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2019 MARKET OUTLOOK

AN INTERVIEW WITH BEN DUNN

Ben Dunn is Head of Quantitative Strategies at Eastspring Investments. Below he discusses how investors can use factor strategies in their portfolios to smooth out returns as volatility picks up further in 2019.

Q How will the sources of volatility differ in 2019? What implications will this have for investors?

2017 was characterised by strong equity markets across the globe, record low levels of volatility and strong, globally synchronised economic and corporate earnings growth. Then, 2018 saw an abrupt return of volatility with an initial jolt in February and again in October on the back of increasing fears of rising inflation, higher bond yields and slowing global growth.

Investors should certainly be prepared for a continuation of recent volatility into 2019. Potential drivers include:

- Trade tensions, particularly between the US and China
- Further signs of decelerating Emerging Market growth
- Moderating US growth
- Liquidity squeeze driven by quantitative tightening
- Emergence of global inflation

At the same time, there is cause for long-term optimism. Valuations are not stretched – particularly after the recent pull back – and especially in some of the more heavily sold-off regions (e.g. Asia and the Emerging Markets). In fact, many markets look cheap relative to history.

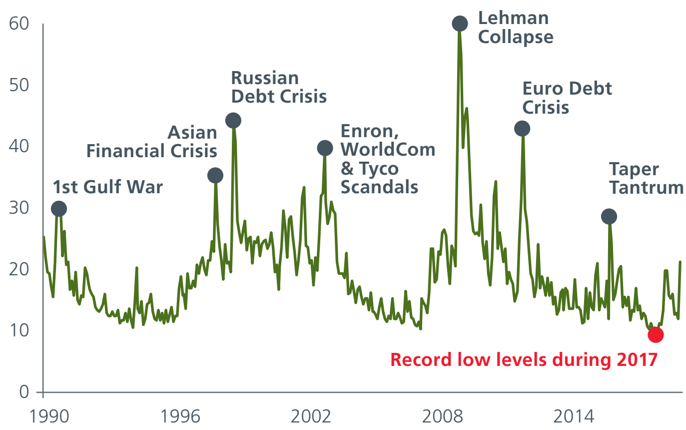
For long-term investors, market sell-offs present good entry points. We have observed historically that equity markets have delivered rewarding returns in the periods following bouts of heightened volatility.

Staying invested during these periods has historically proven to be the right decision in most instances. By trying to time the market, investors risk missing out on the best performing days in the market, which can significantly reduce their returns.

Q If volatility picks up further in 2019, how can investors protect their portfolios on the downside?

The markets seem set to remain choppy for the reasons stated above. For long-term investors, there are two somewhat competing risks to be managed in the presence of increased volatility. The first is wanting to avoid the downside, and arguably the only way to fully protect from equity

Volatility rises during major market events[1]



market downturns is to exit the market. But this introduces the second risk of not participating when the market rallies. A low volatility strategy helps to balance both risks by giving investors defensive positioning when markets turn down while allowing them to participate on the upside when the markets recover.

Choppy markets provide an ideal environment for a low volatility equity strategy which feeds on market fluctuations. By falling less during market pullbacks, this strategy requires less upside to recover during the upswings, thus outperforming the broader equity markets over the longer term.

Additionally, a low volatility strategy tends to overweight the more defensive sectors such as utilities, telecoms and consumer staples. Given that many of the larger risks worrying investors today are either global or regional in nature, these domestically-oriented companies can provide additional shelter from such risks.

Q One of the attractions of the team's low volatility strategy has been the income component from high dividend yielding stocks. With the 10-year US treasury yield around 3% and potentially rising further, is this still an attractive strategy for investors?

Our strategy is sensitive to changes in yields, but less so than it is to changes in market volatility. We benefit far more from increases in volatility than we suffer from increases in yield.

Preferring high quality firms that pay attractive dividends is a complementary and beneficial part of our low volatility process. These companies typically have mature business models, stable earnings and dependable cash flows. Consequently, they tend to be less volatile. While these companies may be sensitive to rising bond yields, their quality and low volatility attributes tend to be rewarded by the market in the long-term.

The consensus belief is that we are past the end of the decades-long bull market for bonds, but the market is pricing in only moderate changes in US Treasury yields. In periods of stable yields, our low volatility strategy tends to steadily add value.

Q What if investors don't want to be positioned defensively? Should they be looking to factors other than low volatility?

Absolutely, although in this instance a low volatility strategy can still be a core component of an optimal asset allocation by reducing equity market risk and allowing more risk budget to be deployed elsewhere in an investor's portfolio.

We strongly believe that diversification is one of the most important levers available to all investors. We hold diversified portfolios of stocks within the portfolios we manage, but also advocate investors allocate across different factors. This can be achieved either by allocating to multiple strategies that target specific factors or through a bottom-up, multi-factor quantitative approach – which we believe is more efficient.

Q Looking into 2019, which strategy seems more appropriate?

Both single and multi-factor strategies have their merits. The choice of strategy should not only reflect each investor's concerns but also the overall composition of the investor's portfolio. If risk is the primary concern, and bearing in mind that higher volatility seems to be on the cards for 2019, then an exposure to a low volatility strategy may be most appropriate.

The key difference is the risk profile and return path the two strategies will take over time. Longer term, we expect both to outperform the market: but a low volatility strategy should smooth out the ebbs and flows of the market while a multi-factor strategy should have a volatility similar to the broader market.

It is challenging to reliably predict which specific factors will drive the market, which is why we prefer to combine a collection of factors that outperform over the long-term, but are relatively uncorrelated with each other.

Sources: [1]VIX Index from Bloomberg. November 2018.

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