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

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**Eugene Barbaneagra**
Portfolio Manager

**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.**

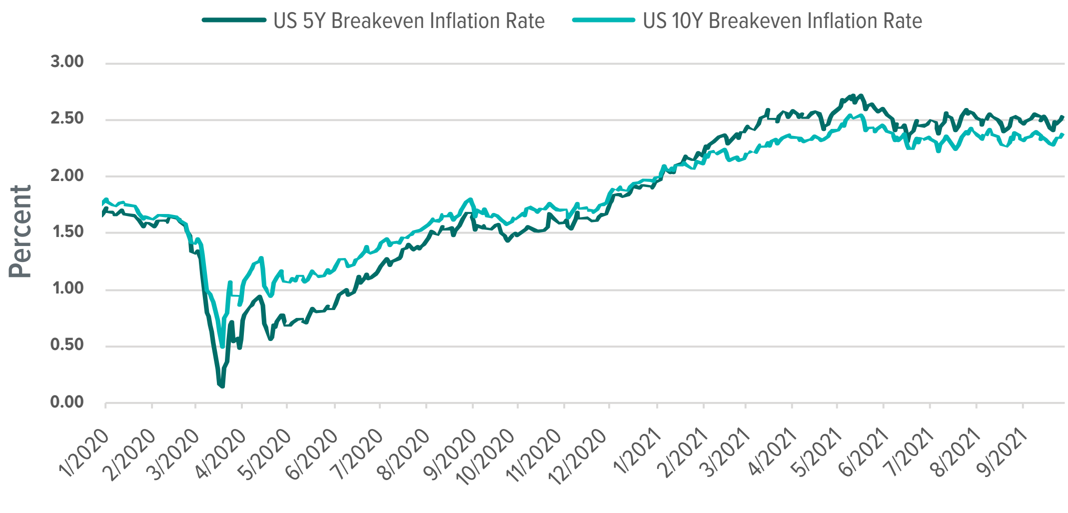
While the Fed has some ability to influence inflation, it can't as easily control expectations for future inflation—a market-based measure referred to as the breakeven rate. The breakeven rate represents the difference between the nominal yield on U.S. Treasurys of a given maturity (interest payment 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**



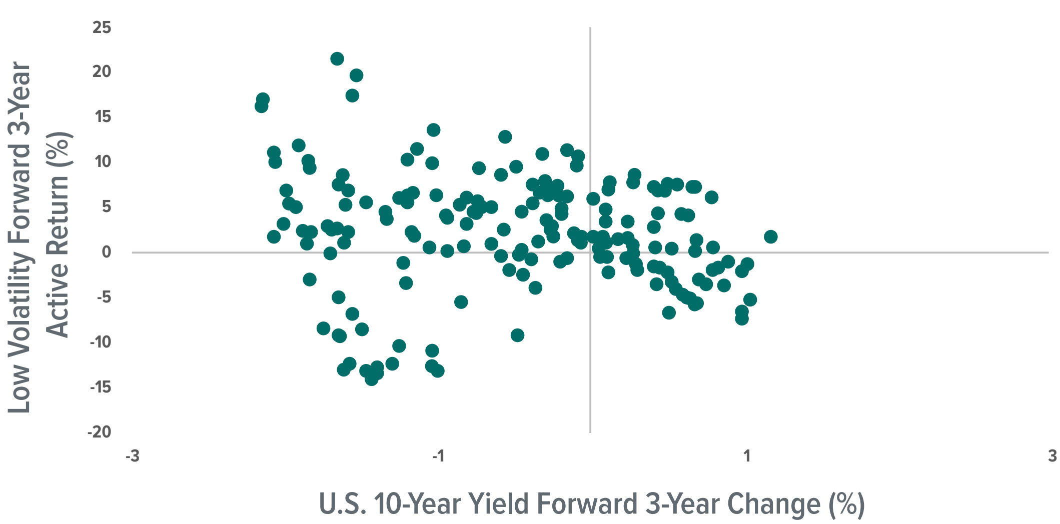

Source: Bloomberg. Data spans 1/1/2020-9/30/2021.

# 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.

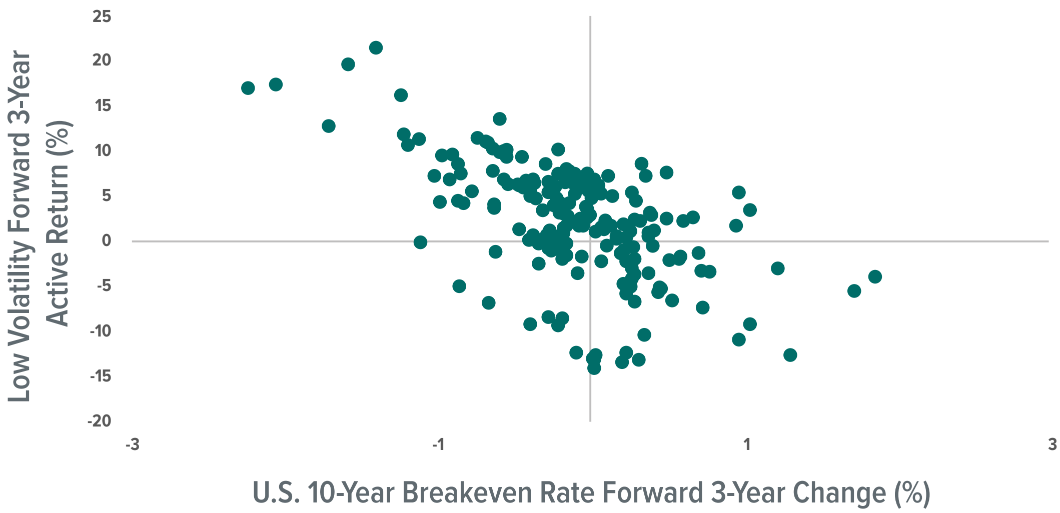
**Exhibit 2: Interest Rates Yield Nominal Impact on Low-Volatility**




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**

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# 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 equites 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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