The benefits of growth with lower volatility

Standard Life Investments

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Introduction

The ultimate test of portfolio manager skill is the risk-adjusted return - or 'bang for your buck' - the manager generates. For an individual portfolio, this is straightforward to judge. However, most investors own several different portfolios. This can have profound implications for their approach to volatility management.

In this paper, we look at some ways of managing volatility and demonstrate how the inclusion of a low-volatility growth strategy can provide a superior overall solution.

We go on to introduce an 'enhanced-diversification' approach, a concept we developed to achieve reduced volatility without compromising growth potential.

The benefits of growth with lower volatility

What is a lower-volatility growth portfolio?

A lower-volatility growth strategy typically targets equity-like returns over a market cycle, but for a much lower level of risk – generally around two-thirds of equity market risk. If the portfolio achieves both the return and risk objectives, this should generate a risk-adjusted return (before fees) that is 50% higher than the risk-adjusted return (again gross of fees) of a passive equity tracker portfolio.

Traditional approaches to constructing lower-volatility growth portfolios

Why then, given its obvious benefits, might an investor choose not to include a lower-volatility growth strategy in the portfolio? One reason is that some investors, while recognising the value of a low-volatility growth strategy in isolation, believe that by combining other portfolios and assets, they can achieve similar results in a broader portfolio. Yet this carries risks. Generally, these portfolios select their investments from a relatively limited selection of asset classes. So, while there may be many individual portfolios to choose from, to achieve robust diversification requires access to more asset types.

For example, in the recent past, portfolios that have adopted a more traditional investment strategy of focusing on equity and fixed income assets have benefited from a fairly stable level of diversification between these two major asset classes. Typically, when equities have stumbled, bonds have rallied, as we saw in the first half of 2016. However, this has not always been the case. Should the relationship between equities and bonds change, these portfolios may lack diversification.

More advanced lower-volatility solutions – broadening the investment universe

Multi-asset, lower-volatility growth portfolios often include a range of investments that are difficult for other portfolios to access. For instance, among these might be relative value strategies across both equities and interest rates. Positions like these rely on traditional assets but, by taking both long and short positions, we can develop risk relationships that are quite different from the underlying asset.

To illustrate, a relative value equity position that owned US large-cap stocks and was short US small-caps would behave quite differently from a long US equity position. The risk in US small-caps is generally higher than in larger companies. Therefore, we would expect the overall strategy to be negatively correlated with the broader US market. This effect could not be reproduced in a portfolio that is unable to take short positions. At best, it would be able to own more large companies than small, but would retain an overall long equity bias and hence be positively correlated to US equities.

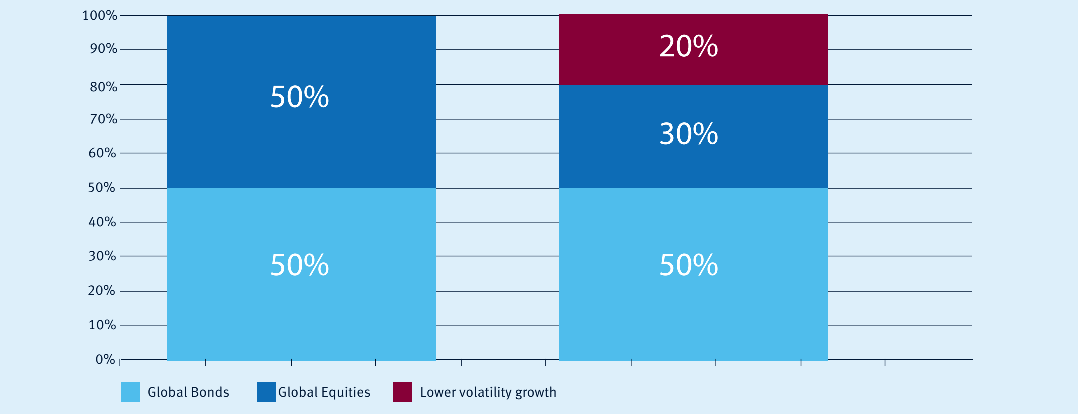
Relative interest rate positions act in a similar way. For example, in the event that bond yields start to rise from their currently very low levels, it will be difficult to make positive returns from holding government bonds. However, interest rates in some countries may stay lower for longer than in others. Profits can be made from relative interest rate movements even if not from absolute movements.

Improving the risk-adjusted return for a traditional portfolio

The diverse spread of assets available to a lower-volatility growth portfolio can have a very positive impact on the wider portfolio.

Figure 1 shows on the left-hand side a simple portfolio allocation that is equally split between global equities and global bonds. Let us assume that we would expect a return of 7% from global equities and 4.5% from global bonds over a market cycle. Using historic correlation and volatility information, we can derive some expected return and risk information for this allocation. Our calculations indicate an expected return of 5.75% and risk of 6.9%, resulting in a return-to-risk reward of 0.84 (5.75/6.9).

Figure 1: Asset allocation of traditional portfolios



If we now reduce the allocation to global equities from 50% to 30% and allocate the remainder to a lower-volatility growth strategy, the risk/reward relationship changes. Return potential (gross of fees) does not change, but the expected volatility falls to 5.8%*. The risk-adjusted return increases from 0.74 to approximately 1 (5.75/5.8), representing a 35% improvement in risk-adjusted performance.

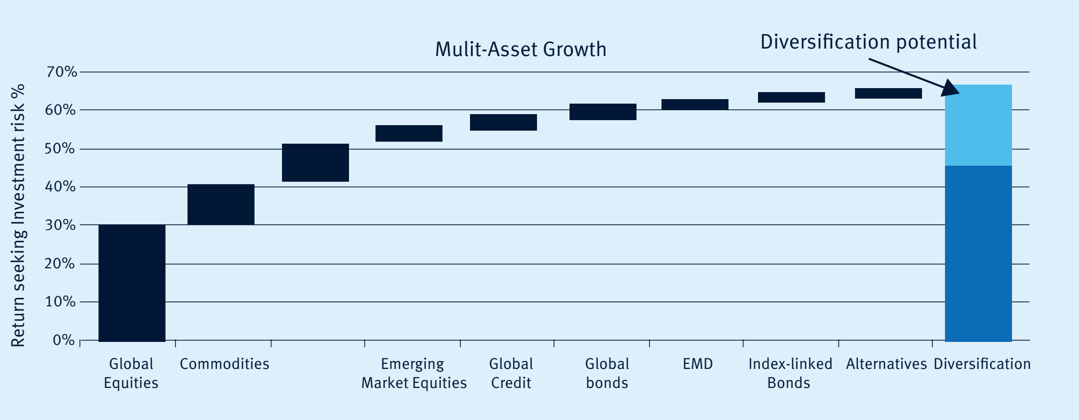
For the wider portfolio manager, this offers additional opportunity. The saving in risk budget might be re-allocated to further investment in low-volatility growth, which would improve the return potential of the portfolio. Alternatively, the investor might simply enjoy the benefits of the same level of return potential but with the expectation of lower risk.
Of course, this analysis depends on the lower-volatility growth portfolio achieving its return and risk expectations over time. In our view, the success or otherwise of these strategies is ultimately determined by the extent of the diversification benefits they can achieve.

Lower-volatility growth portfolios – a risk breakdown

Figure 2 overleaf shows the risk-based holdings of a typical lower-volatility growth portfolio. The darker blue block at the right-hand side of the chart represents the portfolio's expected volatility, typically around two-thirds of equity market risk. This means that, in seeking to deliver its return, the amount of risk the portfolio can deploy is limited to two-thirds of equity market risk plus the risk that can be diversified away (the lighter blue block). Clearly, however, if the level of risk diversification is not substantial, the portfolio will not be able to deploy the total level of return-seeking risk that is required to earn equity-like returns.

*figure derived from historic performance of Standard Life Investments' reduced-volatility, multi-asset growth portfolio which showed 0.75 correlation with global equities since inception in November 2013.

Figure 2: Risk profile of a typical lower-volatility growth portfolio

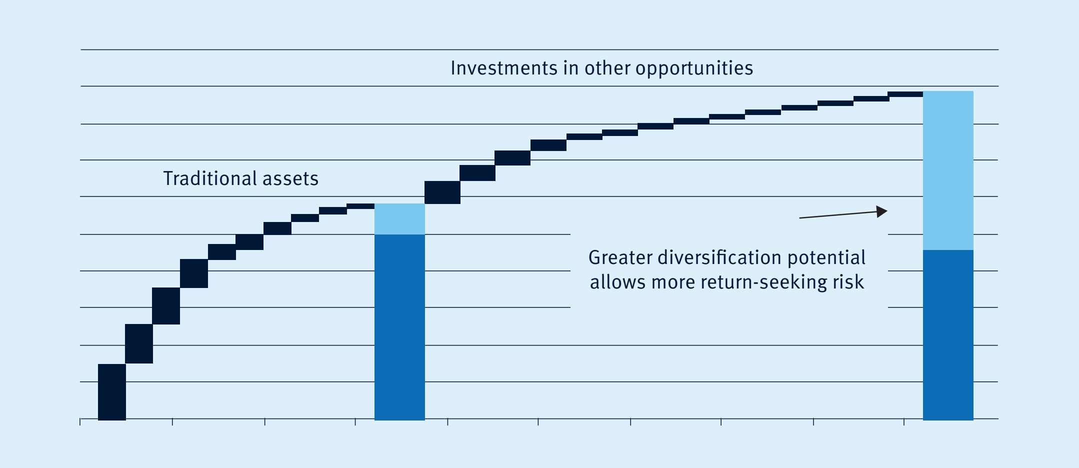


Seeking further risk diversification

In general, while lower-volatility growth strategies have done a good job at reducing portfolio volatility, they have failed to keep pace with equity returns. To remedy this, we have devised a different approach, capable of reducing portfolio volatility while also matching through-the-cycle equity returns.

Our unique 'enhanced-diversification' multi-asset growth strategy invests in a broader range of strategies than traditional low-volatility growth portfolios. So, alongside holdings in equities, corporate bonds and real estate, we add carefully selected investments in relative value equities, interest rates and currencies. This allows us to achieve a significantly higher level of risk diversification. As a result, we are able to deploy far greater return-seeking risk. In this way, we create a much better probability of achieving our long-term return target while, crucially, keeping within the portfolio's expected two-thirds of equity volatility (see Figure 3).

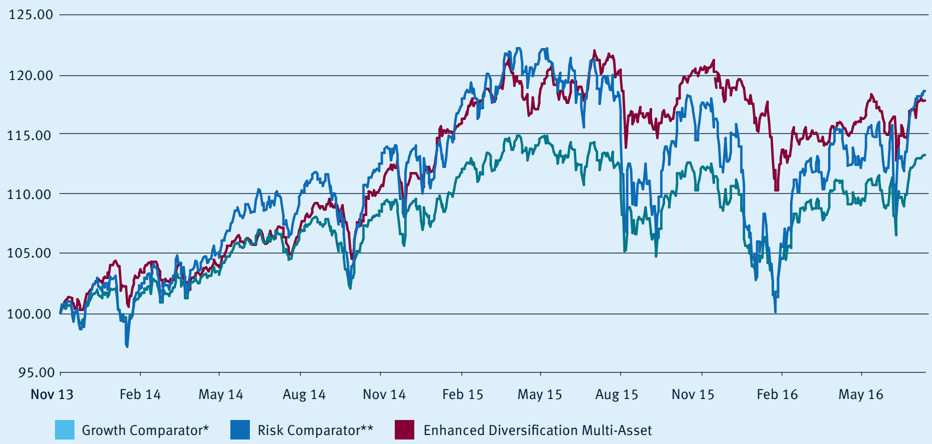
Figure 3: Risk profile - enhanced-diversification multi-asset growth portfolio



An enhanced-diversification multi-asset growth approach in practice

We have been managing enhanced-diversification multi-asset portfolios in the manner described above since 2013. Testament to the effectiveness of this concept, the portfolio has performed exactly as expected since launch (Chart 1). Overall returns have been in line with global equity markets and superior to a 'risk comparator' portfolio that comprises two-thirds global equities and one-third cash (i.e. a portfolio with volatility of two-thirds that of equities). Both the traditional and the broader elements of the portfolio have added value in normal market conditions, with the 'risk dampening' capabilities of the portfolio clearly evident during times of market stress.

Chart 1: Enhanced-diversification multi-asset growth portfolio performance



Enhanced-Diversification Growth Fund GBP Gross Z Shareclass
*MSCI AC World (Hedged to GBP)
**2/3 MSCI AC World (Hedged to GBP) and 1/3 6 Month Libor

Conclusion

Used in conjunction with other investments, lower-volatility growth portfolios offer the potential for superior risk-adjusted performance. An enhanced-diversification multi-asset growth approach can offer further benefits. By accessing a much broader investment universe than many other lower-volatility growth portfolios, it is able to keep pace with equity returns over a market cycle while also delivering lower volatility.

This benefits investors by allowing them to either avoid full equity market volatility or to increase their allocation to growth assets, thereby improving return potential.

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