eastspring investments

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CONSTRUCTING RESILIENT PORTFOLIOS –

A CASE STUDY OF THE US ELECTION

Market price episodes typically happen where there is a gross mismatch between expectation and reality. The outcome of the US presidential election triggered one such pricing episode. Leading up to the election day, polls and news coverage favoured Hillary Clinton. However when the vote count revealed an unexpected Trump victory, markets sold off sharply on November 8th.

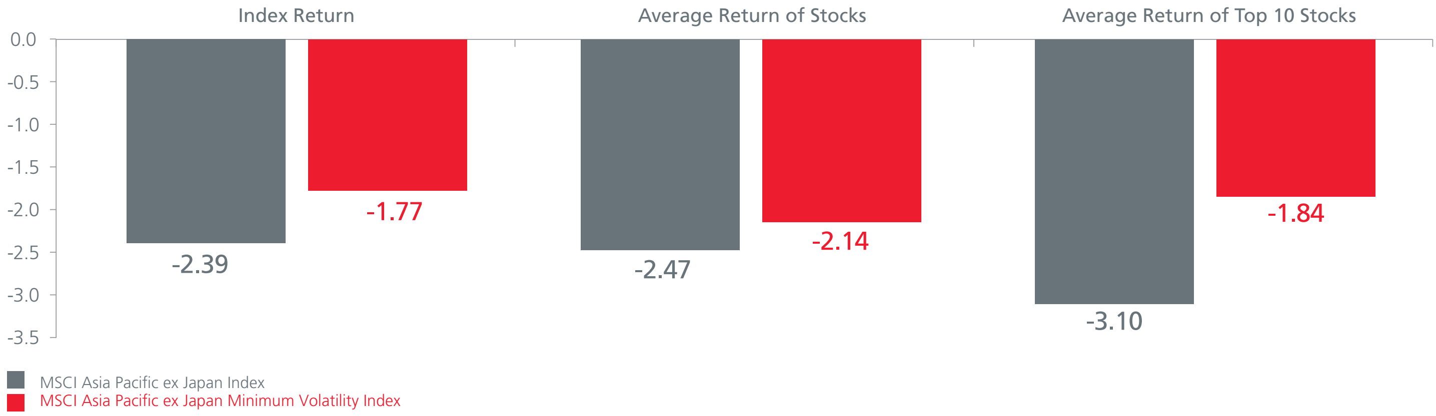
Asian equities were not spared; a Trump presidency had been widely seen as negative for Asia because of his protectionist rhetoric. Yet they staged a quick recovery the following day after observing the overnight optimism on Wall Street.

Rapid price swings are often driven by investors' behavioural biases such as overreaction to unexpected news or a herding mentality. This emotional response is part of what makes investors prone to buying or selling at the worst possible times.

Such pricing episodes underscore the importance of a low volatility ("Low-Vol") equity investment strategy. The strategy is designed to reduce the impact of volatility and provide comfort to investors to remain invested rather than time the market.

By way of proof, both the MSCI Asia Pacific ex Japan ("Broad Market index") and the MSCI Asia Pacific ex Japan Minimum Volatility ("Low-Vol index") indexes closed lower on November 8th, but the latter declined by a lesser amount (approx 25% less), attesting to the downside protection nature of the Low-Vol strategy. Taking it a step further, we also observe that all the stocks in the Low-Vol index, including the 10 largest stock holdings fell less compared to stocks in the Broad Market index (refer to Fig. 1).

Fig.1. Perfomance Comparison on US Election Day, USD, % (9 November 2016)



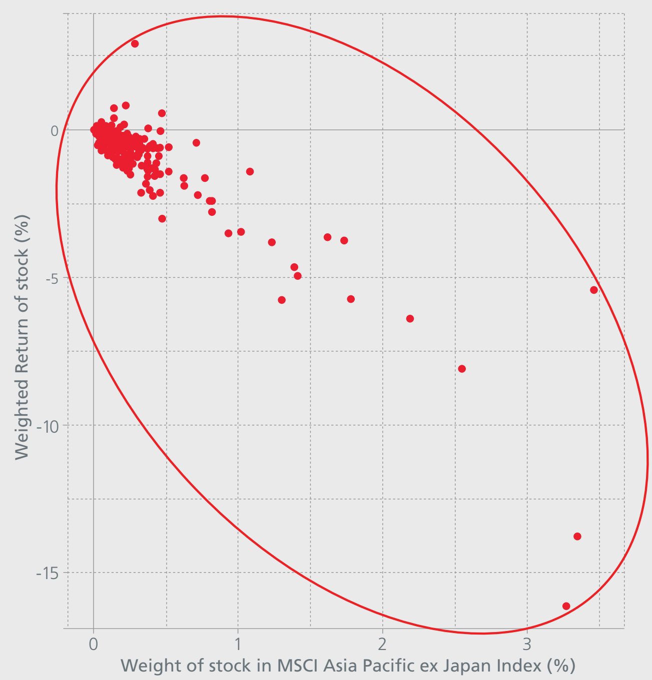
A DETAILED ANALYSIS AT THE STOCK LEVEL GIVES A CLEAR PICTURE OF HOW DIFFERENTLY THE TWO INDEXES PERFORMED ON THAT DAY

Both Fig 2 and Fig 3 illustrate the weighted returns of individual stocks in the Broad Market and Low-Vol indexes respectively.

Clearly there is a very high correlation between the weight of the stock in the Broad Market index (Fig. 2) and the underperformance of the stock. The higher the weight, the worse and more volatile the performance.

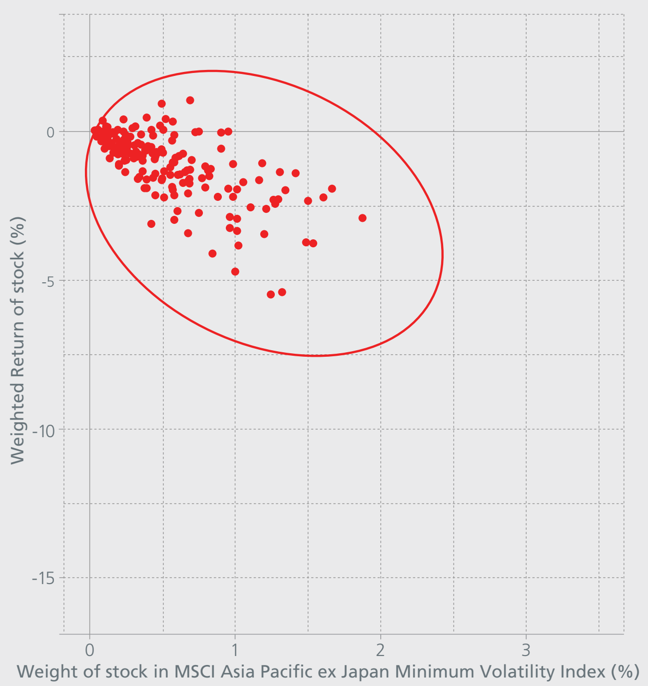
There was a clear and significant trend for larger cap stocks to detract from the performance of the Broad Market index. In contrast, there is less dispersion in the Low-Vol index (Fig. 3).

Fig.2. How did Asia equities investors react to US election?



Source: Eastspring Investments, Factset, MSCI, 9 November 2016.

Fig.3. How did a Low Volatility strategy perform?



Source: Eastspring Investments, Factset, MSCI, 9 November 2016.

TWO OBSERVATIONS STAND OUT

First, the stock weights in the Low-Vol index are more evenly distributed; the largest stock, Tencent Holdings, has a 1.9% weight. In contrast, this stock has a larger weight of 3.5% in the Broad Market index.

Second, the weighted returns of stocks in the Low-Vol index ranged from -5% to 1% while the stocks in the Broad Market index recorded a wider range from -16% to 1%.

In fact, the Low-Vol index showed greater resilience despite its much smaller base of 215 stocks versus the 701 stocks in the Broad Market index.

This suggests that the Low-Vol index fell less because it had a unique portfolio of stocks which was not constructed with a market-capitalisation (market-cap) weighted methodology (i.e. stocks with bigger market capitalisations take a higher weight in the portfolio and vice versa). As the largest stocks in market-cap weighted indexes, such as the MSCI Asia Pacific ex Japan index, are usually heavily owned by asset managers and Exchange Traded Funds ("ETFs"), their prices tend to move in a more volatile fashion when a pricing episode occurs. This was clearly the case on that day.

The top 10 holdings in the Broad Market and Low-Vol indexes (Fig. 4) support this observation; the mix of stocks in the Low-Vol index does not follow that of the Broad Market index.

Fig.4. Top 10 Holdings in the Broad index versus Low-Vol index

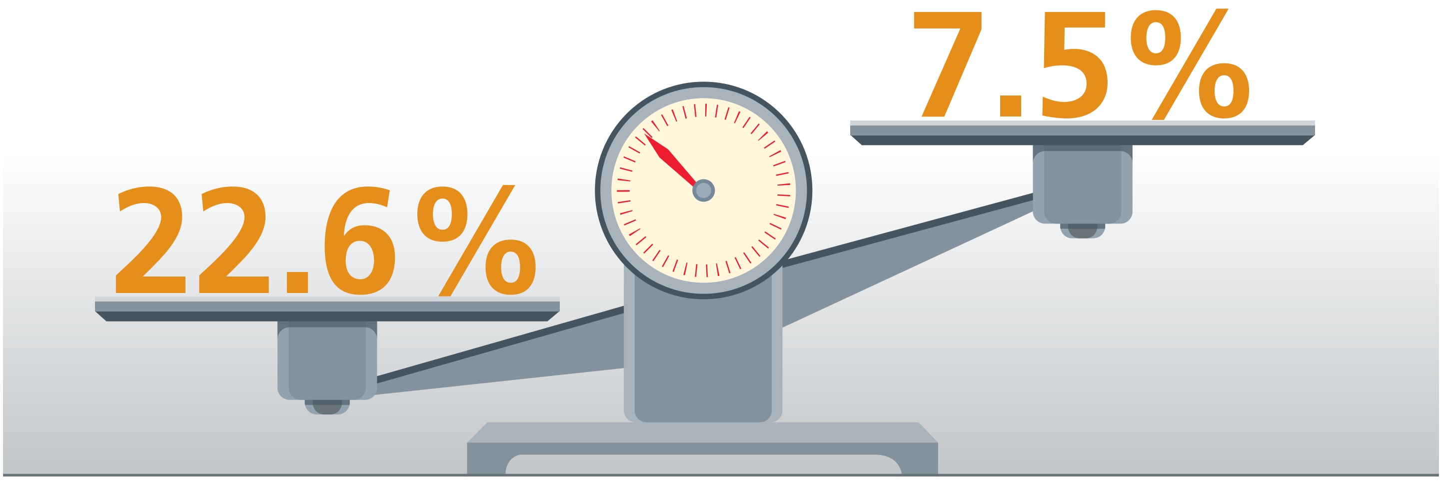
Stock Name	Stock Weight in the MSCI Asia Pacific ex Japan Index (%)	Stock Weight in the MSCI Asia Pacific ex Japan Minimum Volatility Index (%)
Tencent Holdings Ltd.	3.5	1.9 (1st in Index)
Taiwan Semiconductor Manufacturing Co., Ltd.	3.4	1.3 (9th in Index)
Samsung Electronics Co., Ltd.	3.3	0.3 (114th in Index)
Alibaba Group Holding Ltd. Sponsored ADR	2.6	0.2 (160th in Index)
Commonwealth Bank of Australia	2.2	1.2 (16th in Index)
Westpac Banking Corporation	1.8	0.5 (90th in Index)
AIA Group Limited	1.7	0.4 (91st in Index)
China Mobile Limited	1.6	1.0 (27th in Index)
China Construction Bank Corporation Class H	1.4	0.6 (70th in Index)
National Australia Bank Limited	1.2	0.1 (176th in Index)
Total Weight	**22.6**	**7.5**

Source: Eastspring Investments, Factset, MSCI, 9 November 2016. Please note that the securities mentioned are included for illustration purposes only. It should not be considered a recommendation to purchase or sell such securities.

This is not to say that large cap stocks should be avoided. On the contrary, we believe the mix of stocks in a portfolio matters more than the simple inclusion or exclusion of certain stocks.

A robust investment process is therefore key to constructing a portfolio of stocks which embodies the best qualities from the right mix of stocks. A systematic Low-Vol investing strategy can strive to achieve such a portfolio by using an optimiser and a risk model. The optimiser is a tool that seeks to find the optimal portfolio based on a specified risk model, the initial portfolio, the candidate set of stocks, objectives and constraints.

The weights of each stock are selected not to maximise return but to minimise portfolio volatility – a procedure which is less susceptible to forecasting errors and behavioural biases. By seeking to minimise portfolio volatility, the process achieves two important outcomes: exposure to the low volatility style and greater diversification as stock correlations are considered.



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