BROMPTON FUNDS

Brompton Insights

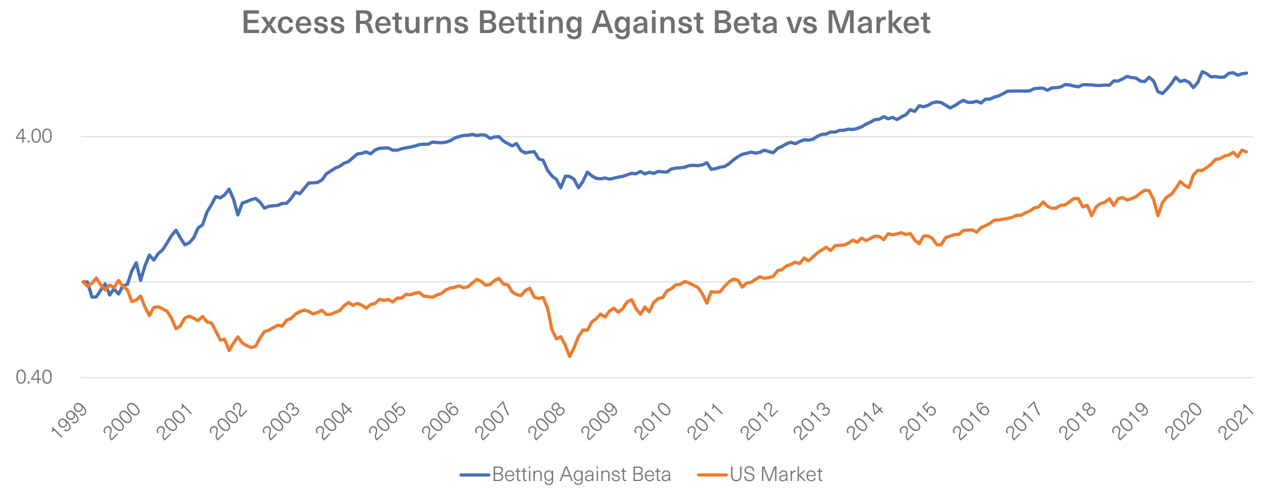
February 2022

Using Low Volatility to Hedge Market Sells Offs

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

The market has experienced one of the most turbulent starts to the year in recent history. The S&P 500 had the worst start since 2009 and the NASDAQ had the worst January in over 30 years. What started off as a rotation from growth to value accelerated into a wider sell-off during the sharp move up in 10-year US Treasury yields. As the steepening of the yield curve begins to accelerate, it creates volatility as investors re-position portfolios across both debt and equity markets. Many investors seek insurance on their portfolios to cushion the drawdowns during market turbulence. The simplest method is by increasing the cash position; however, the effectiveness is questionable as investors cannot consistently time the market for each drawdown over a long period. Institutions and sophisticated investors hedge risk using put options and/other structured strategies. While buying put options is a reasonable way to hedge market downturns, investors sometimes experience FOMO (Fear of Missing Out) by adding portfolio protection at the wrong times, when volatility is elevated and put premiums are expensive. As an example, during the sell-off in January 2021 daily put options were averaging $1 trillion notional[1], which was higher than during the COVID-19 market crash in early 2020. On January 24, 2022, $1.4 trillion notional[1] in put options were traded and on that day the NASDAQ closed higher reversing a 4%+ intraday drop, which has happened only 5 other times in the past 30+ years. The subsequent median 12-month return for these 6 trading events was 26.8%.[2] To put it simply, it is cheaper to buy insurance before the house catches fire, not after.

We believe that low volatility strategies can be used as a market hedge while generating consistent risk-adjusted returns over the long term. In contrast, traditional portfolio insurance (options and other structured strategies) acts as a drag on returns and only pays off when an adverse risk event occurs. The chart below compares a "betting against beta" strategy (going long low beta stocks and shorting ones with high beta) versus a long only market portfolio. Beta is a measure of volatility or systematic risk. The theory behind this is simple: the prices of assets eventually revert to their median risk-adjusted price so that high beta assets are considered overpriced and low beta assets are considered underpriced. During market turbulence, high beta assets experience greater drawdowns than low beta assets.



Source: AQR Capital and Brompton Group (November 30, 2021)

Investors have questioned whether low volatility investing is a fad that will eventually fade. These questions are usually pondered during euphoric bull market runs. We acknowledge the underperformance of low volatility strategies during these periods. However, the compounding long-term benefit of smaller drawdowns that low volatility investing provides during market turbulence exceeds the momentary underperformance during bull markets. The Low Volatility Effect has persisted through time, and across asset classes and market regimes for over 90 years[3]. We believe the Low Volatility Effect will continue to persist over time given investor's risk seeking nature along with leverage constraints which limits the ability to arbitrage. This structural dynamic which has historically favoured Low Volatility strategies is unlikely to change.

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 Portfolio Management team also overlays a covered call options strategy with the goal of further lowering volatility, while also aiming to increase distributable cash and total returns.

[1] *Bloomberg.*

[2] *Bespoke Investment Group, January 24, 2022.*

[3] *Frazzini and Pedersen, Betting Against Beta, 2010.*

BROMPTON FUNDS

VALUE

INTEGRITY

PERFORMANCE

THE FOUNDATION FOR EXCELLENCE

Investor Relations
PHONE 416.642.6000
TOLL FREE 1.866.642.6001
FAX 416.642.6001
EMAIL info@bromptongroup.com

Website
www.bromptongroup.com

Address
Bay Wellington Tower,
Brookfield Place
181 Bay Street
Suite 2930, Box 793
Toronto, Ontario M5J 2T3