DRS vs. Low Volatility Strategies

Strategy Comparison Series

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One of the new strategies attracting attention and assets these days is “low volatility” investing. Also described as “managed volatility” or “minimum volatility,” these strategies are marketed as a better mousetrap in the world of investing. With this post, we will analyze whether or not these low volatility strategies really have anything new to offer. This fits into an ongoing series of posts where we answer the following questions:

1. What are the drivers of returns in each strategy?
2. What are the risks in each strategy?
3. What role does a given strategy play within a portfolio?
4. How does the given strategy compare to the Defined Risk Strategy?

Before discussing the above topics, however, it is necessary to define just what people mean when they use the term “low volatility” investing.

Low volatility better describes an outcome or a goal rather than an investment process; there are several different ways one can produce low volatility results. The products called low volatility or managed volatility typically follow one of two different investment strategies.

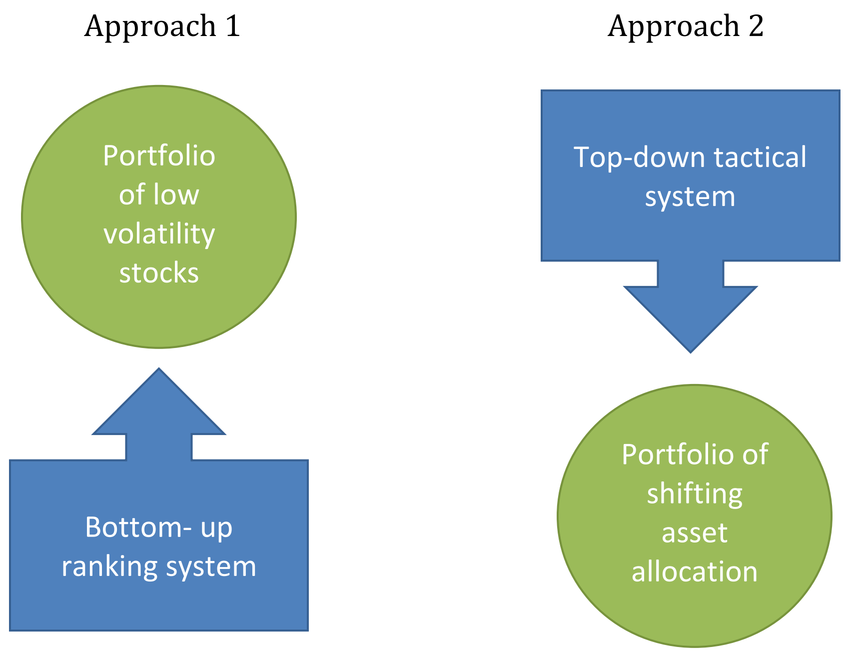
Two Types of Low Volatility Investing

The first and more common approach to low volatility investing is essentially a form of factor analysis. Using a quantitative scoring system, a large pool of stocks is scored then ranked on either their historic or anticipated volatilities. A portfolio is then assembled from the stocks that have favorable, low volatility rankings. For anyone familiar with the “smart beta” movement, this type of factor analysis should sound quite similar.

An alternative way to produce low volatility results is to sell out of the more volatile asset classes before things go south. A strategy like this might potentially invest in equities, bonds, cash and attempt to produce less volatile results by moving from equities to fixed income before a correction or bear market and then jump back in to equities during bull markets. Of course, some would call such a strategy tactical asset allocation or market-timing, and they wouldn’t be too far from the truth.

Different Approaches, Same End

These are two very different paths that attempt to get to the same end point, i.e. a pattern of returns less volatile than that of a buy-and-hold, fully invested, cap-weighted index like the S&P 500. The former approach of scoring individual stocks on their volatility characteristics is more of a bottom-up strategy, whereas the latter, tactical asset allocation approach can be described as top-down. When it comes to the returns, risks, and roles of low volatility or minimum volatility, the two approaches must be treated differently.



Drivers of Returns

If a low volatility strategy is built from the bottom up by ranking individual stocks on their "volatility scores," then success or failure will largely depend on whether or not that factor happens to be in favor. Smart beta, factor analysis, strategic beta, whatever you want to call it, is all the same thing. A subset of stocks from a large pool is identified to be more sensitive to or display certain quantifiable traits. The list of potential traits is inexhaustible, but some of the more common ones are value, growth, dividends, momentum, size, and, yes, volatility. The problem, however, is that there is no one magic factor that always works. Every factor will have periods when it is working and periods when it does not.

For the top-down, market-timing approach to volatility management, the drivers of returns will be at the asset class level, and the keys to success is being in the right place at the right time. Certainly if one has the wherewithal to 1) successfully forecast major market sell-offs and avoid them and 2) predict when markets are about to take off and capitalize on rallies, then their performance results would look fantastic.

Risks

As discussed previously, when it comes to factor analysis, no factor works all the time. The best a factor-based approach can reasonably hope for is to be right more often than it is wrong. The bigger risk, however, is that most factor analysis does nothing to address the biggest "factor" of all—market risk. A fully invested portfolio that tilts toward low volatility, or any other factor, is unlikely to avoid significant losses should the markets sell off by 30%, 40%, 50% or more. This topic is explored in our blog post on smart beta strategies and systematic risk.

For those low volatility strategies that employ a top-down, market timing approach, the risks are different. As stated before, the key to success with the market is being in the right place at the right time. The risks, however, are being in the wrong place at the wrong time. If one "misses the boat" with their tactical asset allocation decisions, either absolute or relative performance can suffer greatly. Market-timing is explored in depth in this blog post, but can be summarized with the old catch phrase, "Live by the sword, die by the sword."

Role in a Portfolio

If either a bottom-up, factor-driven or top-down, market timing low volatility strategy is able to successfully generate lower overall volatility, then it would likely benefit an overall portfolio. In a previous blog, we discussed the detrimental impact volatility drag or variance drain can have on an investment's return. Low volatility is certainly a desirable trait in an investment. In fact, the DRS also has "low volatility" as a goal for its portfolio, but we seek to accomplish low volatility in a different fashion.

Low Volatility Strategies vs. Defined Risk Strategy

Where the DRS differs from "low volatility" or "managed volatility" strategies are in philosophy and approach. Swan believes that the biggest risk that any investor faces is market and systematic risk. During the big, bear market sell-offs, almost everything tends to go down at the same time. A factor-based, bottom-up, low volatility strategy might outperform the S&P 500 on a relative basis, but it will likely still lose a significant amount in absolute terms. With respect to market-timing, Swan has always been skeptical. Swan believes it is too difficult to consistently call the tops and bottoms of markets and reposition the portfolio accordingly.

It is these two core beliefs—the concern regarding market risk and a lack of faith in market-timing—that underpin our "always invested, always hedged" philosophy. Unlike the top-down, market-timing strategies, we remain "always invested" with our buy-and-hold positions in market ETFs. While bottom-up, volatility-factor analysis fails to address systematic risk, we seek to do so and remain "always hedged" by protecting the portfolio via long-term put options. Using this time-tested strategy, we believe we have a better way of producing low volatility results.

About the Author:

Marc Odo, CFA®, CAIA®, CIPM®, CFP®, Director of Investment Solutions, is responsible for helping clients and prospects gain a detailed understanding of Swan's Defined Risk Strategy, including how it fits into an overall investment strategy. Formerly, Marc was the Director of Research for 11 years at Zephyr Associates.

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