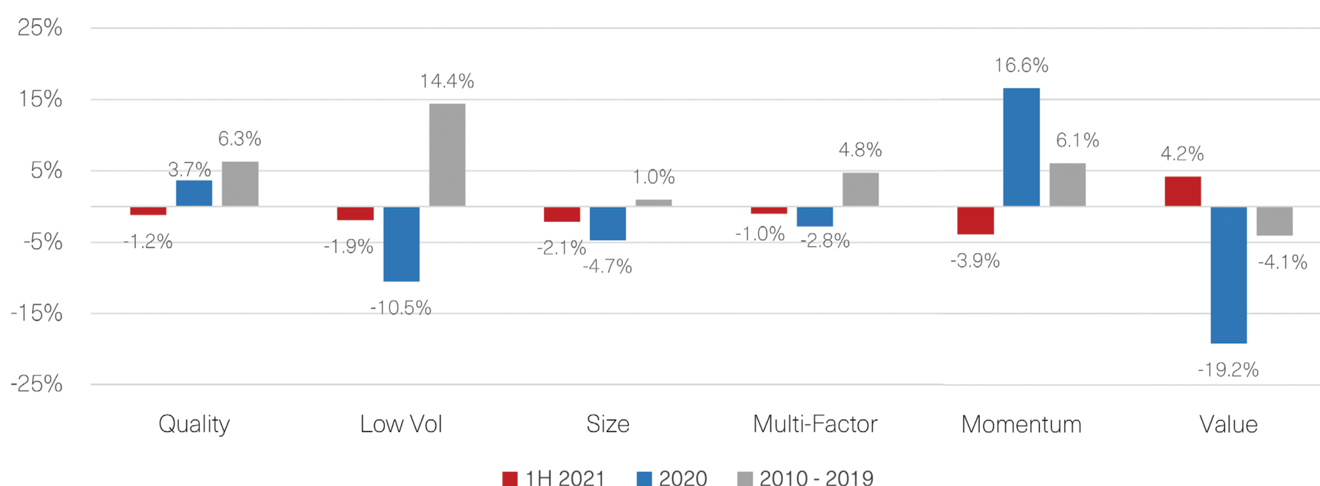
Time to Embrace Low Volatility

Fund in focus: Brompton North American Low Volatility Dividend ETF (BLOV)

After the March 2020 COVID-19 drawdown, investors have benefitted from the best comeback in the equity market since World War II. At the one-year anniversary of the March 2020 lows, the S&P 500 has returned 80%. It is very difficult to top a solid performance in year two of an equity market recovery, which is prone to drawdowns of 10% on average according to LPL Financial. The only time year two of a comeback was better than the recovery in year one, was during the aftermath of the 1987 crash. At this juncture, we believe investors should look towards embracing low volatility strategies in their portfolios given the signs of risk brewing in the equity markets, which we discuss below. To be clear, we are not calling for a top, but rather being prudent in dialing back the risk seeking nature in chasing outsized returns given the historical drawdowns associated with year two of a solid market recovery.

The Low Volatility factor has generated a positive premium in every decade since 1929, with a higher level of statistical significance than the other factors[1]. This pattern was consistent in the 2010-2019 decade as well. However, in 2020 the low volatility factor had a negative return for the first time in 10 years by a large margin relative to other factors. This is not surprising given the historic recovery in the equity markets where a risk-on regime was supported by massive monetary policy and fiscal stimulus. In the first half of 2021, inflationary expectations, given the economic recovery and additional fiscal stimulus, drove massive factor unwind significantly reflating both value and low volatility factor returns, while all other factors saw weak improvements or declining returns. Given the forward-looking nature of the equity market, it is likely the market has already priced-in a recovery growth peak. The question remains, does economic data support peak recovery growth? As an example, the manufacturing ISM index recorded a high level of 64.7 in March 2021, coincidently at the 1-year anniversary of the COVID-19 crash and since then the readings have declined to slightly above 60. It is very rare for the ISM manufacturing index to sit at this high level for any extended period of time. In fact, since 1980 the ISM manufacturing index has exceeded 60 less than 5% of the time.

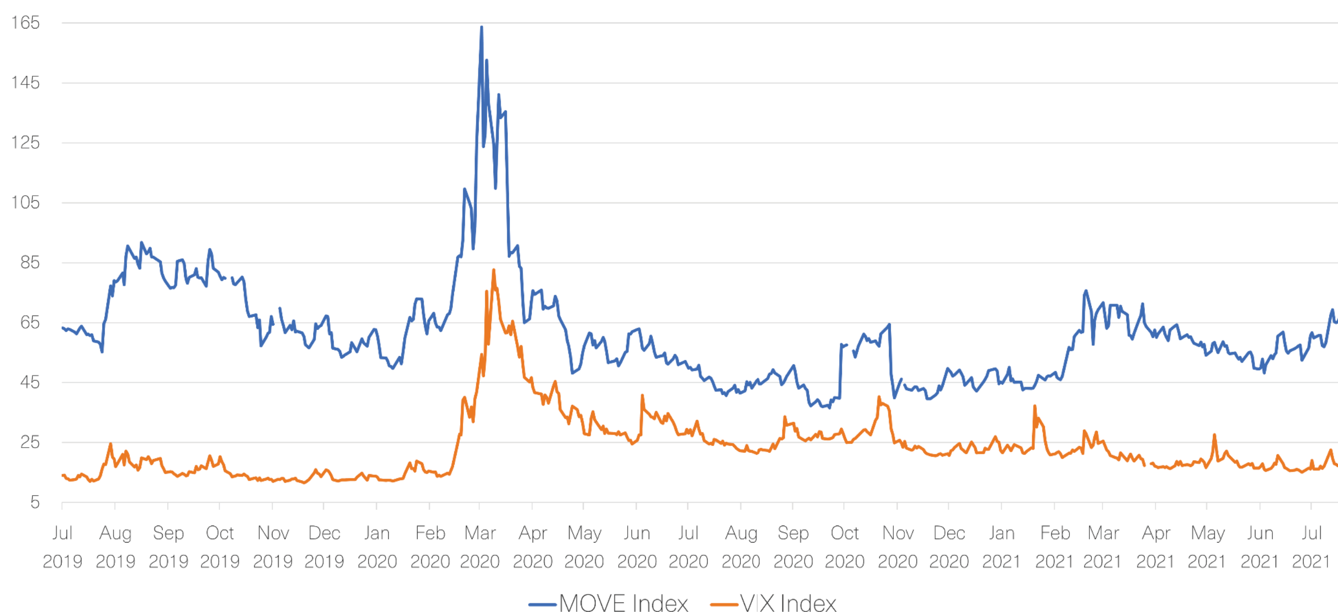
Global Factor Returns[2]



Source: Factor Research (July 5, 2021)

The volatility of the interest rate environment (as measured by the MOVE Index[3]) remains elevated since the reflation of the yield curve drove factor unwinds towards value earlier this year, as shown in the chart below. There continues to be some level of macro uncertainty around growth/inflation mix and the details surrounding the U.S. Federal Reserve tapering of bond purchases and timing and magnitude of interest rate hikes. There is a conceptual link between volatility in stocks and interest rates that exists as rising anxiety in one corner of the market could eventually set the stage for similar sentiment in the other. In many instances, a significant change in the MOVE Index is eventually followed by a higher VIX (a volatility gauge on the S&P 500)[3] as shown in the chart below.

MOVE and VIX Indices[3]



Source: Bloomberg (July 27, 2021)

The Low Volatility factor has generated better risk adjusted returns over long periods of time. While sharp recoveries in equity markets will cause the Low Volatility factor to underperform in the short-term, this is usually temporary. Investors' risk seeking nature (which is amplified during equity rallies) causes mispricing of high beta assets versus low beta and such divergences rarely persist over long periods, which supports the argument in favour of the Low Volatility factor. Given the backdrop of euphoric markets, Low Volatility is here to stay.

Brompton's Approach

Brompton North American Low Volatility Dividend ETF ("BLOV") is designed to produce equity returns with lower volatility through investing in a diversified portfolio of North American large capitalization equities. Our Portfolio Management team employs quantitative analysis with an active fundamental overlay to construct a portfolio with lower overall volatility than the market. The PM team also overlays an options strategy with the goal of further lowering volatility, while also aiming to increase distributable cash and total returns.

[1] Blitz, David and van Vliet, Pim and Baltussen, Guido, The Volatility Effect Revisited (August 26, 2019).

[2] Returns are for hypothetical long/short portfolios of global equities that isolate the relevant factor.

[3] MOVE Index is a yield curve weighted index of the normalized implied volatility on 1-month Treasury options which are weighted on the 2-, 5-, 10-, and 30-year contracts. VIX is a volatility index derived from S&P 500 options for the 30 days following the measurement date, with the price of each option representing the market's expectation of 30-day forward-looking volatility.

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