Are low volatility stocks still defensive?

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Investors shunned traditional low volatility stocks in favour of stay-at-home stocks post the coronavirus outbreak. This highlights the need to consider other factors when building a low volatility portfolio as well as the advantages of having an investment process that can adapt to a changing market landscape.

The MSCI AC World Minimum Volatility Index is down 7.3% year to date[1], underperforming the MSCI AC World Index, which has fallen 1.4%. See Fig. 1. This underperformance appears to go against the tenet of low volatility strategies, which is to protect portfolios during periods of heightened market volatility. A closer look, however, reveals a different picture.

Between January 17 and March 25 this year, when COVID-19 fears first reverberated through global markets, the MSCI AC World Index corrected 26.2% while the MSCI AC World Minimum Volatility Index fell less, by 21.7%. This is the behaviour of low volatility strategies which we have come to expect.

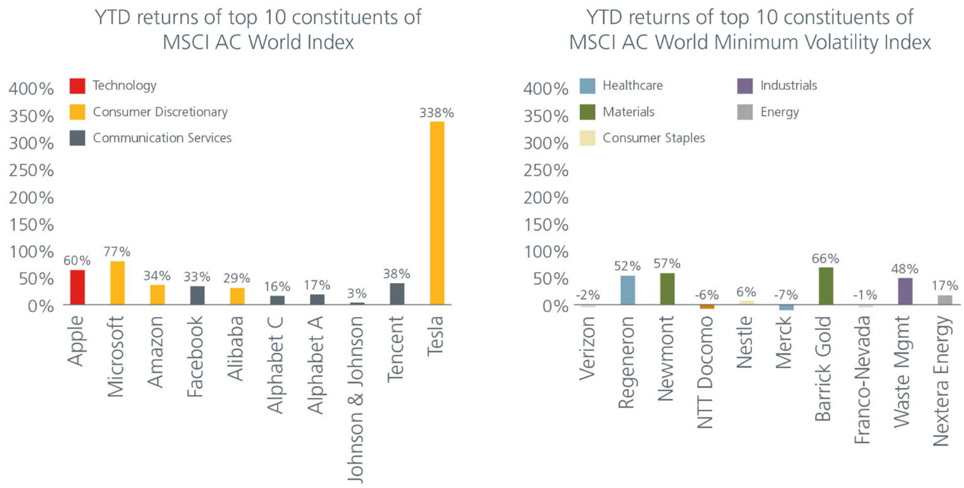
The Minimum Volatility Index's underperformance to date stems from the market's fierce rally after it troughed in March. The MSCI AC World has risen 30.4%[2] from March 25, fuelled by the rapid and unprecedented scale of monetary and fiscal support from global policy makers. Meanwhile, the MSCI AC World Minimum Volatility Index gained 15.9% - still a strong rebound but lacking relative to the broader

Fig 1: MSCI AC World Minimum Volatility vs MSCI AC World

Source: As of 30 October 2020. Bloomberg.

Source: [1]30 October 2020. Bloomberg. [2]30 October 2020. Bloomberg.

Fig. 2



Source: Bloomberg. MSCI. As at 10 September 2020.

market index. Given the exceptional drivers behind the market's correction, investors did not seek "safety" in the traditional defensive, high dividend and low volatility sectors. Instead, they headed for technology, healthcare and ecommerce related stocks which were expected to benefit from social distancing measures and stay at home trends. Fig. 2. shows the different make-up of the two indices and the performance of their top 10 constituents.

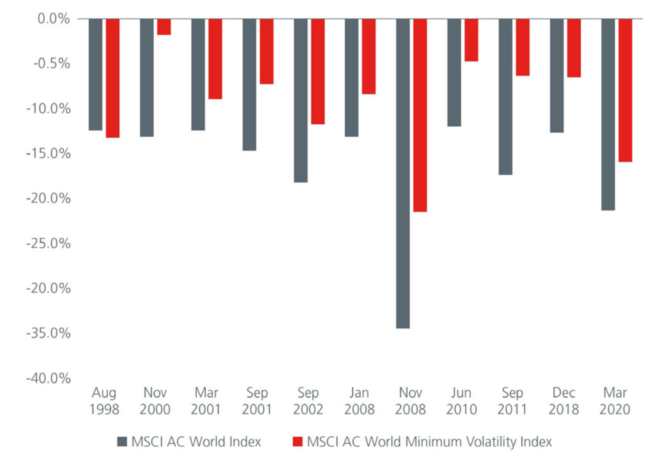
Has the market's definition of defensiveness changed for good? Do traditional low volatility stocks still have a place in defensive portfolios?

DELIVERING IN PAST CRISES

If we examine the market downturns in the last 25 years, we note that the Minimum Volatility Index has delivered what it promises – falling less than the market during periods of heightened volatility – regardless of the cause of the crisis. Fig. 3.

A **low volatility strategy** ultimately provides investors with more efficient returns or better risk-adjusted returns, provided they stay the course. Fig 4. shows that the Sharpe ratio (which measures return per unit of risk taken) of the MSCI AC World Minimum Volatility Index not only beats the market, but also rises significantly as the investment horizon increases.

Fig. 3: Performance during market drawdowns (1996 – 2020)



Source: Eastspring Investments. Returns of MSCI AC World Index and MSCI AC World Minimum Volatility Index over all 3-month periods since January 1996 where the ACWI was down more than -10% and the corresponding Min Vol performance over the same 3 month period.

Fig. 4: Low volatility's Sharpe ratio improves significantly over time

	MSCI AC World Index	MSCI AC World Minimum Volatility Index
3-yr	0.53	0.53
5-yr	0.69	0.81
10-yr	0.73	1.01

Source: MSCI. As at 31 August 2020.

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A DIFFERENTIATED APPROACH TO LOW VOLATILITY NEEDED

The COVID-19 experience highlights that singularly focusing on the lowest volatility stocks - which typically lie in industries like Utilities and Telecommunications - did not work in a crisis that favoured stay-at-home related names and Healthcare companies at the expense of other industries. In fact, typically high beta areas of the market like Biotech, Internet and Technology handily outperformed the traditionally more defensive areas. It suggests that a single factor approach may not be as effective in achieving the lower drawdowns yet broader equity market participation that many investors desire.

As such, an approach that focuses on identifying the most attractive stocks on a combination of factors, taking into account the efficacy of those factors and the correlations as well as interactions across the factors relative to peers, may be more effective.

By considering companies across the global universe of countries and industries with characteristics such as attractive valuations, higher profitability, better quality, improving growth outlook, stronger investor attention, and not just low volatility, our active approach takes advantage of the most attractive pockets of opportunity. This may include exposures to the technology sector or even markets such as **China,** traditionally viewed as the more volatile segments of the market.

NEW CHALLENGES, NEW OPPORTUNITIES

At the point of writing, fears of fresh COVID-19 outbreaks continue to linger. Yet no market crisis is the same, and the genesis of the next one is likely to be different. Quantitative managers like ourselves will continue to find new factors and new ways of defining factors to better capture the market's changing effects. At the same time, non-traditional data sources, artificial intelligence techniques, and the quantification of more subtle concepts like diversity and inclusion, have brought to light new ways of measuring, grouping and synthesising non-linear pieces of information.

We believe that the quant industry's continued innovation and creativity in developing new data sets and tools will give rise to new "low volatility" opportunities for investors. Active quantitative managers who are adaptable, and who have extensive research capabilities and experience will continue to remain relevant even as the market landscape evolves.

This is an extract of a longer article "Low volatility strategies – standing their ground". Please approach an Eastspring sales representative if you would like a copy.

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