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Asset Allocation: Low-Volatility Equities in a Diversified Portfolio

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Snapshot

- Our research has found that lower-volatility stocks typically deliver market-like returns over the long-term while experiencing considerably less volatility and smaller declines than the market as a whole.
- While low-volatility equities generally exhibit low absolute risk, they can sometimes outperform or underperform by large margins for extended periods of time.
- We can't know anything for certain about the future, but history suggests that low-volatility equity investments can help to mitigate portfolio losses during equity-market drawdowns.

The merits of low-volatility investment strategies have been understood for quite some time. In fact, SEI helped pioneer the approach, having launched our first strategy in the space in 2004—after our own research[1] found that lower-volatility stocks not only experience considerably less volatility and lower declines than equities as a whole, but also may even deliver market-like returns over time.

We have found this makes low-volatility equities particularly attractive for investors who care primarily about absolute risk, meaning they are more concerned about the risk of losing money than the risk of underperforming a market index. For example, individuals focused on avoiding losses exceeding a certain amount (say, 10% or 20% of the portfolio's value), may find low-volatility strategies especially compelling.

However, the utility of low-volatility strategies can extend beyond the most conservative portfolios. Even the most aggressive investors may benefit from an allocation that's designed to dampen portfolio volatility.

Why isn't everyone investing in low-volatility strategies?

While low-volatility equities generally exhibit low absolute risk, they can sometimes outperform or underperform by large margins for an extended period of time. Therefore, not everyone is necessarily comfortable with that divergence when it happens in their portfolios.

Such anxiety is natural during periods of market stress. However, if an investor's asset allocation decisions are based on achieving a certain financial goal—retirement, college tuition, a vacation home, or some other spending objective—then the risk of gain or loss relative to the market would not be relevant. Imagine, for example, that an investor's portfolio is up 20% while the market is up 25%—yet the portfolio only requires 6% to achieve its objective. It may be lagging the market, but the portfolio is clearly well ahead of expectations in terms of achieving the investor's goal. And, in our view, it's more appropriate to measure the success of a goals-based portfolio in terms of achieving its given objective rather than outperforming the market.

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[1]Source: SEI—A Global Pioneer in Managed-Volatility Investing. https://intranet.corp.seic.com/sites/imu/IMU%20US%20Documents/Arjan%20Managed_Vol_SIMT%202019-8409.pdf

This is not always the case. Unfortunately, most investors have been conditioned to judge the success of their portfolios against benchmark indexes instead of in relation to their personal goals. This is due to many professional money managers being compensated based on performance relative to the benchmark. In other words, if their portfolios underperform, their compensation declines; if their portfolios outperform, their compensation goes up—indirectly incentivizing them to reduce the volatility of their performance and create portfolios that look similar to benchmarks in an effort to reduce the volatility of their compensation.

When boring is better than the lottery

Another likely reason that investors have not universally adopted low-volatility investing is that most are drawn to trades that appear to offer dazzlingly high potential short-term outcomes. Many also appear willing to pay a premium for the thrill of owning stock in companies that generate a lot of buzz—overpaying to invest in an exciting upstart electric-car company, for example, rather than underpaying for a well-established, highly profitable pharmaceutical company (compared what "rational" finance theory would indicate each company is worth). Rational finance theory assumes rational behavior on the part of individuals and that investors employ rational calculations to make rational choices and achieve outcomes that are aligned with their own personal objectives.

The temptation to chase "lottery-like" returns is understandable. However, these types of trades often come with higher risk and consequently lottery-like outcomes (a low-odds game).

We believe it is far wiser to adopt a more patient investing approach. Our research[2] shows that investors willing allocate to unexciting companies—particularly when buying shares at bargain prices—will likely be rewarded in the form of higher risk-adjusted returns[3] as the value of their "boring" investments slowly compounds over time.

Low-volatility equities and rising interest rates

Low-volatility equities exhibit a moderate amount of sensitivity or responsiveness to interest-rate changes, particularly over certain periods. But that's not necessarily a bad thing.

First, timing interest-rate movements is just as hard as timing stock-price movements. It comes with higher risk. The 40-year bull market[4] in bonds (during which U.S. Treasury bond market prices have moved higher) is proof that it's not as simple as saying "interest rates are low so they have to rise". Since we cannot predict the future, interest-rate exposure remains a valuable diversifier to equity risk.

Second, it's important to remember that even many traditional "balanced" portfolios have far less interest-rate risk than one may expect. In a 50/50 stock-bond portfolio, we can see that stocks account for more than 95% percent of the risk (Exhibit 1).

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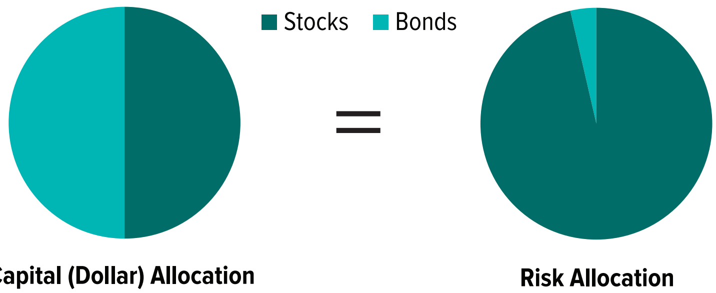
[2] Source: SEI

[3] Risk-adjusted returns: Risk-adjusted return is a calculation of the profit or potential profit from an investment that takes into account the degree of risk that must be accepted in order to achieve it.

[4] Bond bull market: A bull market is the condition of a financial market in which prices are rising or are expected to rise. U.S. Treasury bond market prices have moved higher from 1981 to 2021.

Exhibit 1: Equal Weight Does not Mean Equal Risk



Source: SEI, Datastream. Percent capital to risk (PCTR) calculated via linear regression using monthly returns for the 10 years ended 11/30/2020. Linear regression is a statistical method that attempts to determine the strength and character of the relationship between one dependent variable and a series of other variables. Stocks are represented by the MSCI World Index (net, USD-hedged); bonds are represented by the Bloomberg Barclays Global Aggregate Index (USD-hedged). Portfolios are rebalanced monthly. MSCI World Index: The MSCI World Index is a free float-adjusted market-capitalization-weighted index that is designed to measure the equity-market performance of developed markets. Bloomberg Barclays Global Aggregate Bond Index is an unmanaged market-capitalization-weighted benchmark, tracks the performance of investment-grade fixed-income securities denominated in 13 currencies

From this perspective, low-volatility equity's combination of smaller contributions to relative returns and modestly higher interest-rate sensitivity isn't a big concern in our view. If anything, it may bring a portfolio into better balance from a risk perspective.

Finally, it's helpful to remember that the relationship between interest rates and equities varies throughout time. Recently, technology-related growth companies have dominated the markets; they are meaningfully "long duration[5]" in the sense that most of their earnings are projected well into the future. However, in the event that interest rates rise faster than expected, it's far from clear that those technology-related growth stocks would outperform low-volatility stocks. That's because applying higher rates to future earnings may well hurt long-duration stocks.

SEI's view

While many equity-market crises share similar features, it's important to realize that no two episodes are exactly the same. The selloff in 2020 was especially unusual given the economic circumstances created by a once-in-lifetime pandemic. At the time, safety measures including government-mandated lockdowns made it impractical, or even illegal for consumers to purchase certain goods and services through traditional (in-person) channels.

While most businesses were struggling in the early days of the pandemic, the few already-established masters at delivering products straight to consumers' homes (such as major online retailers and on-demand entertainment providers) outperformed in this environment. Traditionally, these mega-cap[6] technology names would not be expected to remain steady in such a volatile equity market; they had an unusual advantage because of the unique nature of the public health crisis. In a more typical equity selloff, we wouldn't expect them to provide much of a cushion, if any, from losses.

More commonly, general economic weakness causes consumers to spend less and businesses to invest less, which leads to contractions in corporate earnings—particularly in more discretionary sectors. This is likely intuitive because discretionary spending is, by definition, non-essential—and, therefore, the easiest expense for consumers and companies to cut back on. Unfortunately, low-volatility stocks faced headwinds in this environment.

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[5] Duration: duration is a measure of the sensitivity of the price of a bond or other debt instrument to a change in interest rates. The longer the duration, the more sensitive the bond will be to changes in interest rates.

[6] Mega-cap: Mega cap stocks reflect the largest companies in the investment universe as measured by market capitalization.

The good news is that low-volatility equities have performed remarkably well in just about every other market selloff in recent memory.[7] While we can't know anything for certain about the next crisis, history suggests that 2020 was an exception—not the "new normal"—and that low-volatility equity investments should continue to help mitigate losses in the vast majority of market drawdowns going forward.

[7] SEI Data Portal. During equity drawdowns, defensive sectors—such as consumer staples, utilities and telecommunications—often performed better than economically sensitive sectors like energy, financials or consumer discretionary. Defensive sectors generally offer lower volatility. Low-volatility equities tend to overweight defensive sectors. This creates an environment where low-volatility equities volatility are likely to outperform broad market benchmarks during market drawdowns. Past performance does not guarantee future results.

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