eastspring investments

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GETTING A GRIP ON VOLATILITY

The recently launched Eastspring Investments-Asian Low Volatility Equity Fund (the 'Fund') breaks new ground in the Asia Pacific ex-Japan equities sector, says William Barbour, client portfolio manager for the Quantitative Solutions Group at Eastspring Investments

The past decade was a lesson in how volatile equity markets can inflict drawdowns that badly hurt investors' capital. This year has been no different, with markets see-sawing under the influence of factors as diverse as the Federal Reserve's interest rate policy, Brexit, instability in the Middle East and the forthcoming US presidential election.

In short, it is an environment in which investors should consider investment strategies designed to reduce volatility, notes Barbour. 'The benefits of low volatility strategies have been evident in markets since the 1920s,' he says.

He points to the relative performance over the past decade of the MSCI Asia Pacific ex Japan Index and its minimum volatility variant (the 'Min Vol Index'), which in the 10 years to June 2016 has had lower volatility with significantly higher returns. 'That's a free lunch for investors, which is counter to the accepted belief that higher returns require higher risk,' Barbour says.

He argues that the effect is not only due to lower drawdowns during adverse market conditions but the implicit bias of the strategy against the large cap stocks. 'They are inherently volatile because everybody owns them,' he says.

'There's a great deal of investment around market capitalisation weighted indices which favour large companies: ETFs track them, major institutions tend to benchmark themselves against them, and most fund managers won't deviate too far from them. So when markets go down, they go down too.' The vulnerability of large cap stocks to being sold down more makes them more volatile than mid and small cap equities, which consequently enjoy higher weightings in low volatility portfolios.

'Asian markets are particularly cheap at the moment,' Barbour says. 'The price-to-book ratio is around 1.4 times compared with 2.5 times for US equities. We believe this combination of good value relative to global markets, good dividend yield and a low volatility approach makes the Fund an option for consideration as a core part in most portfolios including those of pan-Asian and European investors.'

'The Fund aims to deliver higher risk-adjusted returns with an attractive dividend yield across market cycles through lower drawdown during market downturns, as well as to benefit from a valuation disparity currently benefiting Asian equities'

It is a US dollar-optimised version of a strategy that Eastspring's Quantitative Solutions team has run for an institutional client since December 2013 in Singapore dollar-optimised form, with US$618 million assets at the end of July 2016. Overall this team has around US$1 billion

WILLIAM BARBOUR
Client Portfolio Manager

in various quantitative strategies.

Barbour emphasises that the team starts with 3,500 stocks, a much broader universe than the MSCI Asia Pacific ex. Japan Index, which he says offers a greater opportunity set to find stocks with lower volatility than investors that are following the broad index (the Min Vol Index) itself has about 220 stocks.

Filters for market capitalisation and liquidity leave around 1,000 stocks. Subsequently, a dividend filter is applied as dividend income is a very important driver of investment returns, especially in Asia. Barbour adds, 'Our strategy for institutional clients has produced a dividend yield of between 4% and 5% and is about 4% for the new Fund.'

Dividend trends vary considerably across the region. 'Some countries like Australia may have lower growth but their companies are like cash machines,' he says. 'The Australian market is paying about 75% of earnings. By contrast, in India, companies are investing in new equipment and factories and tend to be dividend-poor, paying out less than 30% on average, so India is an underweight in our Fund as a consequence.

Valuation and sentiment play a key role in portfolio construction

He acknowledges that pure low volatility strategies may appear more expensive than the broader market according to measures like price-to-book and price-to-earnings. Eastspring addresses this by removing stocks with poor valuation and sentiment.

Over time stocks that are cheap tend to outperform and stocks that are expensive tend to underperform. Similarly, stocks with poor analyst sentiment also tend to underperform on a historical basis, so the lowest ranking quintile of an index, based on value and sentiment, are removed from the stock universe.

This reduces the price-earnings ratio of the portfolio on a one-year forward basis to almost that of the broad index, and significantly below that of the Min Vol Index, while on a price-to-book basis the Eastspring portfolio is slightly cheaper than the broad index, with a dividend yield of 4% compared with 3% for the broader index and 3.2% for the minimum volatility index. Adds Barbour, 'We also look at measures of quality such as the debt-to-equity ratio and end up with a universe of about 300 companies that we are actually prepared to own.'

An optimiser is used to produce a portfolio of around 100 stocks under constraints such as sector and country weights, cash holdings, and the lowest volatility at the portfolio level, which is monitored daily by the team. The volatility of a model portfolio is used to indicate when the investment portfolio may need rebalancing, subject to the impact of trading costs and market impact. 'Typically rebalancing is done on a quarterly basis, which means we have low turnover, which helps the Fund's expense ratio,' Barbour says.

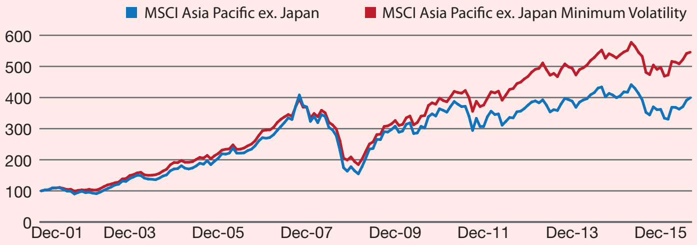
Relative to the broad index, the portfolio is overweight Hong Kong and Singapore, underweight China as well as Australia, Korea and Taiwan. 'The Chinese market is not particularly cheap, and that comes through on the valuation filter,' he says. On a sector basis the portfolio is underweight expensive and volatile sectors such as IT, financials and energy and, overweight 'dull and boring' but relatively resilient telecoms and utilities.

Eastspring offers a unique low volatility strategy in Asia

According to Barbour, the portfolio's factor exposure indicates the success of the investment process in delivering the promised strategy. 'We have a size bias toward mid and small caps, so we are underweight size and growth,' he says. 'Compared with the Min Vol index, we have a value bias because we have taken out those expensive stocks. We have lower volatility than the Min Vol Index, and a slightly smaller size bias. This is the proof that we are doing what we said we would do.'

Barbour says the strategy is extremely innovative. 'There are very few pure low volatility strategies in Asia and no Asia Pacific ex Japan Minimum Volatility ETF currently available, so currently the only way to obtain such exposure to this group of countries which includes Australia and New Zealand is through a fund such as ours. Other funds that claim to focus on low volatility are more stock-specific, with portfolios typically congregated around the large cap indices. We are unique in the way we remove expensive stocks and limit volatility at the portfolio level.'

PERFORMANCE COMPARISON OF MSCI INDICES SINCE 2002



Source: Bloomberg, MSCI, as at 31 August 2016. Performance shown is cumulative since 31 December 2001. There are limitations to the use of such indices as proxies. Historical performance of the indices are not indicative of a proxy for the future performance of the Fund.

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