

Making the Case for Managed Volatility Part 2: What Matters?

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Snapshot

- › Low-volatility strategies are sometimes thought of as bond proxies in that they tend to benefit from declining interest rates.
- › Given that the U.S. Federal Reserve is expected to raise rates in response to inflation as early as the end of 2022, the natural question is whether low-volatility strategies will disappoint in such an environment.
- › Interestingly, nominal interest rates (meaning they don't account for inflation) haven't historically mattered so much as a predictor of future returns for low-volatility securities.

A combination of strong demand and global supply bottlenecks caused consumer prices to surge by 5.3% over the 12-month period ending July 2021, the fastest year-over-year pace in 13 years.¹ Given that the U.S. Federal Reserve (Fed) has historically sought to manage inflation by governing interest rates—typically raising rates to slow the economy when inflation exceeds a target level—the timing of the Fed's next interest-rate hike has come into sharper focus for many investors.

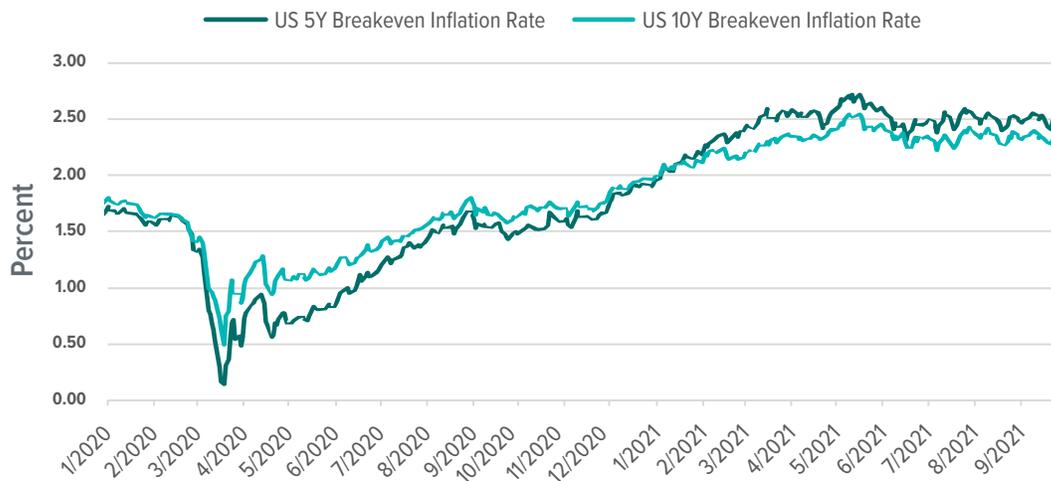
While the Fed has some ability to influence inflation, it can't as easily control expectations for future inflation—a market-based measure referred to as the breakeven rate. The breakeven rate represents the difference between the nominal yield on U.S. Treasuries of a given maturity (interest payment before adjusting for inflation) and the yield on an inflation-linked bond (which inherently rises and falls with the rate of inflation) with the same maturity.

If the Fed were to start raising rates, a move it has indicated could come as early as the end of 2022, investors would view the move as a pre-emptive action to halt further inflation. Expectations for future inflation—the breakeven rate—show exactly this.

Exhibit 1, which tracks the 5- and 10-year US breakeven inflation rates, illustrates that expectations appear to have already climbed significantly over the past 18 months. At the end of September 2021, the 5-year breakeven rate was at 2.50% and the 10-year breakeven rate sat at 2.37%, indicating expectations that price increases may be somewhat transitory and that inflation could eventually decrease over a more extended period.

¹ Source: U.S. Bureau of Labor Statistics

Exhibit 1: Measured Expectations



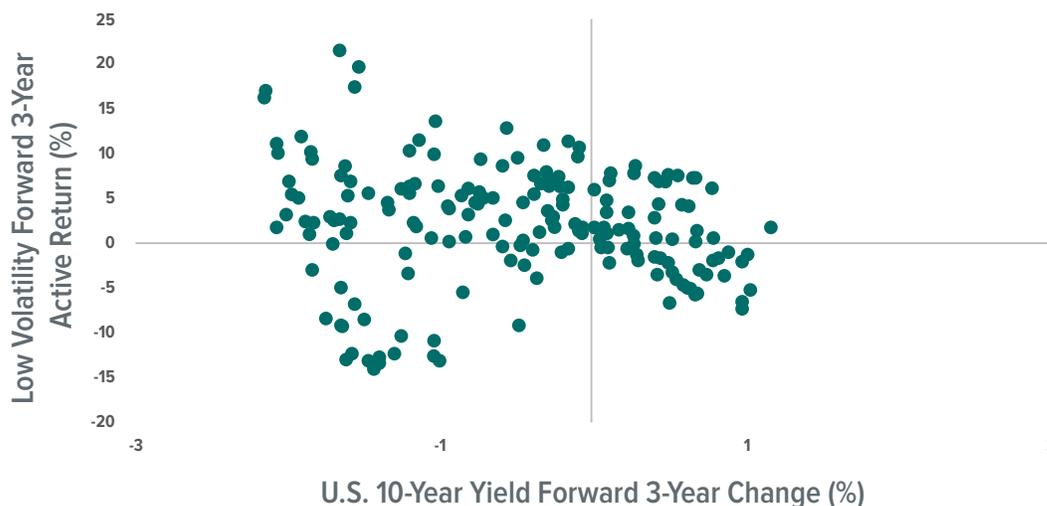
Source: Bloomberg. Data spans 1/1/2020-9/30/2021.

Why does this matter to managed-volatility investing?

With the Fed expected to raise rates at some point in response to inflation, investors naturally question whether their strategies will disappoint in a rising-rate environment. This may be particularly true for investors with low-volatility portfolios, which tend to be overweight defensive sectors like utilities and consumer staples. Low-volatility strategies are sometimes even thought of as bond proxies as they tend to benefit from declining interest rates.

Interestingly, nominal interest rates haven't historically mattered so much as a predictor of future returns for low-volatility securities. Exhibit 2, which plots changes in the yield on 10-year Treasury bonds against relative returns for low-volatility securities, shows that nominal yield changes are not closely related to performance.

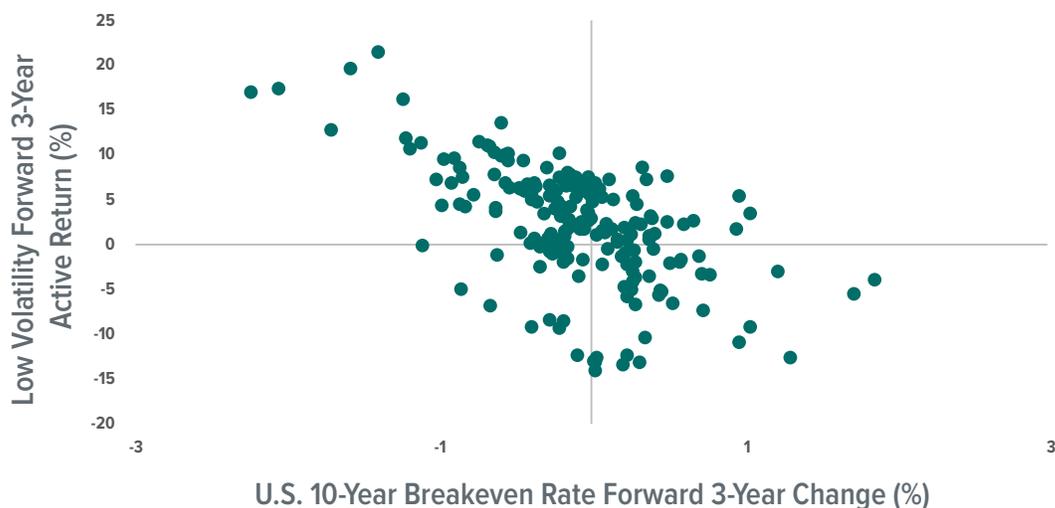
Exhibit 2: Interest Rates Yield Nominal Impact on Low-Volatility



Source: SEI based on data from DataStream, U.S. Bureau of Labor Statistics. Data spans 1/31/2003-6/30/2021. Low volatility forward 3-Year active return is sum of monthly active returns of top tercile U.S. low-volatility factor, liquidity-weighted, against the cap-weighted Russell 1000 Index. The low-volatility metric is a composite of underlying ratios that SEI has determined to be appropriate measures of the factor. Past performance is not a reliable indicator of future results.

It has actually been changes in inflation expectations—not changes in interest rates—that have typically driven low-volatility performance. History shows that the environment can remain favorable for low-volatility returns when rates rise as long as inflation expectations do not also increase. Exhibit 3 plots changes in the 10-year breakeven rate against relative returns for low-volatility securities. As the chart indicates, declining breakeven rates have historically caused low-volatility returns to improve.

Exhibit 3: Inflation Expectations Yield Real Performance Impact



Source: SEI based on data from DataStream, U.S. Bureau of Labor Statistics. Data spans 1/31/2003-6/30/2021. Low volatility forward 3-Year active return is sum of monthly active returns of top tercile U.S. low-volatility factor, liquidity-weighted, against the cap-weighted Russell 1000 Index. The low-volatility metric is a composite of underlying ratios that SEI has determined to be appropriate measures of the factor. Past performance is not a reliable indicator of future results.

Our view

While a continuation of rising inflation expectations would likely prove challenging for low-volatility investments, we believe the worst has already come, and that expectations for higher inflation are likely already factored into the market environment. As discussed in Part 1 of our series Making the Case for Managed Volatility, low-volatility securities have been trading at their lowest level since the so-called tech bubble of the 1990s. In our view, this should make them well-prepared in the event of a significant stock-market downturn.

This highlights the important role that low-volatility equities play within an investment portfolio, which is to produce attractive risk-adjusted returns compared to the stock market as a whole. Investors often question the value of diversification when stock prices are rising, particularly within managed-volatility strategies. But markets can turn quickly. And at SEI, we maintain that when they do, diversification—including exposure to managed volatility—can help to soften the impact.

Glossary

Bond proxies are investments that are thought to replicate the price stability of bonds.

Composite refers to a combination of several measurements or data types.

Risk-adjusted returns take into account the amount of risk that must be accepted to achieve a given return.

Tech bubble was a period of excessive speculation of internet-related companies in the late 1990s.

Tercile is a number that divides an ordered set of data into three parts, each containing a third of the values.

U.S. Federal Reserve is the central bank and monetary authority of the United States.

Yield refers to interest payments received on a bond.

Index Definitions

Russell 1000 Index measures the performance of the 1000 largest U.S. equity securities based on market cap; it is used to measure the activity of the U.S. large-cap equity market.

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