

# The Benefits of Low Volatility As a Strategic Allocation

## Authors



James C. Fallon  
Portfolio Manager



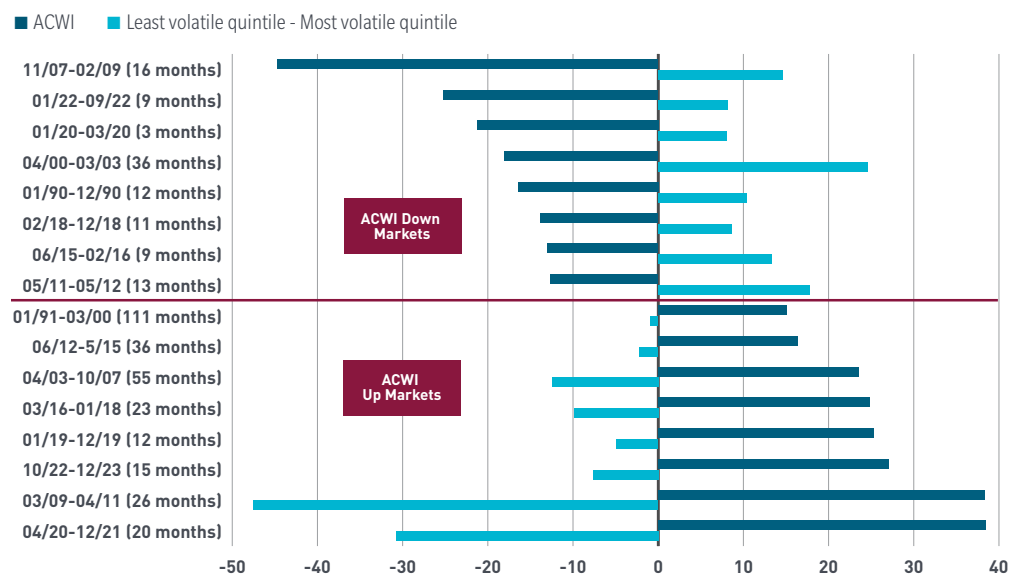
Christopher Zani, CFA  
Institutional Portfolio Manager

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



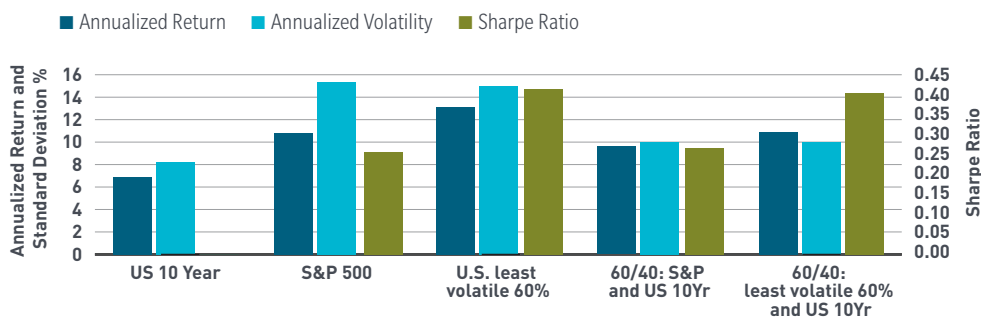
Source: Factset. Volatility based on average monthly standard deviation of returns using past 24 months. High volatility stocks are the 40% of stocks within the universe that have the highest volatility rank. Low volatility stocks are the 60% within the universe that have the lowest volatility. Low volatility 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).<sup>1</sup>

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



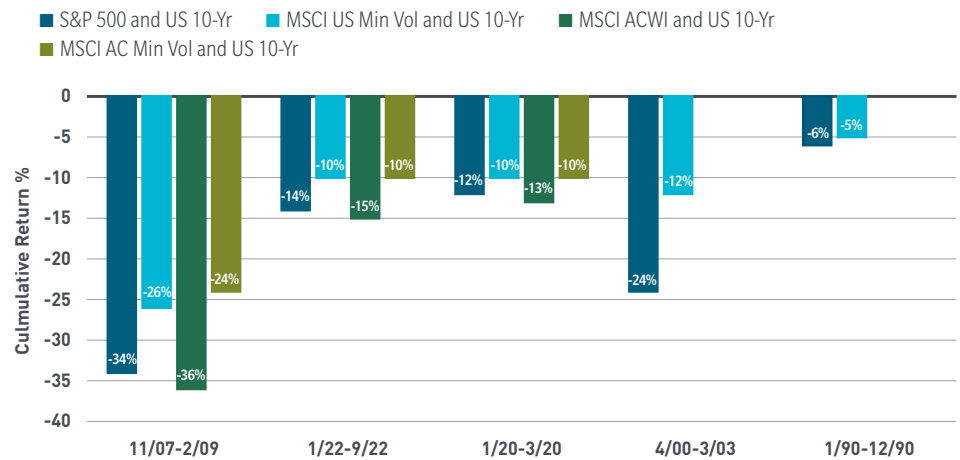
Source: FactSet. Total returns for the period January 1971 through December 2023 for the US Treasury 10-year bond, S&P 500 Index and the least volatile 60% of US stocks (using largest 1,000 US stocks rebalanced monthly) and for 60/40 portfolios with equity allocations utilizing the S&P 500 Index, the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

<sup>1</sup> 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.

“Standard & Poor’s<sup>SM</sup>” and S&P “S&P<sup>SM</sup>” are registered trademarks of Standard & Poor’s Financial Services LLC (“S&P”) and Dow Jones is a registered trademark of Dow Jones Trademark Holdings LLC (“Dow Jones”) and have been licensed for use by S&P Dow Jones Indices LLC and sublicensed for certain purposes by MFS. The S&P 500<sup>®</sup> is a product of S&P Dow Jones Indices LLC and has been licensed for use by MFS. MFS’ Products are not sponsored, endorsed, sold or promoted by S&P Dow Jones Indices LLC, Dow Jones, S&P, or their respective affiliates, and neither S&P Dow Jones Indices LLC, Dow Jones, S&P, their respective affiliates make any representation regarding the advisability of investing in such products.

MSCI makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indices or any securities or financial products. This report has not been approved, reviewed or produced by MSCI.

**The views expressed are those of the author(s) and are subject to change at any time. These views are for informational purposes only and should not be relied upon as a recommendation to purchase any security or as a solicitation or investment advice. No forecasts can be guaranteed. Past performance is no guarantee of future results.**

Unless otherwise indicated, logos and product and service names are trademarks of MFS<sup>®</sup> and its affiliates and may be registered in certain countries.

Distributed by: **U.S.** – MFS Institutional Advisors, Inc. (“MFSI”), MFS Investment Management and MFS Fund Distributors, Inc., Member SIPC; **Latin America** – MFS International Ltd.; **Canada** – MFS Investment Management Canada Limited. **Note to UK and Switzerland readers:** Issued in the UK and Switzerland by MFS International (U.K.) Limited (“MIL UK”), a private limited company registered in England and Wales with the company number 03062718, and authorised and regulated in the conduct of investment business by the UK Financial Conduct Authority. MIL UK, an indirect subsidiary of MFS<sup>®</sup>, has its registered office at One Carter Lane, London, EC4V 5ER. **Note to Europe (ex UK and Switzerland) readers:** Issued in Europe by MFS Investment Management (Lux) S.à r.l. (MFS Lux) – authorized under Luxembourg law as a management company for Funds domiciled in Luxembourg and which both provide products and investment services to institutional investors and is registered office is at S.a r.l. 4 Rue Albert Borschette, Luxembourg L-1246. Tel: 352 2826 12800. This material shall not be circulated or distributed to any person other than to professional investors (as permitted by local regulations) and should not be relied upon or distributed to persons where such reliance or distribution would be contrary to local regulation; **Singapore** – MFS International Singapore Pte. Ltd. (CRN 201228809M); **Australia/New Zealand** - MFS International Australia Pty Ltd (“MFS Australia”) (ABN 68 607 579 537) holds an Australian financial services licence number 485343. MFS Australia is regulated by the Australian Securities and Investments Commission.; **Hong Kong** - MFS International (Hong Kong) Limited (“MIL HK”), a private limited company licensed and regulated by the Hong Kong Securities and Futures Commission (the “SFC”). MIL HK is approved to engage in dealing in securities and asset management regulated activities and may provide certain investment services to “professional investors” as defined in the Securities and Futures Ordinance (“SFO”).; **For Professional Investors in China** – MFS Financial Management Consulting (Shanghai) Co., Ltd. 2801-12, 28th Floor, 100 Century Avenue, Shanghai World Financial Center, Shanghai Pilot Free Trade Zone, 200120, China, a Chinese limited liability company registered to provide financial management consulting services.; **Japan** - MFS Investment Management K.K., is registered as a Financial Instruments Business Operator, Kanto Local Finance Bureau (FIBO) No.312, a member of the Investment Trust Association, Japan and the Japan Investment Advisers Association. As fees to be borne by investors vary depending upon circumstances such as products, services, investment period and market conditions, the total amount nor the calculation methods cannot be disclosed in advance. All investments involve risks, including market fluctuation and investors may lose the principal amount invested. Investors should obtain and read the prospectus and/or document set forth in Article 37-3 of Financial Instruments and Exchange Act carefully before making the investments; **Bahrain** - This document has not been approved by the Central Bank of Bahrain which takes no responsibility for its contents. No offer to the public will be made in the Kingdom of Bahrain and this document is intended to be read by the addressee only and must not be passed to, issued to, or shown to the public generally. The Central Bank of Bahrain assumes no responsibility for the accuracy and completeness of the statements and information contained in this document and expressly disclaims any liability whatsoever for any loss howsoever arising from reliance upon the whole or any part of the contents of this document. The Board of Directors and the management of the issuer accepts responsibility for the information contained in this document. To the best of the knowledge and belief of the board of directors and the management, who have all taken all reasonable care to ensure that such is the case, the information contained in this document is in accordance with the facts and does not omit anything likely to affect the reliability of such information.; **Kuwait** - This document is not for general circulation to the public in Kuwait. The information has not been licensed for offering in Kuwait by the Kuwait Capital Markets Authority or any other relevant Kuwaiti government agency. No private or public offering of the information is being made in Kuwait, and no agreement relating to the information will be concluded in Kuwait. No marketing or solicitation or inducement activities are being used to offer or market the information in Kuwait.; **Oman** - For Residents of the Sultanate of Oman: The information contained in this document does not constitute a public offer of securities in the Sultanate of Oman as contemplated by the Commercial Companies Law of Oman (Royal Decree 4/74) or the Capital Market Law of Oman (Royal Decree 80/98). This information is being circulated on a limited basis only to corporate entities that fall within the description of sophisticated investors (Article 139 of the Executive Regulations of the Capital Market Law). The recipient acknowledges that they are a sophisticated investor who has experience in business and financial matters and is capable of evaluating the merits and risks on an investment.; **South Africa** - This document has not been approved by the Financial Services Board and neither MFS International (U.K.) Limited nor its funds are registered for public sale in South Africa.; **UAE** - This document, and the information contained herein, does not constitute, and is not intended to constitute, a public offer of securities in the United Arab Emirates and accordingly should not be construed as such. The information is only being offered to a limited number of exempt investors in the UAE who fall under one of the following categories of non-natural Qualified Investors: (1) an investor which is able to manage its investments on its own, namely: (a) the federal government, local governments, government entities and authorities or companies wholly-owned by any such entities; (b) international entities and organisations; or (c) a person licensed to carry out a commercial activity in the UAE, provided that investment is one of the objects of such person; or (2) an investor who is represented by an investment manager licensed by the SCA, (each a “non-natural Qualified Investor”). The information and data have not been approved by or licensed or registered with the UAE Central Bank, the Securities and Commodities Authority, the Dubai Financial Services Authority, the Financial Services Regulatory Authority or any other relevant licensing authorities or governmental agencies in the UAE (the “Authorities”). The Authorities assume no liability for any investment that the named addressee makes as a non-natural Qualified Investor diligence on the accuracy of the information relating to the securities. If you do not understand the contents of this document you should consult an authorised financial adviser.; **Saudi Arabia** - This document may not be distributed in the Kingdom except to such persons as are permitted under the Investment Funds Regulations issued by the Capital Market Authority. The Capital Market Authority does not make any representation as to the accuracy or completeness of this document, and expressly disclaims any liability whatsoever for any loss arising from, or incurred in reliance upon, any part of this document. Prospective purchasers of the securities offered hereby should conduct their own due diligence on the accuracy of the information relating to the securities. If you do not understand the contents of this document, you should consult an authorised financial adviser.; **Qatar** - This material/fund is only being offered to a limited number of investors who are willing and able to conduct an independent investigation of the risks involved in an investment in such material/fund. The material does not constitute an offer to the public and is for the use only of the named addressee and should not be given or shown to any other person (other than employees, agents or consultants in connection with the addressee’s consideration thereof). The fund has not been and will not be registered with the Qatar Central Bank or under any laws of the State of Qatar. No transaction will be concluded in your jurisdiction and any inquiries regarding the material/fund should be made to your contact outside Qatar.