

| BY KELVIN TAN |

Long-term equity investors who want to sidestep the volatility of the stock market while achieving superior returns over the long run should consider low-risk stocks. This is the advice of researchers at Acadian Asset Management, a fund management house that focuses on institutional investors, and which adopts a quantitative approach to investing.

For years, investors have accepted the common axiom of investing that risks and rewards are positively correlated — the greater the risks, the more the gains achieved. That is perhaps one of the reasons investors usually like higher-beta stocks, which are generally more volatile than stock market indices.

“Traditional financial theories state that when you invest in high-risk stocks, you will subsequently be rewarded with higher returns. That was what our research team looked at, and they found out it wasn’t true,” says Richard Barry, managing director of Acadian Asset Management Singapore, in a recent interview with *Personal Wealth*. Low-risk stocks — those with lower beta or volatility than stock market indices — achieved better long-term returns than average stocks or those with higher beta, adds Barry, citing a February 2011 *Financial Analysts Journal* article written by the researchers.

The article, *Benchmarks as Limits to Arbitrage: Understanding the Low-Volatility Anomaly*, recently won the CFA Institute’s Graham and Dodd Scroll Award for being the best research paper published in the *Financial Analysts Journal* last year. It was written by Malcolm Baker (a professor of finance at Harvard Business School and senior consultant at Acadian Asset Management), Brendan Bradley (Acadian’s director of managed volatility strategies) and Jeffrey Wurgler (a finance professor at New York University Stern School of Business and senior consultant at Acadian).

In the report, they showed that risk and return in equity markets are unrelated over the long term. For a period of 41 years between 1968 and 2008, they proved empirically that low-beta stocks in the US offered a desirable combination of superior average returns and small drawdowns. “Low-volatility strategies have the potential to allow investors to achieve similar or better returns than capitalisation-weighted indices at substantially lower risk,” they write in the report.

Using data going back to January 1963, the researchers sorted US stocks into five groups according to either five-year trailing total volatility or trailing beta, and tracked the returns on these portfolios. They found out that a dollar invested in the lowest-volatility equity portfolio in January 1968 increased to US\$59.55 (or US\$10.12 in real terms) at the end of 2008. (Over this period, inflation in the US eroded the real value of a US dollar to about 17 cents.) On the other hand, a dollar invested in the highest-volatility portfolio declined to 58 US cents at end-2008 (or less than 10 US cents in real terms).

“Remarkably, an investor who aggressively pursued high volatility stocks over the last four decades would have borne almost a total loss in real terms,” they note. “We believe that the long-term outperformance of low-risk portfolios is perhaps the greatest anomaly in finance. Large in magnitude, it challenges the basic notion of a risk-return trade-off.”

According to Bradley, low-risk US stocks — defined as the least-volatile quintile of the 1,000 biggest stocks in the US — also outperformed the US stock market over the long term. Adding in recent stock-market data of 2009 and 2010, Bradley — in another report — showed that low-risk US equities turned in an annual gain of 10.2% from 1968 to 2010, while the US stock market returned 9.6% over the period. The most-volatile quintile of the



Bonzon says low-volatility equities tend to outperform in unstable market environments



Barry: The compounding advantage of low-volatility funds is the main reason for the anomaly



Liew: I think the jury is still out on these low-volatility funds

Low risk, high returns

The generally accepted notion that high-risk stocks give higher returns is not true, according to Acadian Asset Management’s researchers. We also take a look at the slew of newly launched low-volatility funds in the US.

1,000 biggest US stocks, on the other hand, only managed to generate annual gains of just 6.6% during that period.

“Financial theory contains a certain number of axioms that have been put into failure by practice or reality. Markets are not as efficient as predicted by theory, asset returns do not fit normal distributions and outperformance of low volatility assets add up to the list,” says Yves Bonzon, chief investment officer of Swiss private bank Pictet & Cie, who has been allocating more of his clients’ assets to defensive, low-beta stocks of late. “We are looking to take advantage structurally of the so-called low-beta anomaly and of the fact that over the long run, defensive shares tend to deliver a return equal or superior to that of the market.”

As Bonzon sees it, low-volatility equities also tend to outperform in unstable environments, as experienced by global stock markets after the 2008 global financial crisis. “In the particular case of low beta stocks, outperformance is expected in an economic environ-

ment that is subject to more frequent shocks than usual,” he tells *Personal Wealth*.

Explaining the low-volatility anomaly

What are the reasons for the long-term outperformance of low-volatility stocks? Some investment experts reckon it is just a function of the more efficient compounding exhibited by the low-risk stocks. A defensive stock that falls less than a cyclical counter during a market downturn doesn’t need its price to go up a lot to break even. Indeed, a stock with a value of US\$100 that falls 20% requires its share price to surge 25% to get to par. If that same stock falls only 5%, it needs only a 5.26% climb in share price to break even. Through the different cycles over many years, the compounding advantage of low-beta stocks would add up significantly.

“The [compounding effect] is the main part of the story that explains the low-volatility anomaly,” says Barry. “When you compound these returns over time, the drawdowns

are much less. That is a key factor why the low-volatility strategy has done well. If the drawdowns are more, they need to recover a lot more. If the drawdowns of a portfolio can be reduced, like what the managed volatility strategy has done, the compounding returns will be tremendous.”

At the same time, low-risk equities — usually those in the utility, healthcare and consumer staple sectors with predictable cash flows and stable earnings — tend to give better dividend yields than the average stock. “Low-volatility equities are those that generate resilient cash flows, which enable higher dividends [to be given out],” says Bonzon. The additional dividends is another reason for their superior returns over the long haul compared with higher beta or average stocks, which tend to pay a lower rate of dividend. Indeed, the PowerShares S&P 500 Low-Volatility Portfolio ETF has a 12-month dividend yield of 3.07% compared with 1.93% for the SPDR S&P 500 ETF.

Slew of low-volatility ETF launches

In 2011, fearful of the gyrations in global stock markets triggered by Europe’s sovereign debt crisis and the slowdown in global economic growth, investors gravitated towards newly launched low-volatility equity products in the US. The US is home to several managed volatility mutual funds and low-risk exchange-traded funds that track low-volatility stock indices.

Last year, ETF provider PowerShares was among the first in the US to roll out an ETF that tracks the performance of the S&P 500 Low Volatility index. The Nasdaq-listed PowerShares S&P 500 Low Volatility Portfolio, which was launched last May, has attracted inflows of more than US\$1.6 billion (\$2 billion) from global investors. Following the success of this fund, two international low-volatility ETFs — the PowerShares S&P Emerging Markets Low Volatility Portfolio and PowerShares S&P International Developed Low Volatility Portfolio — were recently launched by PowerShares. Other ETF providers such as BlackRock’s iShares and Russell Invest-

ments have also rolled out low-volatility equity products of late.

These products could give investors comfort when markets encounter extreme turbulence, such as in 3Q2011. But they have to sacrifice some market upside when stocks are rallying.

Underperforming when markets are hot

To be sure, the low-volatility strategy has its downside. For a start, low-volatility funds can underperform significantly when stock markets are rallying sharply. For instance, in a hot year like 2009, which saw the Standard & Poor's 500 index return nearly 27%, the S&P Low-Volatility Index lagged with gains of just 19%. Indeed, low-beta stocks also turned in below-average gains in the years leading to the bursting of the Internet stock bubble in March 2000.

"In a volatile period when stock markets undergo huge gyrations, [investors are] probably better off with a more defensive, low-volatility strategy as it reduces the losses," says Daryl Liew, head of portfolio management at Reyl Singapore (a subsidiary of Swiss boutique wealth management firm Reyl & Cie). "But defensive stocks severely underperformed during the roaring 1990s when growth stocks surged, leading up to the technology bubble."

Low-volatility stocks similarly underperformed the general stock market indices in 1Q2012, when there was a sharp rally in global equities. The PowerShares S&P 500 Low Volatility Portfolio, for instance, was up just 3.35% in that quarter, while the S&P 500 index surged 12%.

"Those low-volatility ETFs could provide

another choice for investors to invest in as they can reduce volatility risk from a surge in market fluctuations. However, if the market becomes bullish, low-volatility ETFs might underperform other riskier types of equity funds," says Xav Feng, head of Asia-Pacific research at global fund research firm Lipper. "I would like to say, volatility is not always bad. If the market moves towards what the investor is expecting, then it could be a good thing."

Still in demand

Despite the increased risk appetite among global investors this year and the recent underperformance of low-volatility equity funds, low-risk managed volatility products continue to be popular among institutional investors, says Barry of Acadian. He argues that managed volatility funds such as those offered by his fund house will have "staying power" regardless of the investment climate.

"For sure, we are seeing a lot more of this strategy and product type in the marketplace. At the asset allocation level, if you can shift the risk consumption of the equity part of your portfolio down with a low-volatility strategy, it allows you to be more creative on how you want to utilise your risk budget," says Barry. "If you lower the total risk of the equity portion of your portfolio, you can move into emerging market equities, for instance, as these equities are perceived to be of higher risk. That is a very big component in making this low volatility strategy increasingly popular with institutional investors."

To illustrate, Barry says one of his institutional clients was able to buy exposure to emerging Asia equities because it decided to allocate part of its global equity assets to low-

volatility stocks. That move freed up its risk budget, enabling it to invest in riskier areas such as emerging Asia stocks. "That emerging Asia trade couldn't have come on without reducing its risk."

Managing expectations

Because the low-volatility investment approach does not work well in a strong bull market, investors have to "manage their expectations", especially during times of short-term underperformance, says Barry.

"We spend a lot of time talking to clients about that because in a very strong bull market, this strategy is not going to do as well. We tell our clients exactly that. But in a flat or down-trending market, a slightly upward-trending market or a market with a lot of volatility, we would expect to add value with a low-volatility strategy."

Liew of Reyl Singapore, however, remains wary of the low-volatility equity ETFs available in the US. "I think the jury is still out on these low-volatility funds. With market trends changing all the time, I wouldn't want to be buying and committing to a particular investment strategy for the long term, especially one that isn't really tested yet. Another concern is that, as with all new themes, even if a market anomaly exists, the launch of all these new low volatility investment instruments in the past year suggests that it may be difficult to achieve similar outperformance since the trade is now getting crowded."

While a low-risk investment approach may have its merits, Liew believes investors should only invest in low-volatility ETFs and funds if they are truly looking to limit their volatility. "Despite all the uncertainties in the world

today, the next 10 years could very well be a great decade to hold stocks, so adopting a low-volatility approach could see investors underperform, like in the 1990s."

For his part, Bonzon of Pictet & Cie reasons that low-volatility products do have a place in the portfolios of long-term investors, especially those looking for protection from market shocks. But these products aren't for short-term trading, he warns. "Excellent market timing skills are required for purchasing and selling them [over the short term]. Otherwise, one must potentially expect sizeable underperformance." Long-term equity investors, however, could use these ETFs to give protection when taking exposure to developed market stocks, for instance, Bonzon says.

"In Western economies, deleveraging is an ongoing process. This process generates deflationary pressures, hence lower economic growth. Furthermore, growth in developed economies is not self-sustained, especially in the European Union where austerity measures have been implemented in various countries. Low-volatility assets provide protection in western economies," he adds.

With stock market volatility on the rise in recent weeks because of renewed concerns in Europe, it wouldn't be surprising if global investors started flocking to low-volatility ETFs like they did in 3Q2011. Investors keen to embrace this strategy should be focused on the long term and be prepared to forego price upside during strong market rallies. To be sure, they shouldn't use these funds to chase returns, says Liew. "I fear many may be disappointed if they invest in these low-volatility instruments with the objective of chasing returns."