The low-volatility equity opportunity

Susanne Willumsen
Director, Senior Portfolio Manager,
Quantitative Equities
Lazard Asset Management

"In a correction, a successful low volatility portfolio should outperform strongly with a significant volatility reduction."

The last 12 months have been another roller coaster for equity investors. As the European sovereign debt crisis escalated during the middle of 2011, markets contracted sharply, before a strong rebound after the Long Term Refinancing Operation (LTRO) and the Greek bailout in December last year. Pension funds are understandably concerned about the risk/return payoff of the asset class particularly during these highly volatile periods. Yet despite these concerns it is clear that institutional investors still need equity as a key plank of their asset mix. We think low volatility equities are a solution for those who can't tolerate the volatility in asset prices, but need the long term capital appreciation that equity offers. If successfully implemented, evidence suggests you can achieve equity market returns with a superior risk/return trade-off through low-volatility stocks.

The benefits of a low-volatility equity approach becomes more apparent when the market contracts sharply like it did during the third quarter of last year. Global uncertainty sent markets into a sharp decline as investors struggled with the increasing prospects of a global recession and sovereign debt default. Market volatility spiked to levels which are approaching those seen during the financial crisis of 2008. In a correction, a successful low-volatility portfolio should outperform strongly with a significant volatility reduction. We are quick to stress that the low-volatility approach will sacrifice excess returns in a sharply rising markets, nevertheless, the reduction in overall volatility and commensurate downside protection can provide a much smoother equity return path and an improved return to risk ratio.

As these volatile periods occur more regularly, as we go through the potentially painful process of deleveraging in the developed world, we believe low-volatility equities are going to have an increasing role in investors' portfolios. Low-volatility equity investing has already gained increasing attention within the institutional investment community over the last few years. Investors are finding that these strategies provide a timely opportunity to address both return and risk priorities. We think one of the most important equity risk priorities is the ability to reduce the loss of capital. This is the basis for a low-volatility portfolio. Put another way, by reducing "risk" we are seeking to smooth out some of the highs and lows of the rollercoaster ride that can be equity investing. For low-volatility investors, absolute return measures of risk have supplanted benchmark aware risk measures, such as tracking error or information ratio which, as we will demonstrate later, contain inherent risks that we are seeking to minimise.

Relative to traditional market capitalisation benchmarks, these strategies provide the benefit of reduced capital loss, but at the expense of underperformance within sharply rising markets. Total returns will be similar over the longer term but with a steadier and more predictable return pattern.

Our research on global equity markets clearly shows that investment in low-volatility equities results in returns that are generally similar to that of the broad market, and that low-volatility tends to outperform high volatility.

Diversify away from market capitalisation benchmarks

Market capitalisation benchmarks (such as the MSCI World or FTSE All Share) remain a useful option for investors. Equity investors using market capitalisation benchmarks as default exposures benefit from the low trading cost and excellent liquidity that this approach offers. We, however, believe that it should not be the sole equity building block in today's environment.

The cost to investors of market capitalisation benchmarks is often greater exposure to what can be the riskiest components of the market. The capitalisation weights are simply an aggregation of the consensus views in the market. A quick survey of major recent market declines illustrates how the greatest concentration of exposure has the potential to occur at exactly the wrong time. For example at the time of the TMT bubble (Technology, Media and Telecoms), technology stocks had reached an all time high in most market cap-weighted benchmarks, while before the global financial crisis, banks and insurance stocks were at higher than normal weights in these indexes.

How should low-volatility work in practice?

Creating low-volatility portfolios is not as simple as just allocating to low risk stocks. Institutional investors stand to benefit from focusing on strategies that diversify risks along different risk dimensions, neutralise currency volatility, minimise trading costs and improve returns through stock selection. Successful long-term low-risk equity managers capture the low-risk anomaly without taking on additional sources of style, sector or market cap risk within their portfolios.

Lazard's research and practical experience investing in low-volatility strategies has resulted in the following core philosophies concerning strategy design and portfolio construction:

- Stock selection can improve returns with a slight increase in risk
- Risk model limitations need to be understood by:
  – recognising that not all risks can be modelled
  – incorporating the changing nature of risk sources
- Currency exposure risks should be efficiently minimised
- Style risk should be reduced and liquidity increased

It is our view that a systematic approach is the best starting point to construct a low-volatility portfolio. The systematic approach can have an explicit focus on risk reduction and can deliberately target low risk stocks.

In our view, the objective of a low-volatility portfolio is to gain exposure to all economic segments of the market without creating undue concentration in any particular industry or set of securities. By managing absolute exposure risk, a portfolio can have the freedom to gravitate to lower-risk segments of the market without being forced to adjust weightings due to an increase or decrease in the capitalisation weight. This methodology allows the strategies to create low-risk portfolios that best maximise risk adjusted returns.

The future of low-volatility

What started as an academic curiosity 40 years ago has evolved over the last five years into a recognised opportunity as investors, managers, and index providers have worked together to better understand and to illustrate the potential of this asset class. A natural question is the impact that this increased investor interest will have on the asset class. At some point a substantial portion of investor assets might migrate from current investor practices to a disciplined preference for low-volatility. A conceivable result is that risk differences within the total market will decline thus reducing the opportunity for low-volatility approaches to capture risk discounts relative to the market.

Yet we don't believe this opportunity is likely to be reduced by a substantive degree in the foreseeable future. Given that the benefit of low volatility is mainly a risk driven one, it does not lend itself to the type of investors that typically arbitrage return opportunities. The natural investor in low volatility is a long-term investor who is managing risk relative to a liability or predicted payment stream. These investors benefit by avoiding inefficiencies created by market cap indices and by aligning equity investment strategies with strategic objectives. In doing so they invest in portfolios with the transparency and liquidity offered by public equities, resulting in a reduction in the requirement for risk management resources and increased confidence regarding the availability of funds.

We think the low-volatility opportunity is here to stay and will only rise further in prominence. The current uncertain global macroeconomic environment is only adding urgency to the opportunity. We believe the risk/return payoff is compelling and offers crucial volatility discounts. Strategies that diversify risks along different risk dimensions, neutralise currency volatility, minimise trading costs and improve returns through stock selection should prove the most successful.