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Managed Volatility in a Relative World: Q&A with Portfolio Manager Eugene Barbaneagra

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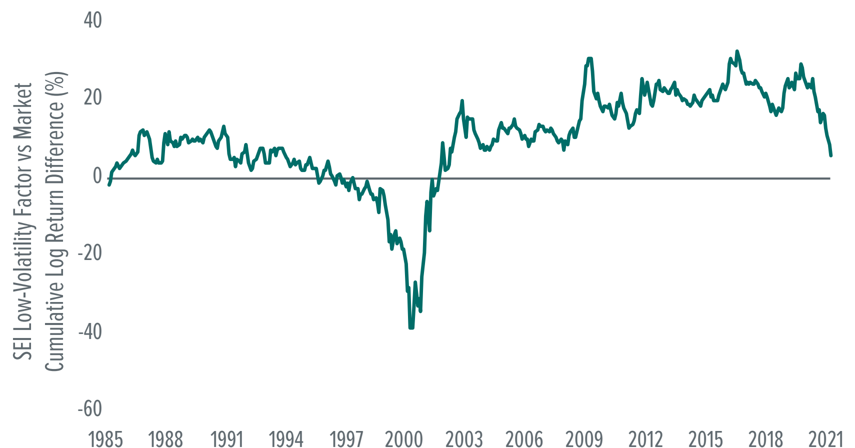
Snapshot

- Tight lockdown restrictions and unprecedented government stimulus measures help explain unfavorable relative performance for low-volatility strategies over the past 12 months.
- Following past crises, investors have tended to revalue defensive options—pushing up the relative performance of low-volatility securities.
- While no investment strategy works exactly as expected all of the time, we continue to believe our managed-volatility strategies will provide some measure of loss-mitigation during the next significant equity drawdown.

Q Managed-volatility strategies have struggled for quite some time. What is causing the strategy to now be out of favor?

A Managed volatility failed to deliver much downside mitigation in the first quarter of 2020 and, over the rest of the year, significantly lagged broader equity benchmarks as markets rebounded to new highs. Exhibit 1 shows that, after a long run of positive performance, the lack of risk reduction during the March selloff likely caught most investors in the strategy by surprise.

Exhibit 1: A Longer Perspective



Period: 1/1/1985-2/28/2021	Low Volatility	Market	Improvement
Return	11.80%	11.60%	0.20%
Risk	12.18%	15.23%	-3.05%
Sharpe Ratio	0.97	0.76	0.21

Source: SEI, FactSet, Axioma, FTSE/Russell; Market is represented by Russell 1000 index. Low-volatility factor portfolio is constructed using the top tercile of the liquidity-weighted index, grouped by the respective factor style and rebalanced quarterly. The metrics are composites of underlying ratios that SEI has determined to be appropriate measures of each factor. Returns shown in USD, gross of transaction costs. Indexes are unmanaged and one cannot invest directly in an index. Past performance is no guarantee of future results. Data spans the period from 12/31/1984-2/28/2021.

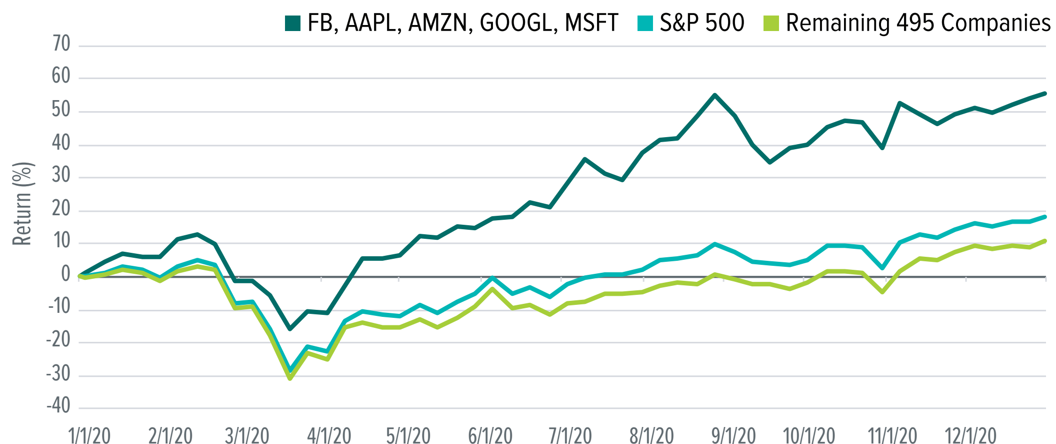
During previous market drawdowns, equities have reacted in somewhat predictable ways. That is, defensive sectors, such as consumer staples, utilities and telecommunications, have tended to perform better than economically-sensitive sectors like energy, financials or consumer discretionary. Those defensive sectors generally offer lower volatility. At SEI, we seek to optimize our managed-volatility funds and, in an effort to provide the best potential risk-adjusted returns, we tend to overweight defensive sectors. As such, our managed-volatilty strategies are designed to outperform the broad market benchmark during market declines (that is, they are designed to experience a relatively less dramatic fall).

This year, we experienced something different from the normal economic cycle. A global pandemic caused by COVID-19 caused countries to shut down their economies in an effort to combat the virus. It became a global economic crisis, the root cause of which was an exogenous shock to capital markets around the world.

How global equity markets reacted was also different; there was less differentiation between sectors than there tends to be in a typical market environment, and smaller companies were hit particularly hard. Because we seek to optimize between returns and risk, we have a greater exposure to smaller companies as well as other factors (such as value, which has underperformed growth in recent years) than our benchmark. In our view, this made for a rare and extremely challenging environment for managed volatility.

Following the decline in U.S. stock markets through March last year, equities rapidly recovered thanks to substantial fiscal and monetary stimulus—continuously reaching new all-time highs during the second quarter and through the end of 2020. Exhibit 2 shows that the rally was fueled by the strong performance of a small group of mega-cap technology stocks that have had increasing influence over the last few years—and which managed-volatility strategies, by design, tend to underweight. In short, this was the perfect storm for managed volatility to underperform.

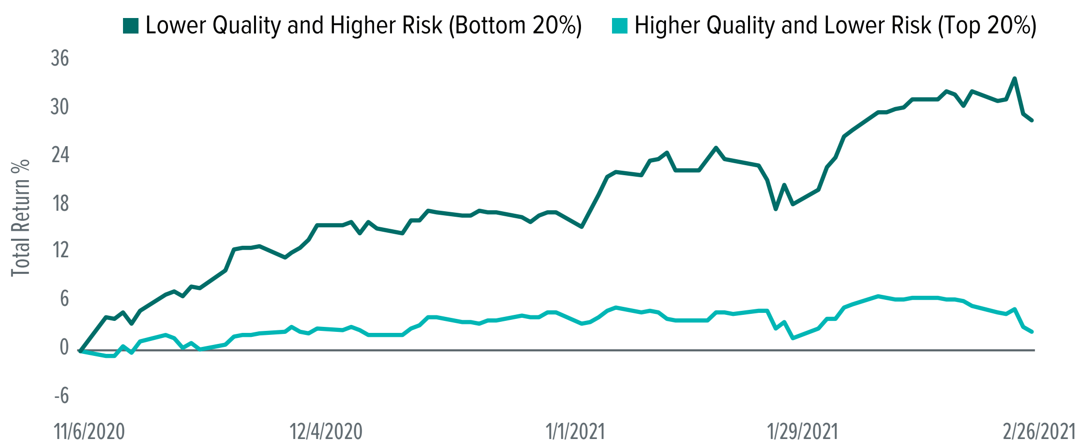
Exhibit 2: "Big Five" Tech, Then the Rest



Source: FactSet, Standard & Poor's. Data spans 1/1/2020-12/31/2020. "Big Five" Tech companies represented by Facebook (FB), Apple (AAPL), Amazon (AMZN), Alphabet (GOOGL), Microsoft (MSFT). Index returns are for illustrative purposes only and do not represent actual investment performance. Index returns do not reflect any management fees, transaction costs or expenses. Indexes are unmanaged, and one cannot invest directly in an index. No mention of particular securities should be construed as a recommendation or considered an offer to sell or a solicitation to buy any securities. Past performance is not a reliable indicator of future results.

Consider a fund manager who invests entirely in companies with "problematic" outlooks and excessive amounts of debt. Imagine that this manager also has an affinity for businesses that squander capital and whose stocks are more volatile in the face of uncertain economic growth—precisely the companies that managed-volatility strategies tend to avoid. While it may seem ridiculous that anyone would favor such investments, those were the types of stocks that generally outperformed from November 2020 (after Pfizer's vaccine announcement) through the end of February 2021. We do not see this as a sustainable trend and believe that, over a full market cycle, investors should shun these traditionally "problematic" stocks.

Exhibit 3: Low-quality Stocks Leading the Risk Rally



Source: Source: SEI, FactSet, FTSE/Russell; U.S. equities are represented by Russell 1000 index. Factor portfolios are constructed using the liquidity-weighted index, grouped by a combination of the respective factor styles and rebalanced quarterly. The metrics are composites of underlying ratios that SEI has determined to be appropriate measures of each factor. Returns shown in USD, gross of transaction costs. Indexes are unmanaged and one cannot invest directly in an index. Past performance is not a reliable indicator of future results. Data for the period from 11/6/2020 to 2/28/2021.

Q Given our conviction in the strategy, and with value coming back into favor, could you elaborate on how our managed-volatility funds should be well-positioned moving forward?

A Clearly, the COVID-19 crisis has not been like other crises of the recent past. Over the last 12 months, widespread lockdowns and work-from-home orders increased the role of online technology, which brought growth forward for many of these companies. Unprecedented fiscal and monetary stimulus by global central banks in 2020 likely impacted the traditional risk-return relationship for equities in the short term. However, as investors become increasingly conscious of the long-term uncertainties surrounding the riskiest securities, "boring" firms will (in our view) return to favor. Businesses that are sustainable, secure, and have reasonable fundamental and business models should weather a global recession if one ensues.

The global equity market implications of central banks' stimulus measures will continue to reveal themselves over the coming years. Following past crises, investors have tended to revalue defensive options—which pushed up the relative performance of low-volatility securities. This was the case after the global financial crisis. We think this rerating of "boring" stocks will happen again in the short future.

Investors often question the value of diversification, particularly managed-volatility strategies, when stock prices are rising. At SEI, we have been a steadfast supporter of both diversification and managed volatility. We have always maintained that markets can turn quickly and that, when they do, diversification— including exposure to managed volatility—can help to soften the impact. If you find yourself questioning the short-term performance of a managed volatility strategy, you may be falling prey to the same behavioral factors that have long caused investors as a group to commit errors such as mispricing risk. When investors use inappropriate metrics in comparing managed volatility to other strategies, or make investment decisions based solely on prior short-term benchmark-relative performance, they are committing common investment mistakes that some institutional investors are even prone to making.

If the next crisis is triggered by an exogenous event, perhaps managed volatility will again fail to live up to expectations that it will mitigate losses. Yet, we have reason to believe otherwise. In some ways, we have been here before. In the run-up to the technology implosion in 2000, markets rallied as increased information technology spending and the novelty of internet stocks drove the market higher. The compelling storyline back then sparked a relative rout in low-volatility stocks. However, investors who stayed the course were rewarded in time as market behavior normalized.

We believe in our research. While no investment strategy works exactly as expected all of the time, our managed-volatility strategy has done so more often than not since inception—and we believe it will continue to provide some measure of loss mitigation during future significant equity drawdowns. Exhibit 4 shows that following previous crises, investors in U.S. equities have usually revalued defensive options, pushing up the relative performance of low-volatility securities. Periods of significant underperformance have happened before; however, over the long term, the strategy has delivered on its mandate of market-like returns with less volatility.

Exhibit 4: This Has Happened Before

	Low Volatility	Market	Excess Return
Oct'98 to Mar'00 (Dotcom Bubble)	5.3%	33.2%	-28.0%
Jan'09 to Dec'10 (Junk Rally)	13.9%	22.1%	-8.2%
Jul'16 to May'18	7.1%	16.6%	-9.5%
Sep'19 to Feb'20 (Tech leadership)	5.4%	23.3%	-17.9%

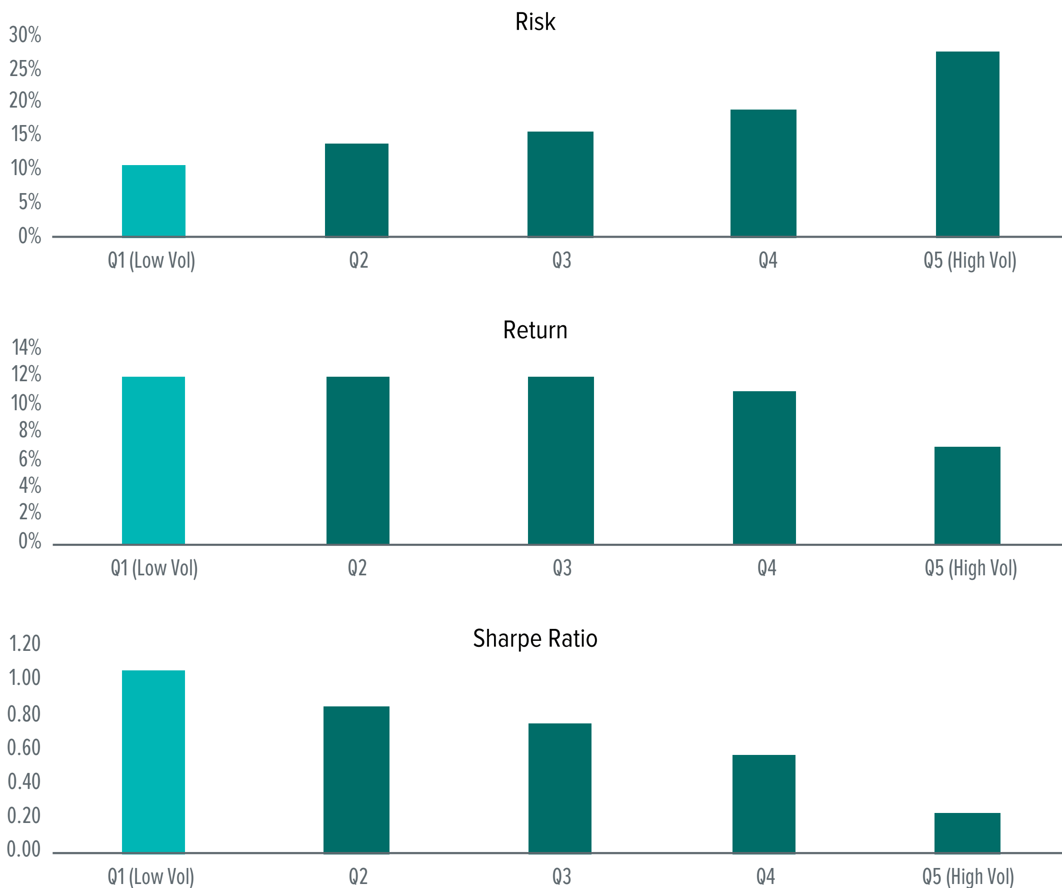
Source: SEI, FactSet, Axioma, FTSE/Russell; U.S. equities are represented by Russell 1000 index. Low-Volatility factor portfolio is constructed using the top tercile of the liquidity-weighted index, grouped by the respective factor style and rebalanced quarterly. The metrics are composites of underlying ratios that SEI has determined to be appropriate measures of each factor. Returns shown in USD, gross of transaction costs. Indexes are unmanaged and one cannot invest directly in an index. Data refers to past performance. Past performance is not a reliable indicator of future results. Data for the period from 12/1/1988-2/28/2021.

Q You have said in the past that adding strategies based on managed volatility to an investor's portfolio can add value over a full market cycle. Do current market conditions and performance change that view?

A Managed-volatility approaches to investing, which are based on a long history of solid empirical evidence, offer investors a unique and compelling way to potentially earn stock-market-like returns with less volatility. SEI was a pioneer in the implementation of managed-volatility investing more than a decade ago, and we have continued to innovate as the investment style has evolved.

Analysis of real-world market data found that, as a group, investors historically overpay for higher-volatility securities and underpay for lower-volatility ones. Said another way, returns on high-volatility stocks were significantly lower, and returns on low-volatility stocks were higher than prevailing finance theories predicted. This was a significant and unexpected finding—an anomaly in financial parlance, as confirmed by subsequent studies using data from other time periods and other markets. Exhibit 5 shows this rather compelling upshot: An investor could potentially earn better-than-expected returns for a given level of risk.

Exhibit 5: A History of Greater Returns with Less Volatility



Source: SEI, based on data for all U.S. stocks from MSCI, Russell, FactSet, Axioma. Risk is measured using the standard deviation of returns over 36-month rolling periods and shown by quintile. Returns quoted in USD and shown by quintile. Data period from 1/1/1986-12/31/2017.

When equity markets are in the midst of extended bull run, nobody wants to think about it ending. Yet, sooner or later it will end. While corrections and bear markets are a normal part of investing, investors do not like to lose any portion of their assets associated with these types of declines.

One way to potentially help dampen the impact of market downturns is to invest in managed-volatility strategies that focus on the more stable companies that have historically shown less downside risk. In our view, because it's impossible to predict when such a decline with occur, it is important for investors to have managed-volatility exposure in their portfolios at at all times.

Q Where does managed volatility fit into a portfolio's asset allocation?

A With the potential to deliver equity-like returns with lower expected volatility over the long run, we believe the appeal of managed-volatility exposure within a broader portfolio is apparent. Depending on how the allocation is funded (meaning which combination of traditional stocks and bonds are sold in order to purchase low-volatility equity), it can allow for potentially higher expected returns, lower expected volatility, or both. Naturally, higher risk-adjusted returns afford investors greater confidence in their ability to achieve their financial goals. Particularly at the lower-risk end of the spectrum, where many investors are concerned primarily with the risk of absolute loss, managed volatility can allow for the possibility of significant long-term growth with potentially smaller expected drawdowns.

We believe deviating from familiar capitalization-weighted allocations and including managed-volatility equity exposure has the potential to create more efficient total portfolios that are better equipped to meet the objectives of long-term investors. Given a sufficient time horizon, we believe it's important for investors to focus on the longer term rather than short-term market fluctuations.

Definitions

Cumulative log return refers to the continuously compounded rate of return on an index or investment.

Factors are the inefficiencies that an active investment manager seeks to exploit in order to add value.

Fiscal stimulus refers to government policy measures—such as tax cuts or government spending—that are taken to improve economic activity.

Monetary stimulus refers to central-bank policy measures—such as lowering interest rates—that make it cheaper to borrow or invest.

Sharpe ratio is a measure of risk-adjusted return for a security, index or investment. A higher Sharpe ratio is considered superior to a lower Sharpe ratio.

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