The upside of less downside - how defence can win in Au equities

Roy Maslen & Hamish Fitzsimons | AB Global | 30 May 2017

Investors want equities for growth and income. But equity markets fall, and fall frequently. In two out of every three years, the market experiences a 10% or greater decline from peak to trough. These sell-offs can cause lasting financial and emotional harm to investors.

The financial impacts are especially damaging for investors approaching, or in, retirement. They may need to put off their retirement date or withdraw money at the bottom of the market to meet their day-to-day needs, which locks in losses.

The emotional turbulence of being trapped in a downward spiral of stock prices can cause financial pain by leading investors to sell stocks at the wrong time. It can also drain investors' confidence, which can delay their return to the market until stock prices are much less cheap. Professionals also feel the effects, as they must spend time soothing clients time that could be better spent giving advice.

There is a way to invest in equities that can help ease the emotional and financial sting of market downturns by seeking to "smooth the ride". It involves managing upside/downside capture, or the extent to which a portfolio participates in markets when they rise and when they fall.

It's possible to achieve equity market-like returns with less risk by forgoing some upside when markets rise and reducing the downside when markets fall. To do this, investors need to be independent of the benchmark and diversified effectively, focusing on the stability, quality and price of individual stocks.

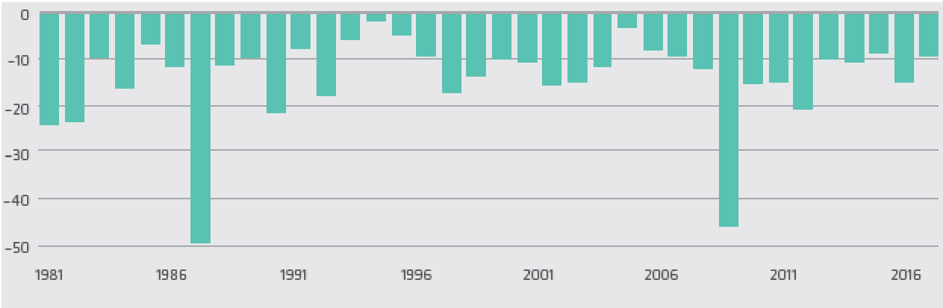
This paper looks at how upside/downside capture works, how it can help investors avoid the risks of market benchmarks, why it's relevant to investors across the age spectrum, and why some strategies are more effective than others in terms of upside/downside capture.

1. VOLATILITY: A CHALLENGE FOR ALL INVESTORS

Many investors, whatever their risk profile, need equities in their portfolios. Thanks to the compounding of reinvested capital gains and dividends, stocks have the potential for attractive long-term performance. The average 10-year rolling return for the All Ordinaries Index from 1980 to 2016 was more than 11%.

But long-term averages mask the underlying short-term volatility of the asset class. Equity downturns are quite common, and at times severe (Figure 1). This volatility is a challenge for all investors, irrespective of where they are in the investment lifecycle.

Figure 1: Annual equity drawdowns are frequently above 10%
S&P/ASX All Ordinaries Calendar-year drawdowns (%)
To 31 December 2016



Source: S&P Dow Jones. Largest peak-to-trough move within a calendar year.

For investors who are approaching retirement or are already retired, the effects of equity volatility can be particularly serious. During the global financial crisis, many pre-retirees saw their wealth cut almost in half just as they were about to leave the workforce. Some were faced with a stark choice: keep working or accept a lower standard of living in retirement.

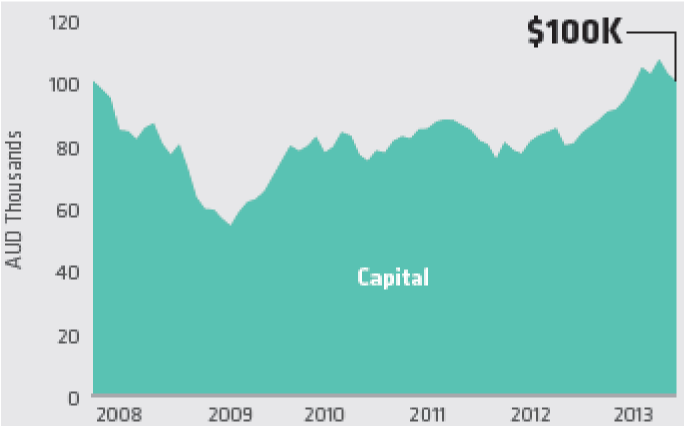
The pain of equity declines can be even more intense for people already in retirement. Markets might recover relatively quickly, but the chances of retirees fully recouping their losses are small, because they must withdraw cash from their investments to meet their living expenses – or else compromise their lifestyles.

To see what's at stake, compare the experience of three investors:

- a buy-and-hold investor;
- a retiree withdrawing from his assets to meet his living costs; and,
- an investor who switched to cash.

The buy-and-hold investor with $100,000 invested in the S&P/ASX 200 Index in October 2007 – just before the Global Financial Crisis – would have nearly recouped his losses in early 2013, before the portfolio lost ground again in June of that year (Figure 2).

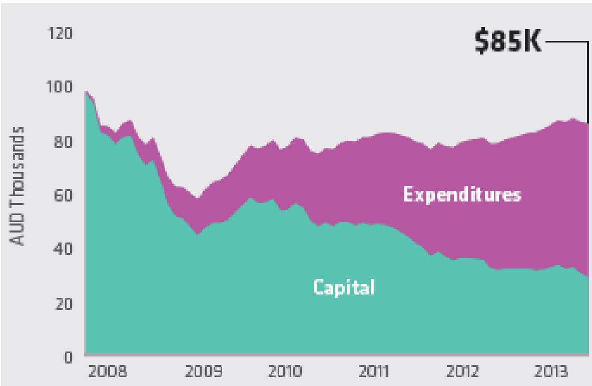
Figure 2: Buy and hold investor
From 1 October 2007 to 30 June 2013



Source: FactSet, MSCI, S&P Dow Jones, Thomson Reuters I/B/E/S, Worldscope and AB; see Disclosures and Important Information. Past performance is no guarantee of future results. Based on A$100,000 invested in October 2007 in the S&P/ASX 200 Index Performance figures include the value of any franking (or imputation) credits received.

The retiree spending $10,000 a year from assets invested over the same six-year time frame would have been worse off, to the tune of $15,000. Why? The ability to recover his capital loss would be reduced by his need to withdraw assets to meet his spending needs, leaving him less wealth to take part in the market rebound (Figure 3).

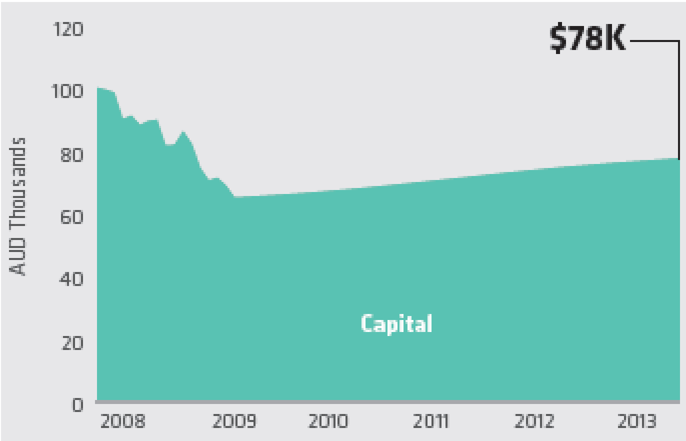
Figure 3: Retiree spending $10,000 a year
From 1 October 2007 to 30 June 2013



Source: FactSet, MSCI, S&P Dow Jones, Thomson Reuters I/B/E/S, Worldscope and AB; see Disclosures and Important Information. Past performance is no guarantee of future results. Based on A$100,000 invested in October 2007 in the S&P/ASX 200 Index Performance figures include the value of any franking (or imputation) credits received.

The third investor, who succumbed to emotion and switched to cash in response to the market downturn, would have been worse off still, trailing the buy-and-hold investor by $22,000 (Figure 4).

Figure 4: "Fearful saver" switching to cash*
From 1 October 2007 to 30 June 2013



Source: FactSet, MSCI, S&P Dow Jones, Thomson Reuters I/B/E/S, Worldscope and AB; see Disclosures and Important Information. Past performance is no guarantee of future results. Based on A$100,000 invested in October 2007 in the S&P/ASX 200 Index Performance figures include the value of any franking (or imputation) credits received. *Move to cash occurs on February 28, 2009.

2. MANAGING UPSIDE/DOWNSIDE CAPTURE CAN HELP

Taking advantage of better upside/downside capture requires investors to redefine success.

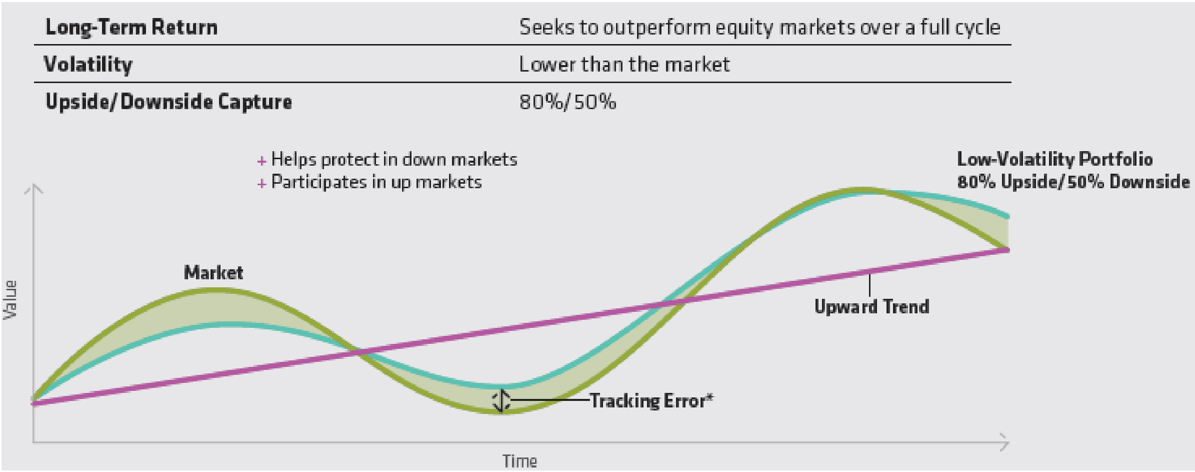
Some investors are comfortable with sticking close to an index and enduring the inevitable volatility. They get equity market returns with equity market risk, based around the companies that are included in the index – for better or worse. This approach adheres to the investing maxim that investors must accept higher risk for the prospect of greater returns, and give up on higher returns if they want to reduce risk.

Many investors want something different, however equity market returns over a full cycle with a smoother ride. How is it possible to achieve investment success with this goal? Because that investing maxim turns out to not be entirely correct.

In reality, stocks with lower volatility are systematically underpriced – the "low-volatility anomaly". There is much research that seeks to explain this anomaly, mostly centered around behavioural economics. Essentially, humans are not always perfectly rational.

By exploiting this low-volatility anomaly, it's possible for investors to build equity portfolios designed to sacrifice some upside while reducing downside (Figure 5). Over a full market cycle, this type of strategy can ultimately outperform.

Figure 5: An equity portfolio with a "smoother ride"



Source: AB. For illustrative purposes only. * Tracking error: The difference between portfolio returns and the market.

Imagine a hypothetical equity portfolio designed to capture 80% of every market rally and fall only 50% as much as the market during every sell-off. Historically, how would such a portfolio have performed over the long term?

You might think that this strategy would have underperformed the broad equity index, but a portfolio designed this way can indeed outperform the market. Our research shows, for example, that it would have beaten the S&P/ASX 200 by more than three percentage points between January 1990 and December 2016, with much less risk and volatility (Figure 6).

The reason is simple – a portfolio with reduced downside risk loses less in sell-offs, so it has less ground to make up when markets recover.

Figure 6: Low volatility can outperform over time
Calculated performance of a hypothetical low-volatility portfolio vs. S&P/ASX 200
1 January 1990 to 1 December 2016

	S&P/ASX 200	Low Volatility Portfolio*
Annualised Return	9.1%	12.3%
Annualised Volatility	13.2%	8.7%

Source: FactSet, S&P Dow Jones and AB. For illustrative purposes only. Past performance is no guarantee of future results. * Captures 50% of the downside and 80% of the upside. Calculations based on monthly periods; market rallies and downturns can take place over both shorter and longer periods.

3. ACTIVE MANAGEMENT: A KEY TO EFFECTIVE LOW-VOLATILITY STRATEGIES

While a portfolio of stocks with low volatility or relatively stable share prices might sound low maintenance, it shouldn't be confused with a passive strategy. "Smoothing the ride" through the market's ups and downs requires careful design and dynamic active management.

Investors should focus on four critical areas to implement a low-volatility equity strategy successfully:

- Invest in stocks with attractive stability, quality and price attributes;
- Avoid "volatility traps" - stocks that have shown low volatility but could change;
- Diversify: The index reflects the listed stocks, not necessarily the most effective stocks; and,
- Manage macro risks - and don't manage one risk by taking on another

3.1 Invest in stocks with stability, quality and reasonable valuations

There are multiple ways to beat the benchmark in equities. For investors focused on beating it by reducing downside, stability matters most.

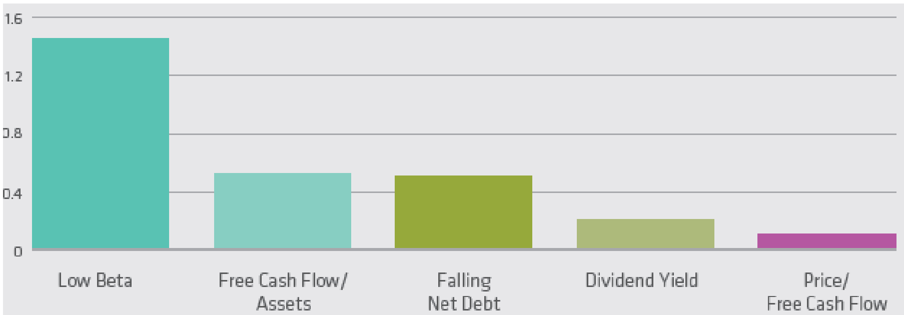
It's logical to begin with price stability, identifying stocks with low beta or a low correlation to broad market moves. A stock's beta can change over time, so it's important to look at how the stock has performed relative to the market over a long period (five years, for example) as well as more recently (the past 12 months). This perspective helps gauge whether the overall pattern of stability may be changing.

But stability alone is not enough - a focus on quality can uncover stocks that may be more likely to offer lasting stability. Price or a reasonable valuation is always important, too, because stability should be bought at the best possible price.

The importance of combining low volatility (low beta) with quality (balance-sheet strength) and reasonable valuation (a low price-to-free- cash-flow ratio) is shown in Figure 7, together with other relevant factors.

Each bar shows the returns for the most attractive 20% of stocks for each factor during the months when the S&P/ASX 200 was down. Stocks with high free cash flow to assets, low asset growth, and declining shares on issue and net debt have delivered superior returns in down markets.

Figure 7: Invest in stability and quality with reasonable valuation
Relative monthly returns for factors in months when index* is down (%)
1 January 1990 to 31 December 2016



Source: FactSet, MSCI, S&P Dow Jones, Thomson Reuters I/B/E/S, Worldscope and AB; see Disclosures and Important Information. Past performance is no guarantee of future results. Returns of the most attractive 20% of stocks for each factor. * Subset of S&P/ASX 200 consisting of large-cap stocks, as defined by AB.

Quantitative research can be an effective tool in identifying and analysing the presence of these factors across all stocks in the market.

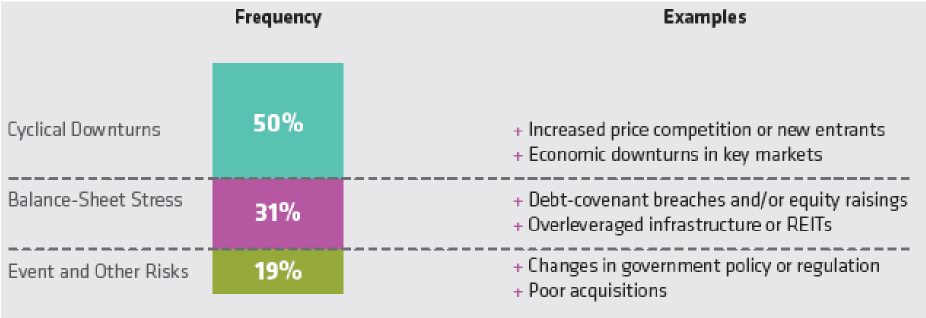
3.2 Avoid volatility traps

Quantitative research alone isn't enough to protect against the harsh realities of life, however. Even stocks that score highly on each factor can fall prey to unexpected developments that undermine their prices.

For example, a utility company in a sector that is undergoing a large-scale regulatory review may appear to be stable. But the stability won't necessarily be permanent if the outcome of the regulatory review could hurt the utility. This is the so-called volatility trap.

Volatility traps usually result from stock-specific causes, and the way to avoid them is with fundamental, bottom-up stock research. Figure 8 shows that cyclical downturns account for 50% of volatility traps, followed by balance-sheet stress and event risk.

Figure 8: Avoid volatility traps through strong fundamental research



Source: FactSet, MSCI, S&P Dow Jones, Thomson Reuters I/B/E/S, Worldscope and AB; see Disclosures and Important Information. Past performance is no guarantee of future results. Based on AB research for the period from January 2002 to July 2012.

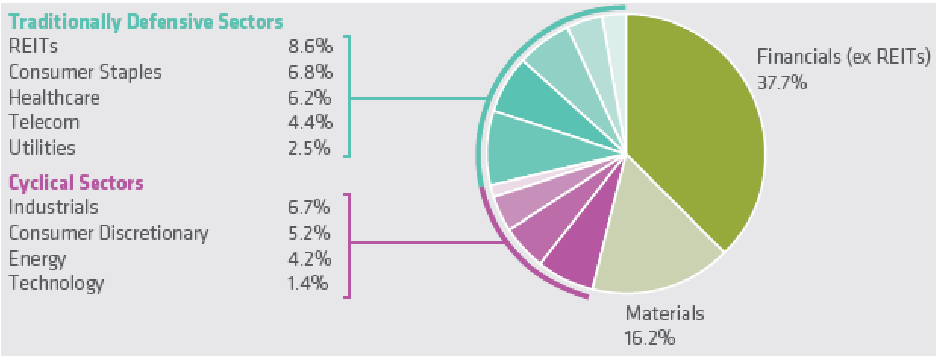
Cyclical risk can manifest itself through a broad economic or business downturn, changes in a company's key markets – such as a slump or the entry of new competitors – and increased price competition, as seen among Australian supermarkets in recent years. Quantitative research can provide insights into a company's balance-sheet strength from a numerical perspective, and fundamental research can reveal factors such as the willingness of lenders to provide credit and the price they would charge for it.

Event risk can be unexpected, such as a change in government or regulatory policy, the restatement of company earnings, or an acquisition that falls short of expectations. It can also be expected, such as a forthcoming regulatory or legal ruling that could hurt the stock price. In the case of expected event risk, the best course of action for investors focused on the downside can be to stay on the sidelines, and not own the stock until the risk outcome is known.

3.3 Create a diversified portfolio

The Australian equity market is relatively small, dominated by financials, resources and a handful of large-cap stocks. In recent years, typically 10 to 15 stocks have accounted for around 50% of the S&P/ASX 300 Index (Figure 9).

Figure 9: Don't be afraid to differ from the benchmark
At 31 December 2016



Source: S&P Dow Jones and AB. Based on the S&P/ASX 300 Index; numbers may not sum due to rounding.

To some extent, this sector skew reflects the skew of the economy, and to some extent it reflects the companies that happen to be listed on the stock exchange. A stock's index weight does not reflect its attractiveness as an investment. Being big does not necessarily mean being beautiful.

A closer look at the index reveals other challenges:

- Some sectors and subsectors are almost nonexistent in the Australian index. And, unfortunately for those looking for a smoother ride, the "missing sectors" include some of the lower-volatility industries, such as branded consumer goods, pharmaceuticals and some technology stocks.
- Some sectors, even though they are quite large, are dominated by one or two stocks, and these shares may not be attractive from the perspective of stability, quality and price.

For these reasons, investors should consider moving away from the benchmark – and allocating a small part of their portfolios to carefully chosen international stocks that can fill the gaps in the Australian index.

3.4 Manage macro risks

It's important to avoid creating a portfolio that solves one problem but creates another.

One of the challenges of implementing a low-volatility strategy in Australia is that by just buying traditional "defensive" stocks with big index weights, it's possible to end up with a portfolio dominated by real estate investment trusts, utilities and infrastructure stocks. Such a portfolio would be heavily exposed to interest-rate risk.

Other methods of designing a low-volatility strategy could result in a portfolio having large amounts of risk from foreign exchange, US policy, European Union politics and China's economy, to name a few factors. It's always possible to add a stock to a portfolio for the "right" reasons (stability, quality and price), only to see it underperform because the related macro risks were poorly understood. Careful portfolio construction should aim to identify and reduce such risks.

4. LOW-VOLATILITY STRATEGIES AND AUSTRALIAN INVESTORS

A couple of important points need to be considered regarding the issues that commonly come up when advisers discuss low-volatility strategies with their Australian clients.

The use of derivatives is sometimes considered as a way of lowering volatility. Some clients are comfortable with the added risks and costs involved. Other investors would prefer to avoid them - they don't want to replace concern about market downturns with concern about derivatives. By following the principles outlined in this paper, such investors can aim to mitigate the risk of market falls with a single transparent portfolio of long-only equities, thereby avoiding the cost and complexity of a derivatives-based strategy.

Another point is that many clients' portfolios are already concentrated in more volatile or high-beta stocks, such as banks and resources. According to Australian Taxation Office data, about 30% of self-managed superannuation fund assets consist of listed equities.[1] It is not unusual for these holdings to be weighted towards franked high-dividend bank stocks. In such cases, clients may have more embedded volatility in their portfolios than they realise.

In this situation, a low-volatility strategy could be an attractive way to complement stocks that clients already own and are familiar with, while diversifying their portfolios with the aim of reducing the risk profile of their overall equity holdings.

5. UPSIDE, DOWNSIDE AND THE BRIGHT SIDE

Not all equity market volatility is bad. Sharp upward spikes in share prices can obviously benefit investors. But just as markets will go up, they will go down, too.

Some investors may want long-term gains but worry about the short term. Others wish to preserve capital and maintain some portfolio growth as they approach or enter retirement. Both groups can improve their chances of meeting their financial goals by smoothing their ride through markets, making them less likely to be held hostage to market fluctuations.

An effective, actively managed low-volatility equities portfolio can be a reliable, simple and cost-effective way to create this smoother ride. Such a strategy should focus on stocks with relatively stable prices, high quality and reasonable valuations. Its process should be based on both quantitative and fundamental research insights, attention to macro themes, and a highly conservative approach to the use of derivatives.

ENDNOTE

1. Australian Taxation Office, *Self-Managed Super Fund Statistical Report*, June 2016.

DISCLAIMER

Roy Maslen is Chief Investment Officer of Australian Equities at AB Group. Hamish FitzSimons is a Portfolio Manager for Australian Equities at AB Group