



▶ LOW VOLATILITY STRATEGIES – WHY INVESTORS NEED NO LONGER SELL IN MAY

The outperformance of low volatility strategies in the month of May and in 2018 is testament that the strategies deliver one of their key benefits – downside protection in challenging markets. Against an uncertain market outlook, this helps investors stay invested and enjoy market-like returns over the long-term, but with much lower volatility.

The adage “Sell in May and go away” seemed to ring true again for investors in May this year where almost every equity market fell on the back of rising trade tensions between the US and China. However, as markets correct, valuations fall and opportunities emerge. We note that the price to earnings ratio of Asian equities is close to its historical average. Meanwhile, valuations of global equity markets are below their historical averages². How can investors take advantage of emerging opportunities while navigating rising market volatility?

Low volatility strategies may be the answer. Low volatility strategies tend to fall less when markets correct, which helps investors stay invested and remain positioned to participate in the upside when markets eventually rise again.

As equity markets tumbled in May, low volatility strategies, as measured by the MSCI AC Asia Pacific



Ben Dunn
CIO, Quantitative Strategies
Eastspring Investments

ex Japan Minimum Volatility Index and the MSCI AC World Minimum Volatility Index outperformed their respective broad market indices. Not just in May, the low volatility indices outperformed their broad market indices since the market began falling in April this year as well as in 2018. See Fig. 1.

By falling less when the markets correct, low volatility strategies tend to outperform the markets over an up/down market cycle. For example, if we were to consider the rallies in 2016 and 2017 followed by the correction in 2018, the MSCI AC

Fig. 1. Low volatility indices outperform in falling markets³

	MSCI AC Asia Pac ex Japan Index	MSCI AC Asia Pac ex Japan Min Vol Index	MSCI AC World Index	MSCI AC World Min Vol Index
May-19	-7.4%	-4.2%	-6.2%	-1.3%
Since 18 April	-6.4%	-2.5%	-2.4%	2.2%
2018	-16.2%	-7.9%	-11.2%	-3.5%

World Low Volatility Index outperformed the MSCI World Index over this period up to end May 2019 (See Fig. 2).

The low volatility effect, which underpins these strategies, refers to how lower volatility stocks keep up with and even tend to outperform higher risk stocks over the long term, defying traditional finance theory. Research⁵ reaching as far back as 1967 shows that this effect exists across different markets. Meanwhile, since the effect arises from behavioural biases including the tendency for investors to overpay for glamourous stocks and overconfidence bias, it is not expected to go away anytime soon.

Given that a resolution to the ongoing trade tensions might take some time, market volatility is likely to persist. Adding low volatility strategies into a portfolio can help provide investors with some downside protection.

That said, should there be a quick resolution to the trade woes, this would probably surprise the market and result in a strong rally. Investors may be better off staying in the market – missing out on the 10 best trading days has been shown to reduce gains by more than 40%⁶. Low volatility strategies can help investors stay invested by dampening the overall volatility in their portfolio when markets fall.

RATE CUTS BODE WELL FOR LOW VOLATILITY STOCKS

Meanwhile, the markets are expecting that the Federal Reserve (Fed) would cut interest rates to mitigate any growth slowdown and other negative spillover impacts from the trade tensions. At the point of writing, the futures market is pricing in an 84% probability of a rate cut in July and a 95% probability of another cut in September⁷.

Should the Fed embark on a rate cutting cycle, this could bode well for low volatility strategies. Research looking at median returns during the 12 months following the last 7 Fed rate cutting cycles shows that the low volatility factor, together with momentum, tends to outperform. See Fig. 3.

Actively managed low volatility strategies can potentially enhance returns by selecting stocks with favourable traits and avoiding those with undesirable characteristics (e.g. unattractive valuations, poor analyst sentiment). This potentially increases the odds of picking winners in the portfolio.

With low volatility strategies, investors need no longer sell in May or any other month for that matter. Given the uncertain outlook for markets, low volatility strategies can provide a cushion during down markets and prevent investors from missing out should events transpire to cause markets to rally. Ultimately, with low volatility strategies, investors can enjoy market-like returns over the long-term, but with much lower volatility.

Fig. 2. Low volatility index typically outperforms across up/down market cycles⁴

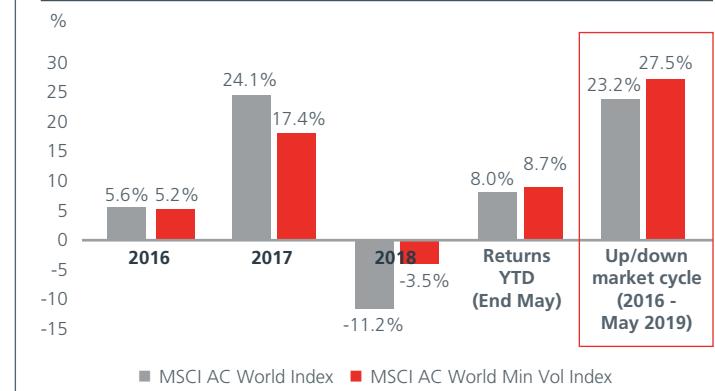
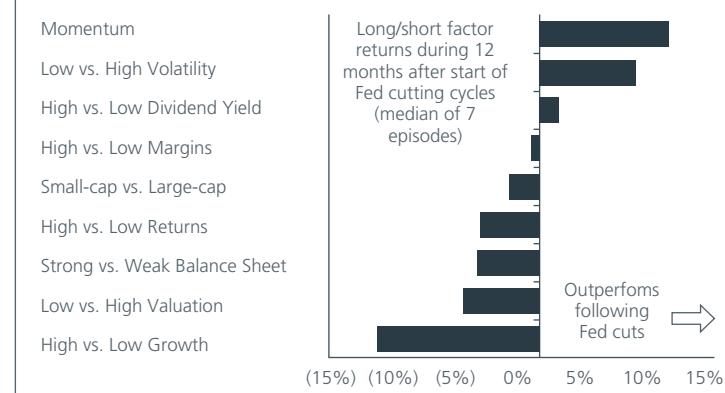


Fig. 3. Factor returns following the start of Fed cutting cycles⁸



Sources: ¹Bloomberg, as at 24 May 2019. Past performance is not necessarily indicative of the future or likely performance. ²Bloomberg. Analysis over 10-year data as of end May 2019. ³Bloomberg. June 2019. In USD terms. Past performance is not necessarily indicative of the future or likely performance. ⁴Bloomberg. June 2019. Past performance is not necessarily indicative of the future or likely performance. ⁵Pratt (1967). Black, Jensen and Scholes (1972). Baker and Haugen (2012). ⁶Analysis done by comparing a buy and hold strategy for the MSCI Asia Pac ex Japan Index for the last 15 years (as of end May 2019) versus another strategy which missed out the 10 missing trading days. Bloomberg. For illustration purposes only. Past performance is not necessarily indicative of the future or likely performance. ⁷Bloomberg. 13 June 2019. ⁸Goldman Sachs Global Investment Research. As of 6 June 2019. Past performance is not necessarily indicative of the future or likely performance.

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