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Quant investing in Asia: Cushion and complement with a low volatility strategy

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Heightened market volatility episodes have become more frequent in recent years with several fast and deep corrections. With a low volatility strategy, investors can stay invested while minimising the volatility in their portfolios. This way investors reduce the risk of exiting the market at the worst time and missing the market's best days which can significantly lower their overall returns.

Quant strategies typically appeal for their structured, systematic and repeatable investing approach. By eliminating behavioural biases and relying instead on empirical evidence from huge chunks of data, quant-based investments are not clouded by human prejudices and personal preferences.

That said, non-quant practitioners point out that these strategies rely on past data which may not prepare a quant model to be sufficiently nimble to predict and adapt to future market events. COVID-19 is cited as one such example. Nevertheless, the evidence shows that a low volatility quant strategy ("low vol") has delivered what it promises – delivering more stable returns than the market even during the severe COVID-induced drawdown and subsequent market rebound.

In 2021, when the delta COVID variant surged in Asia, the MSCI Asia ex Japan Minimum Volatility Index fell 5% between 18 March and 20 August, while the broader MSCI Asia ex Japan index fell 10.7%.[1] This pattern was repeatedly visible throughout the year during the intermittent market drawdown episodes.

RISING VOLATILITY

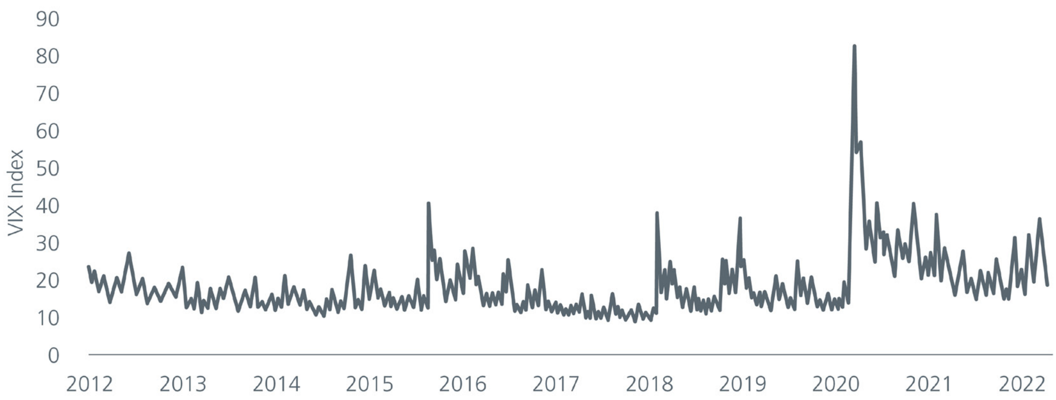
In recent years, bouts of heightened market volatility have become more frequent with several fast and deep corrections. These episodes can happen without much warning. Market expectations of volatility spiked in March 2020 and have remained at levels higher than we have seen for most of the last decade, initiated by the uncertainty over the COVID recovery. See Fig. 1.

Other factors that have caused recent market swings are global supply chain disruptions, China's property market woes, the US Fed tightening, surging commodity, food, and energy prices and more recently the Russia-Ukraine crisis.

In 2019, there were 42 days in which the MSCI Asia Pacific ex Japan index experienced swings of more than 1%. In 2020, this number more than doubled

Source: [1]Refinitiv Datastream, MSCI indices, Eastspring Investments as of 31 December 2021.

Fig. 1: Volatility has spiked since March 2020



Source: Eastspring Investments, Bloomberg, data as of 31 March 2022. Note: VIX Index = Chicago Board Options Volatility Index.

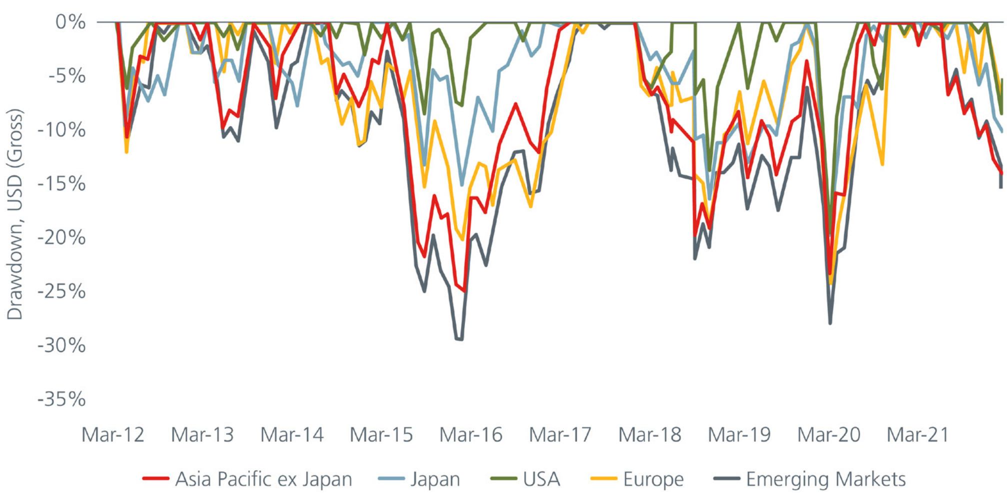
to 86. In the first quarter of 2022, there have already been 25 days of such swings.[2]

When such swings happen, investors who are unable to endure the pain of market corrections may decide to exit the market at precisely the worst time, thus potentially losing out on any sharp market reversal. Low vol strategies help to minimise the losses by falling less during turbulent times. Equally, such a strategy only needs to rise by a smaller magnitude to return to the same level. This effect compounds over time.

A STRONG CASE FOR LOW VOL IN ASIA

Emerging and Asian markets are typically more volatile than Developed markets. See Fig. 2. Over the past ten years, both EM and Asia experienced higher drawdowns than the US and Europe during periods of heightened volatility. The time taken to recover

Fig 2: Asian markets endure higher drawdowns



Source: Bloomberg. MSCI indices, Eastspring Investments as at 31 March 2022.

Source: [2]Bloomberg, MSCI Asia Pacific ex Japan index, Eastspring Investments as of 31 March 2022.

from these drawdowns is equally important. Over the same period, it took Asian markets 14 days, on average, to recover from the selloffs compared to 4 days for the US and 8 days for Europe.[3] Given that Asia is vulnerable to a higher risk of drawdown and takes a longer time to recover, Asian low vol looks particularly compelling as an investment strategy to help investors better navigate market gyrations and stay invested over the long term.

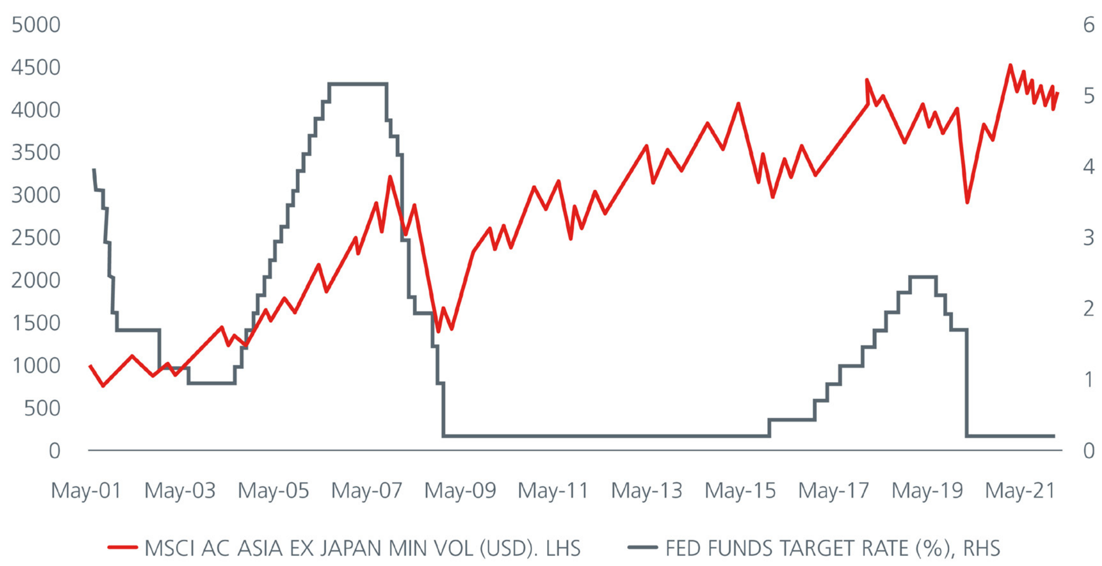
Separately, COVID has caused economic scarring in Asia. Although the region is still expected to grow by 5.2% in 2022 and 5.3% in 2023[4] on continued recovery in domestic demand and solid exports, the pace of recovery will not be even across the region given the varied nature of the economies. As Asian economies continue to develop and mature, there will be intermittent episodes of economic rebalancing which can trigger market volatility. China's 2021 regulatory clampdown on property and other sectors is a case in point. Investors who desire a broader Asian equity exposure can consider complementing their portfolios with an Asian low vol strategy.

RATE HIKES APPEAR TO BE BRUSHED ASIDE

Concerns over rapid rises in US rates have rattled Asian stocks in recent months. To cool US inflation, the US Federal Reserve ("US Fed") has indicated it might have to raise interest rates more aggressively than it had originally thought. Investors are understandably concerned about the downward pressure on economic growth from higher interest rates.

The last time the US Fed took on an aggressive stance was between 30 June 2004 and 29 June 2006, during which time rates were hiked by 425 basis points from 1% to 5.25%. During this period, the MSCI Asia ex Japan Minimum Vol Index still returned 26%. See Fig. 3.

Fig 3: Asian low vol held up well during past rate hikes



Source: MSCI AC Asia ex japan Min Vol Index, Fed Funds rate from Refinitiv Datastream as at 9 February 2022.

Source: [3]eVestment, Eastspring Investments as of 31 March 2022. [4]Asian Development Bank, April 2022.

AN INFLATION BUFFER

Low volatility stocks are usually found in defensive sectors and are typically mature companies with stable earnings, predictable cash flows and high dividends. Dividend paying companies are a buffer in an inflationary environment, providing more immediate return of capital and proof of a company's cash-generating ability.

Dividend income is also a long-term driver of Asia's equity returns. Furthermore, Asia ex Japan companies have the highest aggregate free cashflow cover ratio, suggesting that dividends are well supported by robust balance sheets. See Fig. 4.

The number of stocks in Asia Pacific ex Japan that have dividend yields above 3% is almost twice that of Europe and more than 3x that of the US[5]. A careful selection of good quality, dividend paying low volatility stocks can therefore cushion against rising inflation.

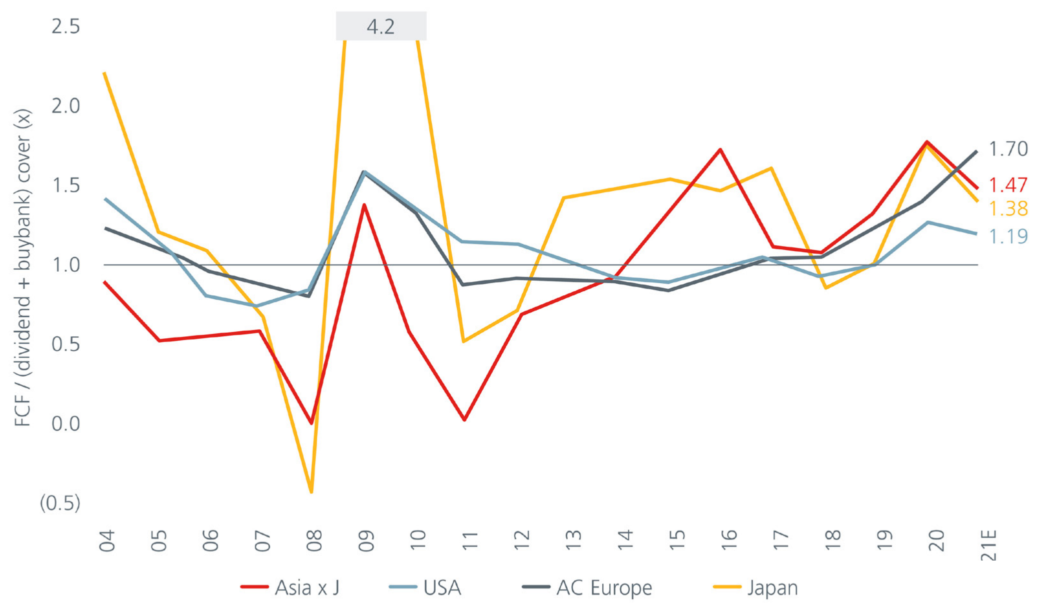
A LOW VOL PORTFOLIO ≠ A PORTFOLIO OF LOW VOL STOCKS

While the benefits of low vol strategies are evident, a key drawback cited is that they tend to lag when the market rallies quickly. COVID, too, highlighted that relying on a single factor approach i.e., low vol, may not be always be effective in achieving the lower drawdowns yet broader market participation that many investors desire.

This is why an approach which considers a large universe of stocks rather than only focusing on stocks with low vol characteristics is preferable. Thus, the resulting portfolio benefits from greater opportunities to add alpha through stocks with attractive fundamental characteristics and then leverages an advanced portfolio construction approach to arrive at a low volatility portfolio.

This process ultimately yields well-diversified exposure across sectors, countries, industries, and

Fig 4: Asia ex Japan's free cashflow cover above 1x since 2013



Source: Eastspring Investments, Bloomberg, Jefferies Research, as of 17 March 2022. Aggregates are bottom-up calculated with free float adjustments based on current universe. FCF stands for free cashflow. Indices are MSCI regions (ex-Financials).

Source: [5]MSCI indices and companies are constituents of MSCI World Index, as of March 2022 stocks and culminates in a low vol portfolio, not a portfolio of low vol stocks. Long-term investors who wish to remain fully invested in Asia even during periods of elevated volatility can consider complementing their asset allocation with low volatility strategies to help manage the risk of drawdown in choppy market regimes.

This is the sixth of a series of eight articles which examines the different investment strategies investors can adopt to tap on the opportunities that are emerging in Asia.

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