"Managing" a low-risk portfolio

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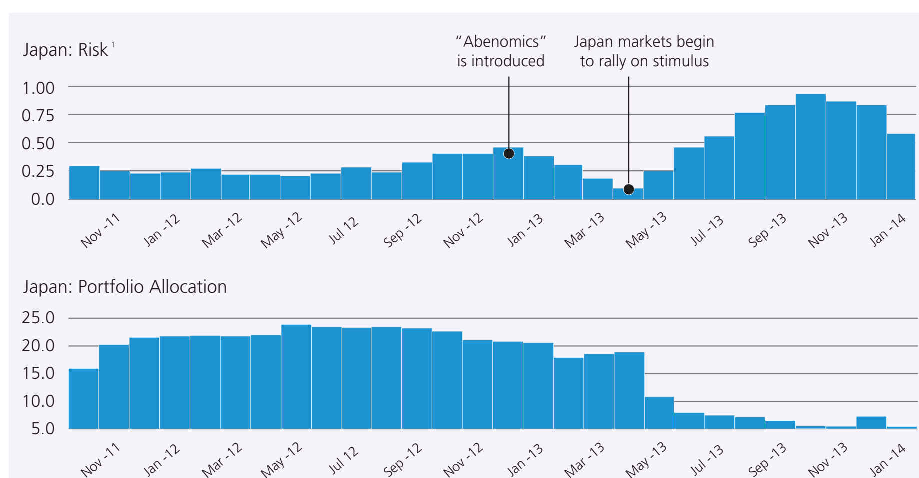
We believe the objective of any low-volatility equity portfolio is to produce equity returns with a significant discount in risk (standard deviation of returns) in comparison to traditional market capitalisation-weighted benchmarks. This can often result in a healthy dynamic between the desire to build the lowest risk, diversified equity portfolio and one with the highest return potential. To best meet its objectives, a low-volatility portfolio requires an assessment of risk and return potential at both the stock and portfolio level. Long-term success requires a balanced approach centered on low risk, but sensitive to the complete investment opportunity set.

There is a common perception that low-volatility equity portfolios are largely composed of consumer staples, health care and utility stocks. Due to their relatively stable businesses and lower risk profile, companies in these sectors will typically constitute a meaningful percentage of a low risk portfolio. At the same time, any single stock or entire sector can be in vogue and/or out of favour with equity investors, underscoring the importance of stock selection. Maintaining a large allocation to a group of stocks simply because they are low risk may yield a low risk outcome but lack the equity appreciation that most investors seek.

Evaluating the tradeoff between risk reduction and return potential results in a more dynamic approach that allows us to remain sensitive to the market's ever-changing preferences as well as attitudes toward risk. Since low-volatility portfolios are constructed to maximise the equity return constrained to absolute levels of risk, individual holdings are prized for their ability to produce returns and/or reduce risk. As such, the need to include holdings that resemble a market capitalisation-weighted benchmark or minimise tracking error becomes irrelevant. Instead, diversification is a means of absolute risk control. Significant portfolio concentrations in particular

Figure 1: Rotating away from Japan



As of 31 January 2014

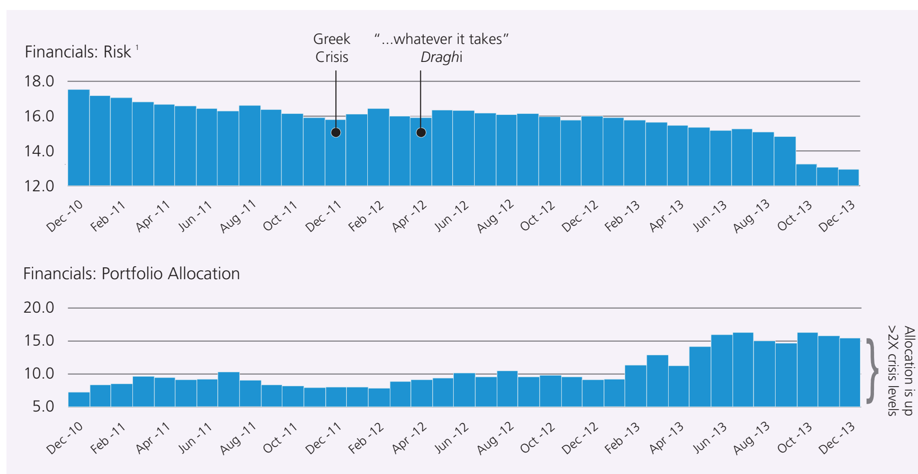
1 Risk is measured as the beta of the MSCI Japan Index vs the MSCI World Index measured over the previous 100 trading days.

The allocations mentioned are based upon a portfolio that represents the proposed investment for a fully discretionary account against the MSCI World Index. Allocations are subject to change.

Source: Lazard, Northfield Information Services, Inc., MSCI

"...any single stock or entire sector can be in vogue and/or out of favour with equity investors, underscoring the importance of stock selection."

Figure 2: Rotating into financials



As of 31 December 2013. 1 Financial risk was calculated monthly using a universe of non-US companies with a minimum market capitalisation of US$300 million. The allocations mentioned are based upon a portfolio that represents the proposed investment for a fully discretionary account against the MSCI World Index. Allocations are subject to change. Source: Lazard, Northfield Information Services, Inc., MSCI

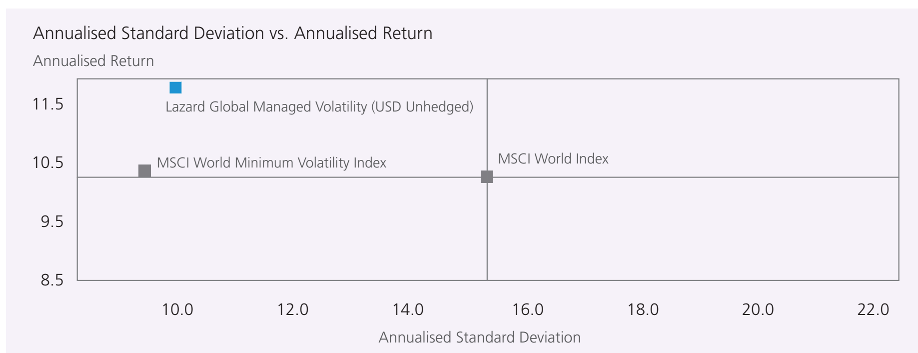
sectors or along the market-capitalisation spectrum may subject the portfolio to unforeseen macro risks or liquidity risk in the case of small-cap stocks.

The past year has seen a significant shift in the composition of our Managed Volatility strategy, both as a function of the changing risk profile in the global equity markets and a change in the investment opportunity set. For example, the fiscal stimulus provided to the Japanese economy by Prime Minister Shinz Abe's economic programme sent the local equity market soaring. Stock valuations accordingly became less attractive and, despite the stimulus, the opportunity set was reduced. Similarly, the volatility of the market has increased significantly, raising its risk profile as well as its correlation with other equity markets. In turn, we have responded with a rotation away from Japan and largely into the United States, as shown in Figure 1.

We have also seen a change in the risk profile of the financials sector, as central banks have flooded the markets with liquidity and reduced some of the risks associated with many financial firms. With the adoption of the Basel accord, many major financial institutions have shown significant improvement in their balance sheets, and greater stability in their earnings. At the same time, the valuation levels of many consumer staples stocks have begun to appear expensive, despite their inherent safety and low-risk characteristics. For the first time since 2005, we have increased the Managed Volatility strategy's exposure to financials (largely non-US names), as illustrated in Figure 2, and reduced our large positions in consumer staples and, to a lesser extent, health care.

Incorporating a stock selection process within a low-volatility strategy has proven to be an effective way of capturing more of the market's upside return, especially in environments such as we are currently experiencing, where traditional low-volatility sectors such as consumer staples and health care are out of favour. Figure 3 provides the risk/return characteristics of our global low volatility strategy versus MSCI World and MSCI Global Minimum Volatility indices since inception of the strategy. An index-based approach can be successful at meaningfully lowering overall volatility, but with an inability to discriminate beyond a stock's risk attributes, it may fall short of an optimal risk/return tradeoff. The ability to balance a stock's return potential together with its risk-reducing properties can improve overall portfolio returns without losing the risk-reduction properties of a low volatility strategy. This has been evidenced throughout the past year, as risk attitudes have shifted and stock preferences have changed. Distinguishing between investment opportunities based on company fundamentals becomes increasingly important in a low-volatility portfolio when low risk is not favoured. Incorporating a stock-ranking component can provide superior long-term gains to the low-volatility investor.

Figure 3: Performance Summary – Lazard Global Managed Volatility (since inception to 1 January 2010)



As of 31 January 2014

Performance is presented gross of fees. Past performance is not a reliable indicator of future results. Reporting currency: USD

Source: Lazard, MSCI

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