High Opportunity in Low Volatility Equity

Central Issue of the Paper

Low volatility strategies have been popular amongst investors for quite some time. The appeal of this strategy is clear. Low volatility stocks have historically delivered higher returns with lower risk than the capitalization-weighted market. Moreover, the behavioral and market-structural forces that have been suggested as possible explanations are inherently hard to change, which means the anomaly might not readily disappear. In “Tactical Timing of Low Volatility Equity Strategies” by Sanne de Boer and James Norman, the authors attempt to tackle two common concerns about the timing of an allocation. The first is that relative valuation of low volatility stocks may be expensive compared to the rest of the market, so they should wait for more attractive levels. The second is that low volatility stocks, which tend to pay higher dividends, may underperform against the backdrop of potential rate increases. In this paper, the validity of these concerns is examined by researching drivers of global low volatility equities’ performance relative to the capitalization-weighted index since 1980. They consider valuation as well as the macroeconomic backdrop and find that relative valuation levels have not been a good predictor of low volatility equities’ relative return. In addition, while low volatility equities’ performance was indeed more sensitive to interest rate changes than the capitalization weighted index, both delivered similar risk adjusted returns (Sharpe ratios) in rising-rates environments.

Approach Employed by Paper

Low volatility investing is a broad term that captures a wide range of defensive portfolio construction methodologies, generally resulting in similar performance benefits. The hypothetical Global Low Volatility Portfolio considered in this analysis invested in a diversified combination of low volatility capitalization-weighted country-sector baskets of stocks included in the MSCI World Developed Markets Index, e.g. US Financials, UK Telecoms. In earlier research, the authors have shown this approach to capture the global low volatility effect with less concentration risk and a higher level of liquidity than when using stock specific data, delivering comparable returns.

Low volatility investing has exhibited a strong track record versus the capitalization-weighted market index (Cap-Weighted Index). Since 1980, the Global Low Volatility Portfolio delivered higher returns at lower risk over the most recent 3 and 5 years, it delivered higher risk-adjusted returns as measured by the Sharpe Ratio. Only in the final year of their analysis period, when the
Cap-Weighted Index delivered a strong return with unusually low volatility, did the Global Low Volatility Portfolio underperform while not delivering a risk reduction benefit.

Another important point the authors share is that none of their three-valuation metrics, dividend spread (DIV), book-to-price (BP) spread and earnings-to-price (EP) spread, had much efficacy as predictors. Thus, the concern that a current high relative valuation of low volatility stocks presents a sub-optimal environment for allocating to low volatility strategies appears to be unfounded. This result is counter to the common wisdom that valuation levels are significant predictors of future performance. Since valuation has historically been a good predictor of stocks’ relative performance, it is surprising that it is not a better predictor of the Global Low Volatility Portfolio’s relative performance. In trying to understand this, they found that the relative valuation of the Global Low Volatility Portfolio is primarily driven by its dynamic country and sector positioning rather than the valuation changes of static holdings.

Many investors have predictions about the upcoming macro environment. This raises the question about how low volatility performance relates to its concurrent macro environment, with a rising interest rate environment being of particular interest as many investors expect normalization to higher rates given the Fed’s recent moves. What the authors witnessed is that the portfolio underperformed during economic booms when strong real GDP growth and elevated inflation were accompanied by interest rate increases. The interest rate environment had the strongest relation to the performance of the Global Low Volatility Portfolio among the economic indicators considered.

**Findings of the Paper**

Investors understand the appeal of low volatility equity investing but have expressed concerns about the tactical timing of making an allocation, primarily related to valuation levels and the interest rate environment. This paper illustrated that valuation levels of the Global Low Volatility Portfolio primarily reflect its dynamic country and sector positioning more than the valuation of its existing holdings. This can explain its relative valuation being a poor predictor of its future relative performance. de Boer and Norman’s research also showed that the Global Low Volatility Portfolio has tended to underperform during periods of rising interest rates. However, rate increases don’t happen in isolation and in such a rising rate environment the strategy may still deliver the total return needed for investors to achieve their goals, while reducing volatility.