Volatility In The New World?

As talk of volatility returns to the market, investors need to make sure that they are truly diversified, says Ian Heslop, Head of Global Equities at Old Mutual Global Investors and Manager of the Old Mutual Arbea Fund.

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Volatility is said to be back, but that's maybe too premature.

The wild price swings that investors endured in February were just the market reacting to US bond yields hitting 3%, rather than something more structural. Investment sentiment hasn't changed and until that happens and asset prices are affected, volatility, in my view will likely remain subdued for the foreseeable future.

That is not to say that volatility can't make a comeback this year, or even next year. In fact, what has changed since February is that the market is now starting to factor in that the years of abnormally-low volatility might be behind us. There has been a noticeable uptick in the perception of what volatility is going to be.

For real volatility to return, as opposed to the odd spike here or there, central bank policy would need to explicitly change. This is what we expect to happen, but it hasn't happened yet. The years of easy money, which has been in place since the global financial crisis, needs to come to an end. That doesn't necessarily signal a headwind for the market, but rather a removal of a tailwind that has propelled equities for the best part of nine years.

Investors recognise that a marked shift in monetary policy will have some sort of impact on markets, but the big unknown at the moment is by how much. Right now, equities are trading at about 12% volatility. That is an improvement on last year but still well below historical averages. The issue for the market is when volatility returns to more normalised levels of around 18%, that would be a massive move which if not managed correctly, could have a significant impact on certain investment strategies.

HOW ROBUST ARE PORTFOLIOS?

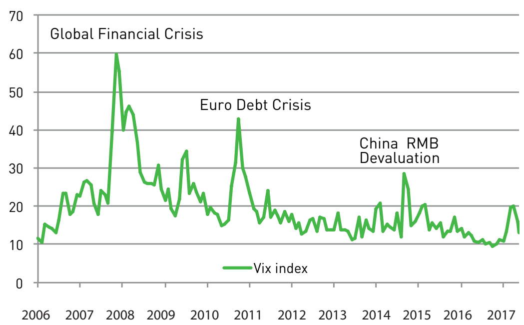
If a portfolio has expectations built into it that equity volatility will remain below 10%, and then volatility spikes, it may well lead to some forced selling of stocks. In other words, it could make any market swings more violent, a taste of which we got earlier this year. Portfolios with the ability to manage their volatility, to be below that of the equity market will be key in this environment.

To be sure, the return of volatility has been predicted before and then never materialised, but we believe that it's different this time. The US Federal Reserve has new leadership in place and has notably started to normalise monetary policy. So unless we see an unexpected spike in inflation, which would have an adverse effect on equities and yields, our central assumption is that volatility will gradually return over the next few years.

So, if volatility is coming back, how should we manage the risk? Which stocks? What about asset allocation? These are the questions that clients have started to ask.

A return of dispersion – the gap between the best performing stocks and the worst – to markets would be beneficial to active managers. When it does, they will have a better opportunity to outperform because their investment universe of equities would have broadened. Fund managers will still need to pick the right stocks, of course, but it means that the outcome is a little more skewed in their favour.

Figure 1: Vix Index



Source: Bloomberg as at 14th of May, 2018

When weighing the future prospects of the market, it is not just about volatility that investors have to start thinking about more; it's also the correlation between asset classes.

The conundrum facing the market, however, is that as interest rates rise and volatility returns, there is a good chance that both stocks and bonds will fall in tandem. So what should investors do? They will need to find something else that will do the job of diversification for them, which will be so important when volatility spikes.

This is where market neutral strategies can enjoy an advantage and where investors will need to become more in tune with market dynamics. The Old Mutual Arbea Fund, which uses a systematic global equity market neutral strategy, is genuinely uncorrelated to global stock markets and is positioned to adapt to this changing environment.

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