Win with tortoise wisdom

MICHAEL (XIAOCHEN) SUN
Director at Eastspring Investments

CHRIS HUGHES
Portfolio manager at Eastspring Investments

- Stay invested even in uncertain times with low volatility strategies that mitigate potential losses and reduce concentration risk

- Losing less during downturns while participating in market upswings gives low volatility investing its edge

THE story of the hare and the tortoise is a children's favourite around the world. In the story, the persistent and determined tortoise unexpectedly wins a race against a fast but overconfident hare. While seemingly unrelated, the fable offers a valuable lesson to investors, particularly in today's volatile markets.

Many investors are drawn to the excitement and buzz around the latest "hare-like" stocks that dominate news and social media.

However, such stocks can be unpredictable and risky.

Research shows that investing in less exciting "tortoise-like" stocks, which exhibit steady (and often more predictable) growth over time, can be more effective in the long run.

Focusing your portfolio on these stable and established companies is known as "low volatility investing" because it results in a portfolio with less variability in value over time.

Winning by losing less

A low volatility portfolio helps to balance performance over time by losing less in negative market periods while still participating in positive market periods, albeit to a lesser extent than the broad market.

This approach of losing less during downturns while participating in upswings gives low volatility investing its edge. Like the tortoise, a low volatility portfolio may not be the fastest, but it can ultimately win the race.

Low volatility strategies have historically delivered a higher degree of upside capture – achieving gains during positive market phases – and a lower degree of downside capture, giving rise to superior risk-adjusted returns.

We have discussed the asymmetry in upside and downside capture in a low volatility portfolio but there is another dimension to this downside protection where the power of compounding truly shines.

Consider a single share valued at US$100 at time A. If the market crashes and the share loses 50% of its value, it will drop to US$50 at time B.

To return to its initial value of US$100, the share needs to gain not just 50%, but 100%, as it is starting from a lower base.

This simple maths highlights the importance of minimising losses during downturns.

Although a high-growth stock may recover from a 50% drop, the 100% gain to break even puts immense pressure on its performance and exposes it to further risk if the recovery stumbles.

In contrast, a low volatility "tortoise" stock, having suffered a smaller loss (for example, 30% loss shown in the left illustration), only needs to climb 43% to reach its original US$100 value.

This makes it less vulnerable to further tumbles and makes it easier to keep pace with the overall market over the long haul.

Lighten the load

Recent years have seen an influx of investors into portfolios weighted by the market value of constituent companies (for example, passive strategies).

The idea is that other investors can do the hard work of valuing companies, and you can benefit by simply copying them with an implicit assumption that the market is efficiently capturing all available information in an unbiased manner.

However, as with any homework copying strategy, the key question is how good the student you are copying is!

There is reason to believe that as more investors adopt these strategies, they can distort the market, causing prices to become detached from any rational valuation of the underlying company.

It is like walking into a shop and declaring that you will pay whatever the shop owner asks – you are unlikely to get a good deal!

Low volatility portfolios do not suffer from this problem because they weight stocks based on volatility, not valuation; these portfolios do not mindlessly buy more of a company during a market mania.

This approach is complemented by diversification across sectors, countries, and stock levels, contributing to a well-rounded risk management strategy.

Low volatility equity portfolios generally offer investors a smoother ride through the business cycle which makes it easier to maintain exposure to stocks and resist the siren voices of market timing.

Long-term, low-risk strategies

Global financial markets have weathered a series of significant shocks over the past few years, including the Covid-19 pandemic, geopolitical tensions like the Ukraine-Russia conflict, and high-profile banking collapses such as those of SVB and Credit Suisse.

These events have contributed to a slowdown in overall economic growth, especially in China, and have led to sharp upward inflationary pressures and interest rate hikes.

In addition, the emergence of new artificial intelligence technologies has dominated markets as investors throw money at the stocks, they expect will dominate the new era.

This has led to extremes of market concentration in the market capitalisation indexes, as we discussed in our earlier article.

Investors are facing a high degree of uncertainty, with ominous headlines dominating the news.

The ongoing Ukraine-Russia conflict and Israel-Gaza conflict have led to volatility in crude oil prices across Brent and WTI.

Additionally, lower growth and increased risk premiums in Chinese assets may lead to an overall decline in asset valuation and reduced capital inflows.

Developed markets are grappling with looming deficits, waning demand, and the possibility of recessions, while upcoming elections in the United States and United Kingdom add to the overall sense of uncertainty.

It is crucial to remember that the stock market is a marathon, not a sprint.

Low volatility strategies prioritise stability and loss avoidance, providing a steadier path towards financial goals even amidst market fluctuations.

We recommend that long-term investors consider exposure to low volatility solutions.

By doing so, investors can maintain their equity exposure and capitalise on the long-term equity premium, while simultaneously mitigating potential losses, reducing concentration risk and diversifying performance sources in these uncertain times.

Past experience suggests that this avoids some of the wild swings in valuation that are seen over a market cycle and leads to higher risk adjusted returns.