Investment Insights

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The Benefits of Low Volatility As a Strategic Allocation

Authors

James C. Fallon
Portfolio Manager

Christopher Zani, CFA
Institutional Portfolio Manager

As we move further beyond the golden era of TINA (There Is No Alternative) — when US equity markets enjoyed strong annualized and risk-adjusted returns — it's worth contemplating whether elevated levels of volatility will return in 2024 or for longer.

In markets such as the ones we saw in 2022 wherein the economy faces many headwinds, a consistent strategic allocation to low-volatility stocks may help to maintain an exposure to equities while mitigating overall portfolio risk. In our recent paper "The Time is Right - The Case for Low Volatility Investing" we shared how global low volatility stocks have shown the ability to perform well in market downturns. Exhibit 1 from that paper compares the returns of up markets to those of down markets from worst to best periods since 1991. For each down market (upper part of illustration), low volatility outperforms high volatility. Conversely, during up markets (lower part of illustration), high volatility typically outperforms, and sometimes dramatically.

Historical data show that although low volatility stocks tend to underperform market capital–weighted indices during positive-trending environments, they produced returns comparable or better than cap-weighted indices over the long run. More important, a strategic allocation to low-volatility stocks has the potential to provide a compelling risk/return experience for investors.

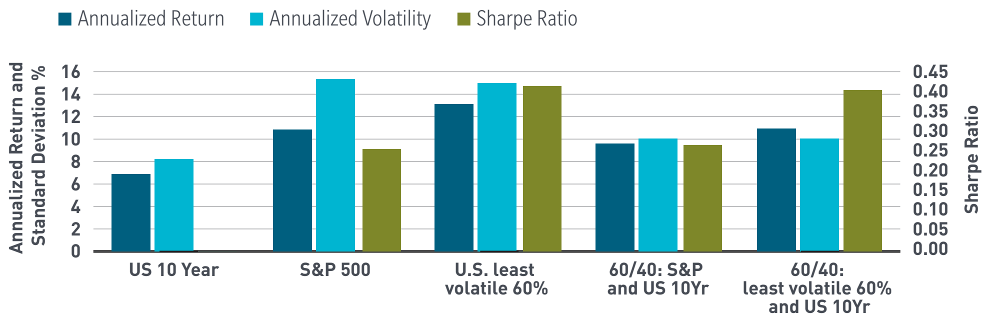
Exhibit 1: Performance of low volatility minus high volatility stocks during ACWI up and down markets

Source: Factset. Volatility based on average monthly standard deviation of returns using past 24 months. High volatility stocks are the 40% of stocks within the universe that have the highest volatility rank. Low volatility stocks are the 60% within the universe that have the lowest volatility. Low volatility minus high volatility data is equal weighted using a universe of about 2,700 global stocks; data annualized except for periods less than 12 months.

Exhibit 2 provides perspective on the long-term performance of low-volatility stocks (middle) compared to US fixed income and equity markets (left-hand side). It shows that from January 1971 to December 2023 a low- volatility investment universe — in this case the least volatile 60% of the 1,000 largest US stocks — outperformed the S&P 500 Index by 226 basis points and with a higher Sharpe ratio (.42, versus .26).[1]

We also provide insight on the benefits of low volatility in a portfolio context by employing a traditional 60/40 portfolio (right-hand side). A 60/40 portfolio, in which 60% is invested in stocks and 40% in bonds, has been the reference point for many portfolios, and its stock-bond combination is core to what has long been considered a diversified portfolio. The 60/40 portfolio using the least volatile 60% US stocks as the equity allocation (far right) provided better returns with less risk than the 60/40 portfolio using the S&P 500 Index.

Exhibit 2: Low volatility stocks offer a better risk/return experience

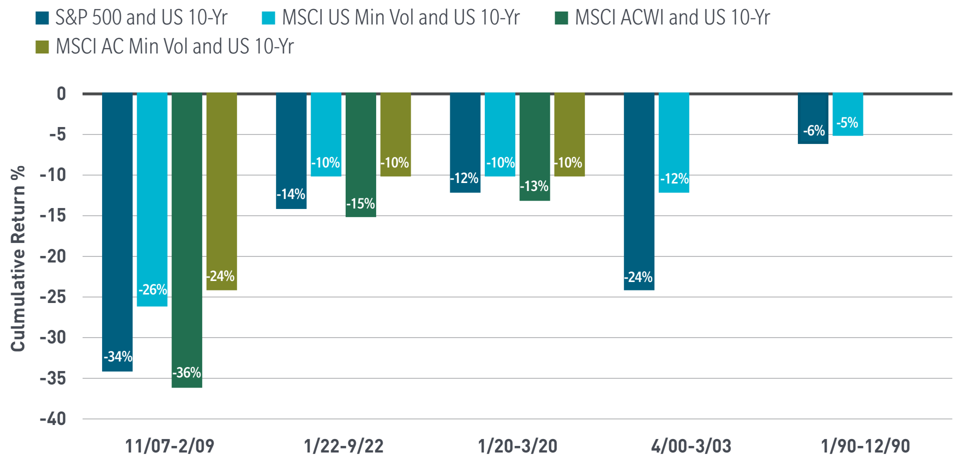


Source: FactSet. Total returns for the period January 1971 through December 2023 for the US Treasury 10-year bond, S&P 500 Index and the least volatile 60% of US stocks (using largest 1,000 US stocks rebalanced monthly) and for 60/40 portfolios with equity allocations utilizing the S&P 500 Index, the least-volatile 60% of US stocks and the US 10-year Treasury as the fixed allocation. Volatility based on average monthly standard deviation of returns using past 24 months.

The analysis above, while helpful in providing perspective on performance over the long term, doesn't provide insight on how a 60/40 portfolio using an allocation to lower volatility stocks will perform in down markets. To provide this perspective, Exhibit 3 compares the performance of four 60/40 portfolios - two utilizing the S&P 500 Index and the MSCI All Country World Index (ACWI), and two using the MSCI US Minimum Volatility Index and the MSCI ACWI Minimum Volatility Index - during the five biggest global down markets identified in exhibit 1.

The results show that the portfolios using an allocation to a minimum volatility index declined less than the portfolios using an allocation to the broad market index across all periods (the exception being the global min vol index in the two farthest dated periods as data was not available). The margin of outperformance for the US portfolio ranged from 1% in the 1990 drawdown to 12% in the tech meltdown of the early 2000's, while the global portfolio outperformed by 3% in the early days of Covid and by 12% during the GFC from 2007 to 2009.

Exhibit 3: Performance of 60/40 portfolios during significant market downturns



Source: FactSet. Cumulative returns for 60/40 portfolios with equity allocations utilizing the S&P 500 Index, the MSCI ACWI, the MSCI US Minimum Volatility Index, the MSCI AC Minimum Volatilty Index and the US 10-year Treasury as the fixed income allocation for the periods identified as the 5 largest recent down markets of the MSCI ACWI.

The goal of any investment professional is to insulate against big losses and mitigate risks as they build a diversified portfolio that has the best chance of delivering compelling returns. We cannot be certain whether equity markets in the years ahead will enjoy the strong returns that we saw over the decade ended in December 2021, or when we will see the global economic environment return to the relative stability experienced during that time. Given this uncertainty, we believe an appropriately sized strategic allocation to a low-volatility strategy may allow investors to lose less in a downturn and realize the long-term competitive returns they seek without having to experience extreme swings.

Endnotes

[1] Sharpe ratio is a measure of risk-adjusted return. It describes how much excess return you receive for the volatility of holding a riskier asset.