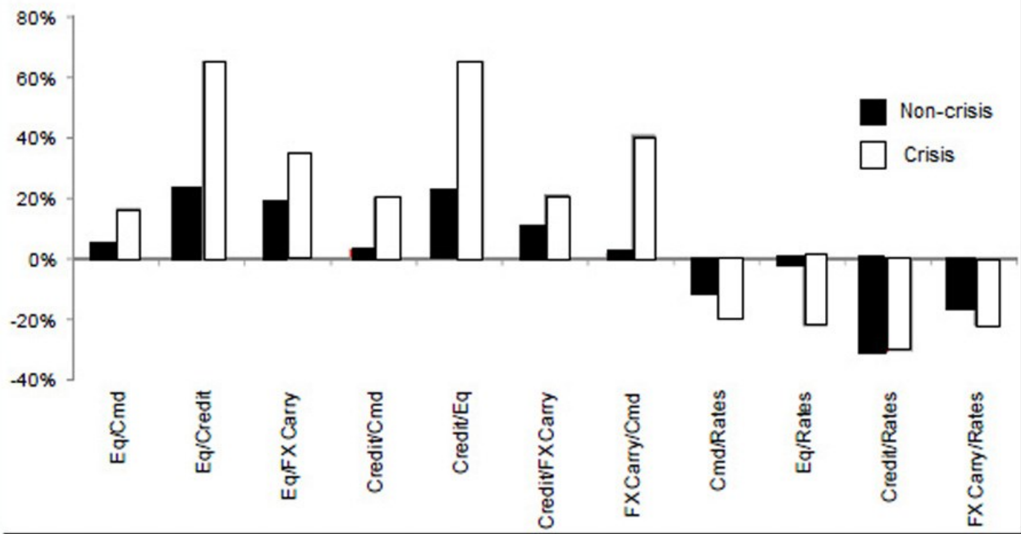
Risk-On/Risk-Off Trading And Correlations

As I have tried to stress before, **jobbing in and out of an asset in isolation in search of a few pips here and there is a mug's game. It is a key reason why 90% of retail traders lose all of their dealing money within 90 days**. Not being one of these – and, rather, being one of those that makes life-changing serious money – requires self-discipline, knowledge of trading fundamentals (see earlier), a sound grasp of technical analysis and risk management (see later) and the ability to discern what patterns are in play across the global financial markets. This last point is what this section is about.

In general terms, the degree to which the price action of all major financial markets assets are correlated positively or negatively has varied since this phenomenon fully manifested itself after the collapse of Lehman Brothers in 2008. It is equally the case, though, that **these correlations, which are a function of the risk of systemic failure across the global financial system, remain a significant common price component of all assets in all regions across the world**.

When the risk of this failure rises there is a shift towards less risk-exposed assets ('risk off') and when it falls there is a move towards more risk-exposed assets ('risk on'); both conditions together being acronymically termed 'RORO'. Either way, the fact that the prices of apparently disparate individual assets move in tandem (either positively correlated or inversely correlated) means that **classical methods of maximising returns whilst minimising risk will remain sidelined for the foreseeable future, calling for shrewder and nimbler investment approaches going forward**.

Correlations between asset classes in crisis and non-crisis periods



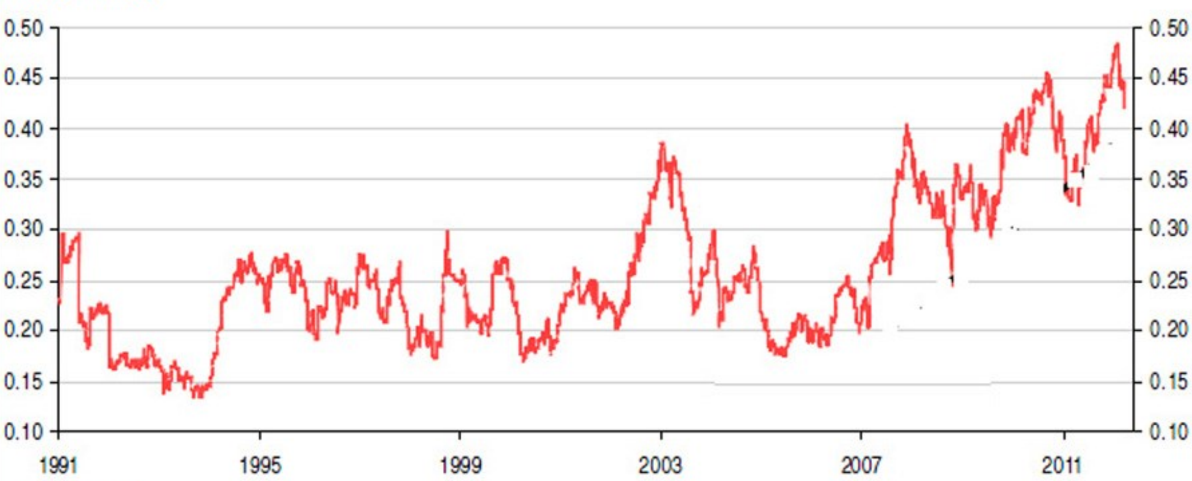
Crisis periods defined as months where the past quarters returns of MSCI World are in the bottom decile. Non-crisis periods defined as months where the MSCI World returns are in the upper half of quarterly returns.

Source: Various market data inputs

The notion that different regions, asset classes and market types (developed or emerging) are driven in large part by their own fundamentals, and that consequently diversification of risk can be achieved by investing cross-regionally, cross-asset class and cross market-type, or any combination thereof, weighted appropriately, remains largely redundant during many market periods.

A more nuanced approach is now generally required: for example, 2013 started out looking risk-on but with the distinct potential for temporary risk-off conditions being triggered by political concerns, in the eurozone periphery in particular.

RORO Index



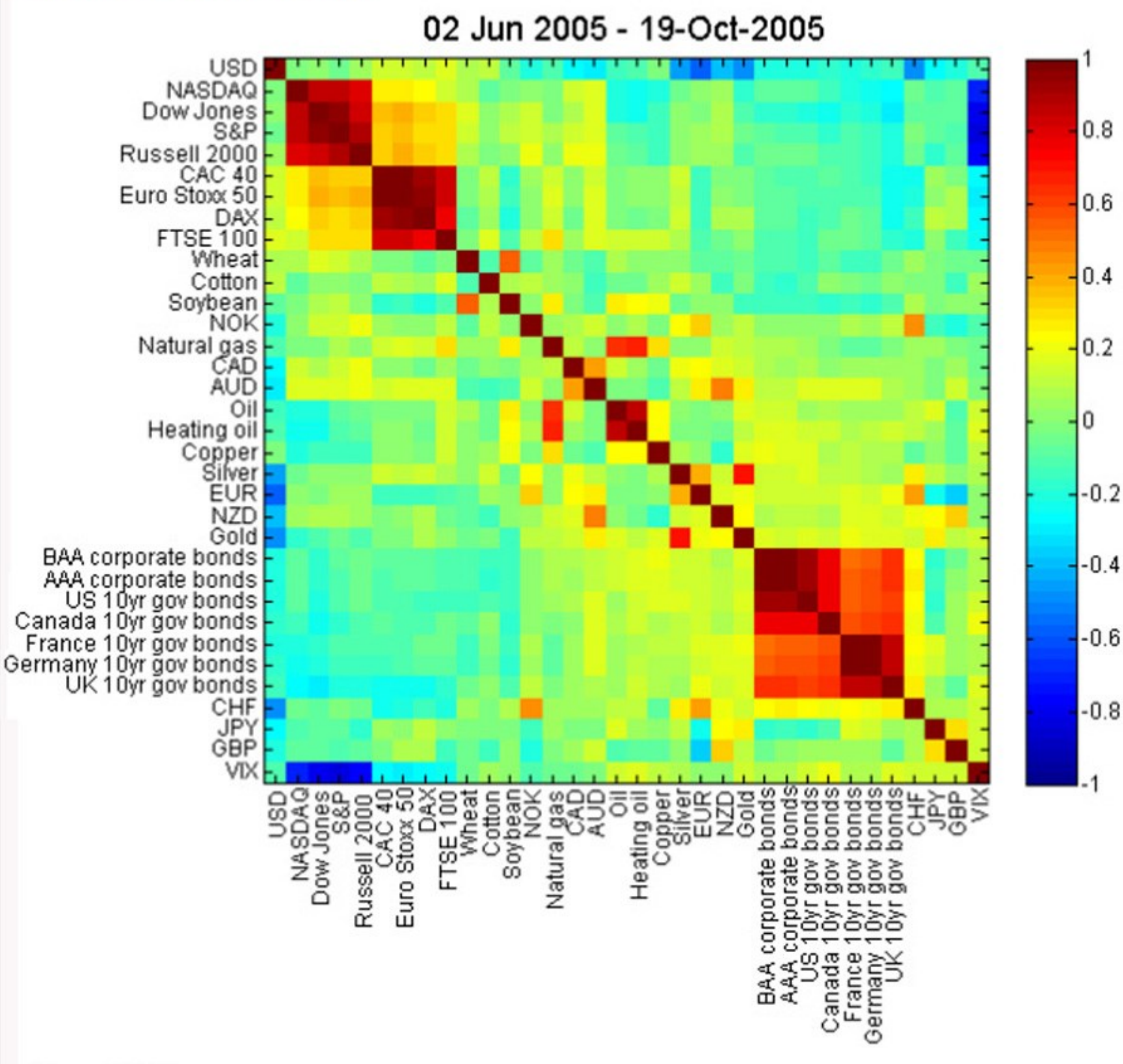
Source: HSBC

Consequently, at that time, one might prefer a higher allocation to cash instead of holding any government bonds or related developed market currencies, and then a risk-weighted allocation to exposures such as equities, emerging market currencies and selected commodities that are likely to respond well to risk-on environments.

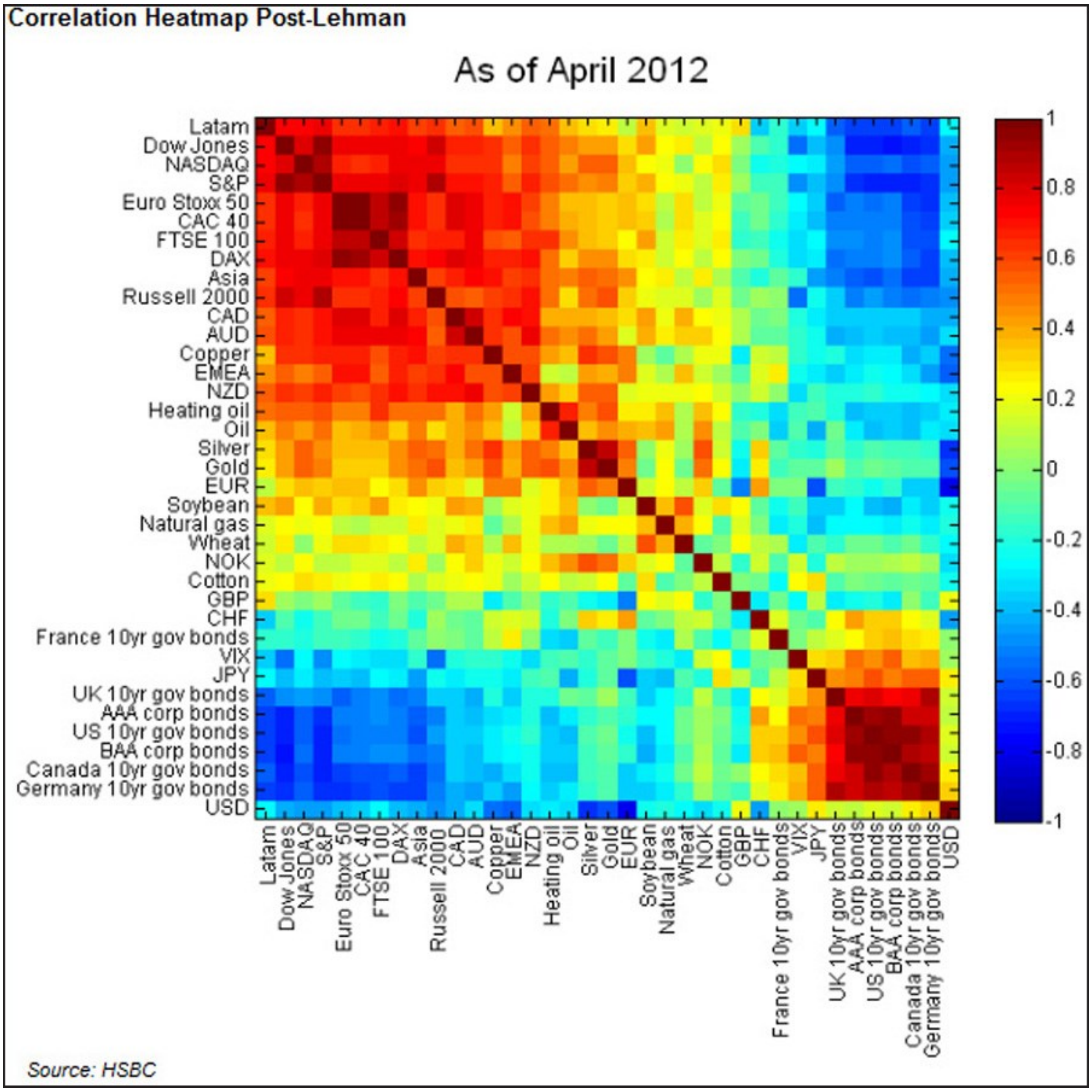
This might be considered a bar-bell approach to risk/return, with the former flight to quality exposures in government bonds being sized to zero in favour of more cash and an appropriately sized allocation to riskier exposures.

This said, the **idea of what may be classed as 'safe-haven' assets or 'risky' ones has changed much in a short time and continues to do so at a fast pace** (by the way, many banks and trading platforms issue 'heatmaps' of changing correlations, but HSBC's is always especially good).

Correlation Heatmap Pre-Crisis



Source: HSBC



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