EQUITY CONTROLLED VOLATILITY STRATEGY

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Equity volatility – or the "fear factor" as popularised in fiction – recently came back to the forefront of market operators' minds, the result of events such as the Greek crisis during 2015 and questions around China's economic growth prospects and plunging oil prices earlier this year.

More than fear though, volatility is an indicator of uncertainty. Faced with this situation, investors react differently: some would naturally shy away from equities and reduce their exposure despite the potential losses, while some would decide to "keep calm, carry on" – and potentially increase their exposure once opportunities are around the corner!

There is, however, a more pragmatic solution to benefit from a smoother ride during turbulent times affecting equity markets: controlling the level of volatility of your equity investment.

Equity controlled strategies have indeed some key advantages embedded in them: they aim to reduce equity volatility, to hedge some of the downside risks and to limit the amplitude of drawdowns, while at the same time retaining an equity market exposure.

To achieve this objective, these strategies rely on a transparent, disciplined and systematic – and therefore repeatable – process using risky assets (equities) and non-risky assets (index futures or cash/money market instruments).

Initially, the ex-ante volatility of a given equity market index is calculated, giving more weight to the most recent data observations, through the use of the ex-ante Exponential Weighted Moving Average (EWMA).

A pre-determined target level of volatility for this equity market index is then set – let's assume 15% for instance.

If the ex-ante EWMA volatility is below the pre-defined volatility target, the model will progressively increase it equity exposure to 100% of the portfolio's value or even above that level if leverage is used, through the buying of index futures. On the contrary, if the ex-ante EWMA volatility is above the pre-defined volatility target, the model will progressively reduce the equity exposure and re-allocate in cash/money-market type of instruments through the selling of index futures.

In terms of outcome for investors, the strategy historically outperforms selected equity indices in periods of sharp drawdowns (such as in 2008) and/or rising equity market with low volatility. The strategy underperforms in cases of volatile non-trending market and/or rising equity market with high volatility (the rebound of markets in 2009 for instance).

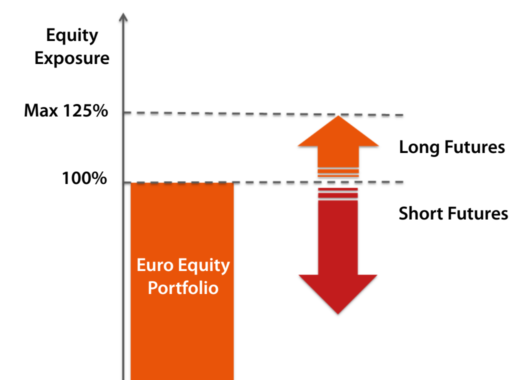
This approach is particularly interesting for some institutional investors – insurance companies for instance – who are subject to Solvency Capital Requirements (SCR), as it can potentially help them to reduce the capital impact related to their equity investment.

This pragmatic approach to managing equity volatility is also supported by academic research. A recently published article* confirms that there is "empirical evidence that the application of a volatility targeting strategy to equities targeting constant volatility over time does add value… increasing the Sharpe ratio and reducing the size of drawdowns."

In summary, equity controlled strategies, as managed by Generali Investments in the GIS Euro Equity Controlled Volatility fund (UCITS), are pragmatic and efficient solutions to reduce volatility and improve risk-adjusted performance over time and across market cycles.

Providing investors with more certainty during their equity investment journey is therefore possible.

VOLATILITY CONTROL PORTFOLIO STRATEGY



Source: Generali Investments Europe S.p.A. Società di gestione del risparmio.

* *"Predicting the success of Volatility Targeting Strategies: Application to Equities and other asset classes"*, R. Perchet, R. Leote de Carvalho, T. Heckel, P. Moulin, The Journal Of Alternative Investments, Winter 2016

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