RBC Global Asset Management
PH&N Institutional

Low volatility equities in (another) turbulent year

Low volatility equity strategies have historically performed much better than the broader stock market during market declines.[1] However, during the pandemic-induced market decline in the first quarter of 2020, the average low volatility equity strategy – while outperforming broad market indices – did so by a much smaller margin than historically,[2] a subject we discussed in a paper at that time. In that paper, we argued that the reason for this disappointing result was the unique causes of that market decline, and that this outcome should not be interpreted to mean that low volatility equity strategies were "broken." In this update, we look at the first half 2022 equity market drawdown, its causes, and the more favourable capital protection low volatility equity strategies were able to generate this time around.

Introduction

In recent years, we have witnessed meaningful uptake in low volatility equity strategies by institutional investors globally. While not all low volatility equity strategies are constructed in the same manner and investors' reasons for implementing a low volatility equity strategy may differ, a common trait shared by most of these strategies is that they typically invest in "defensive" stocks of stable, more mature businesses that generate more reliable earnings and cash flow streams. This has generally led to strong downside protection versus broad market indices.

However, during the pandemic-induced market decline in the first quarter of 2020, most low equity volatility strategies – while outperforming broad market indices – did so by a much smaller margin than historically.[3]

As policymakers moved quickly and assertively to support the global economy in 2020, equity markets roared higher. This further challenged the faith of low volatility investors as these strategies lagged the broad market rally,[4] notwithstanding the fact that these strategies should be expected to lag in such an environment.

Markets declined sharply once again in the first half of 2022, and may not have found a bottom as of this writing. But a silver lining of the current drawdown is that it has given low volatility equity strategies another opportunity to prove their worth.

History doesn't repeat, but it rhymes

The phrase above is used so often in the investment industry that it's a cliché, but it's a helpful notion to keep in mind because it's true. While no two equity market declines are exactly the same, they often share certain causes and characteristics.

The decline in markets in 2020 was unique because it was caused by a policy-induced recession, as governments took steps to slow the spread of COVID-19. As a result, spending on certain technologies accelerated significantly, there was a sharp shift in consumption away from "traditional" brick-and-mortar stores and services and towards online shopping for goods, and social distancing measures negatively impacted retail and office real estate.

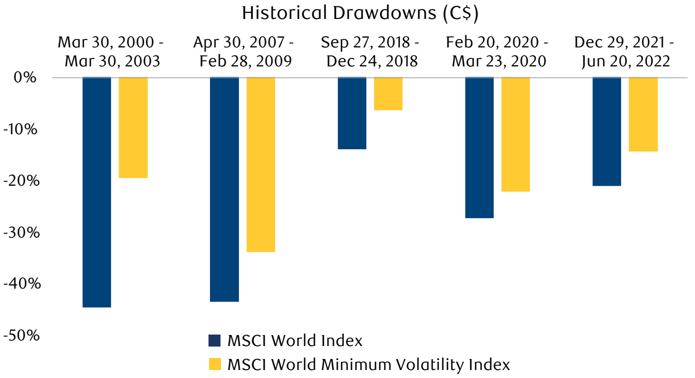
In markets, this could be seen in the uncharacteristic-for-a-recession performance of certain sectors, notably the significant outperformance of technology companies that benefitted from this environment, many of which had come to represent large weights in capitalization-weighted indices. This made it challenging for many low volatility equity strategies to outperform, as they are often underweight these companies.

The causes of the decline in markets in 2022 have been much different. It began with an increase in interest rates in the second half of 2021 that hurt the valuations of high-growth companies – so called long-duration stocks – where significant cash flows were many years in the future. Then, as it became apparent that inflation was stronger than nearly everyone had anticipated, and that central banks would need to respond aggressively to slow growth and bring inflation back under control, cyclical areas of the market began to underperform.

[1] As of September 30, 2020, median downside capture of eVestment's Global Low Volatility peer group was 65% over the past 7 years.
[2] PH&N Institutional, "Low Volatility Equities in a Turbulent Year," January 2021.
[3] Ibid.
[4] Ibid.

This is a much more typical economic pattern, and low volatility equity strategies tend to be underweight both high growth and cyclical businesses, in favour of more defensive businesses. It should come as no surprise then that, in this most recent drawdown, low volatility equity strategies have resumed their pattern of outperforming during market declines.

Figure 1: Relative performance of MSCI World Index vs. MSCI Global Minimum Volatility Index during market drawdowns



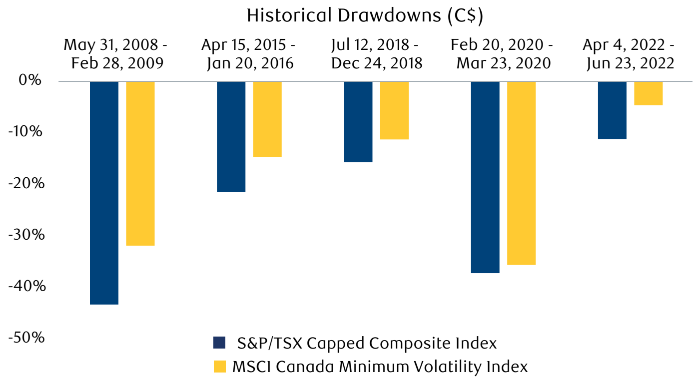
Source: RBC GAM, MSCI. Represents the five largest drawdowns for the MSCI World Index since 2000. Returns are calculated using monthly data for periods prior to 2010, and daily data for subsequent periods. The MSCI World Minimum Volatility Index was launched on Apr 14, 2008. Data prior to the launch date is back-tested test (i.e. calculations of how the index might have performed over that time period had the index existed). There are frequently material differences between back-tested performance and actual results. Past performance – whether actual or back-tested – is no indication or guarantee of future performance. Back-tested data provided by MSCI.

As noted above, however, every cycle is different, and this one bears a few unusual features. One is that, for the first time in decades, interest rates are rising at the same time as the market is anticipating an economic slowdown and equity markets are falling. Rising rates aren't always good for the relative performance of low volatility equity strategies, as these strategies tend to have large allocations to traditionally interest-rate-sensitive sectors such as Utilities. However, in this cycle, rising rates have had a greater impact on the valuations of high-growth companies as noted above, while Utilities have benefitted from the expected resilience of their earnings in a slowing economic environment.

Another unusual feature of this drawdown has been the performance of the Energy sector. Consumption of oil and natural gas is sensitive to growth in the economy, and this highly volatile sector would typically underperform in a period where the market anticipates slowing growth. This was the case in 2020, when plummeting demand caused oil to briefly trade for a negative price. This time around, while slowing growth and economic shutdowns in China have impacted demand, these factors have been dwarfed by the war in Ukraine as well as a slower-than-normal supply side response from the rest of the world; as a result, oil prices are currently near all-time highs.

The resulting outperformance of Energy stocks has meant that the Canadian equity market, with its large weighting in oil and gas producers, has been the top-performing major developed market in the first half of 2022. This is unusual, as the Canadian market tends to be more cyclical and volatile than other markets globally. As for the performance of low volatility equity strategies in Canada, this has meant that they have not outperformed by as much as they have in other parts of the world.[5]

Figure 2: Relative performance of the S&P/TSX Capped Composite Index vs MSCI Canada Minimum Volatility Index during market drawdowns



Source: RBC GAM, MSCI. Represents the five largest drawdowns for the S&P/TSX Capped Composite Index since 2002. Returns are calculated using monthly data for periods prior to 2010, and daily data for subsequent periods. The MSCI Canada IMI Minimum Volatility (CAD) Index was launched on Feb 01, 2016. Data prior to the launch date is back-tested test (i.e. calculations of how the index might have performed over that time period had the index existed). There are frequently material differences between back-tested performance and actual results. Past performance – whether actual or back-tested – is no indication or guarantee of future performance. Back-tested data provided by MSCI.

Conclusion

As of this update, it is not clear whether the current market volatility is behind us. If it is, and markets recover sharply, then low volatility equity strategies may well lag again. However it is reassuring to see that they have performed their role well during the most recent drawdown, helping protect investors' capital when other parts of their portfolios are underperforming.

[5] Source: RBC GAM, MSCI. As at June 30th, 2022, the MSCI Canada Minimum Volatility Index has outperformed the S&P/TSX Composite Index by 5.4% year to date, while the MSCI World Minimum Volatility Index has outperformed the MSCI World Index by 8.3% year to date.

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