



Brainy's Articles on Share Trading Correlation

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Introduction

The topic of correlation is a useful one for traders and investors to understand. It can help to reduce risk in an investment portfolio. It can also be used as the basis of a trading strategy.

This article in Brainy's series on Share Trading (number ST-6150) provides an introduction to correlation. As it is a complex topic, the reader is encouraged to seek more information from other sources.

What is correlation?

In fairly simple terms, *correlation* is a measure of how closely two specific items track each other.

For example, we might expect that two large and similar global mining companies like BHP and RIO might have price charts that somewhat resemble each other. Have a look at the price chart below where the price charts of these two companies are superimposed. We can see that over the period from December 2008 to March 2009 the prices of the two stocks did basically track each other, with a little variation at times. But, even after the price of the two stocks might deviate for a while (as in late February), they eventually return.

You can notice on this price chart that the two stocks have very different share prices. The BHP chart is shown in black, with the price axis on the right-hand side. The RIO chart is drawn in red, with the price axis on the left. There is no single point on the chart that the two stocks have in common. The vertical price axis of both is automatically scaled to fit into the available range. But, it can be seen that the "up and down" performance of the two stocks is very similar. That is, they are closely correlated.

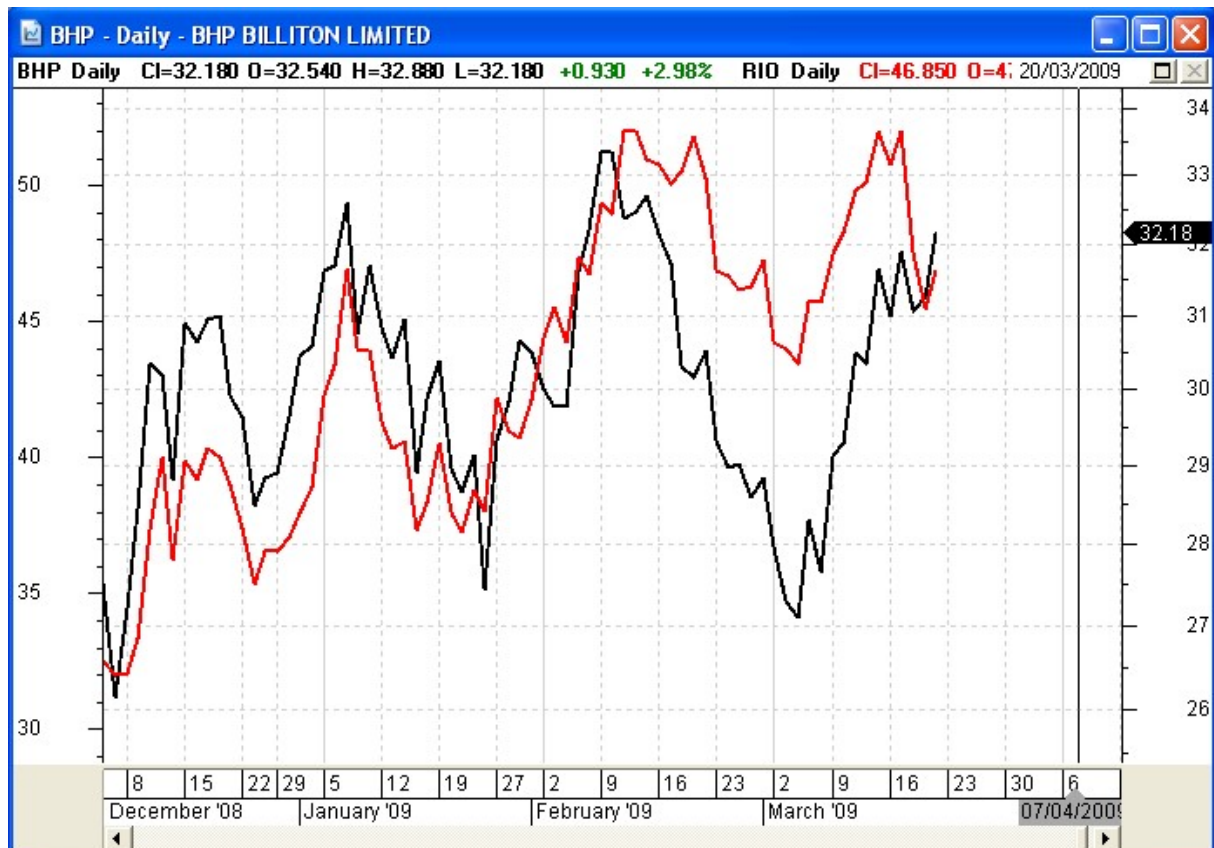


Figure 1: BHP and RIO on same price chart.