European equity markets: Facing lower returns and higher volatility?

Candriam Optimum Quality:
High-Quality Fundamentals, and a Unique Approach to Reducing Volatility

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Low-volatility solutions: Why now?

Concerns of financial market volatility are rising, while economic growth is likely to be less robust than in recent years and uncertainty seems the 2019 motto. To capture the modest returns available in such an environment, it is not only necessary to control volatility, but imperative to control drawdown. Recovering from drawdown is even more difficult in environments with only modest market upside potential. Ideally one hopes to discover the holy grail of investing, a way to retain upside risk while limiting downside.

Grounded in financial research: The low-risk anomaly

Academic research has identified a 'low-risk anomaly'. This is an apparent market inefficiency in which the theory of higher risk being rewarded with higher returns has not been supported by data. Indeed, the converse has been found by some studies[1]. Candriam's own internal research shows that over the period from 1990 to 2018, the lowest-risk quintile of European equities generated above-average returns.

Most low-volatility equity strategies are designed to capture the benefits of this low-risk anomaly, i.e. higher equity returns with lower downside risk. Although most low-volatility strategies are also low-beta, the investment strategies used, and the resultant portfolio characteristics, vary widely across managers. Some strategies focus on individual low-volatility equities, a strategy which ignores correlation among the equities held in the portfolio. More sophisticated approaches employ minimum variance optimisers to consider the volatility of the overall portfolio. As with most of the quantitative processes, share price volatility data incorporated in the models is typically historical, and may not reflect future changes in volatility of an equity, which could arise from changes in a company's fundamentals.

The Candriam Optimum Quality investment solution

High-Conviction, High-Quality Fundamentals – Candriam's European Equities Team analyses the universe using our established proprietary framework. Each company is analysed and graded on five categories of fundamentals – quality of management, business growth, competitive advantages, value creation, and financial leverage. Our analysts developed thorough valuation models for those companies which satisfy our fundamental quality thresholds. Our conviction, both fundamental and valuation, is central not only to capturing upside, but to protecting the drawdown. From this short list of high-quality companies, our portfolio focuses on those which demonstrate lower volatility.

Minimum Variance Optimisation -- We apply a proprietary minimum variance optimiser to construct our portfolio and determine position weightings. Our optimiser goes beyond historical measures of volatility. It applies greater weights to those equities determined by our in-house analyst to be of the highest fundamental quality, and it incorporates an element of investment manager input to overcome any obvious historical biases.

Drawdown Reduction – In early 2018 the process was enhanced with derivatives-based drawdown control, a step which we had investigated, designed, and tested carefully for more than 18 months. Rather than just reducing overall volatility, investors would prefer the elusive goal of limiting the downside risk more than they limit upside potential. We add portfolio insurance by purchasing long-term index put options. In an aim to limit downside more than we cap the upside, we partially fund the cost of this protection by writing covered short-term call options against selected individual holdings. These single-name option writing decisions are based on current share prices of holdings, our valuation targets, volatility measures, and our analysis of the value of the option pricing available. They are made possible by our thorough fundamental and valuation analyses.

The Candriam difference

Our optimiser does not search just for low-volatility names. Some min-var processes take a further step, and include fundamental quality measures as well as price volatility data, but most of these use historical measures of quality. At Candriam, our process optimises only our highest-quality names, attempting to adjust for future volatility. We believe that our fundamental, 'Optimum Quality' process, adopted in 2014, is unique in Europe. Our drawdown reduction process adds to this already-innovative approach. This use of call writing premiums to fund portfolio insurance is possible only because of our conviction in our fundamental and valuation analyses.

Candriam is a pioneer in Responsible Investing, with over two decades of experience. Our name says it: **Candriam**, Conviction and Responsibility in Asset Management. Launching our first sustainable fund in 1996, we established our independent internal SRI Research Department in 2005. Because of Candriam's long history of responsible investing, the inclusion of responsible elements in our fundamental analysis is embedded in all our thinking. The 2018 carbon footprint of the Optimum Quality portfolio was 75% less than that of the benchmark index, according to TruCost. ESG factors are qualitative inputs into our Optimum Quality fundamental analysis of quality of management, market growth, and competitive advantages.

Candriam's European Equities Team includes a dedicated European equities derivatives specialist, with over two decades of experience. Our seven fundamental European equity analysts average more than fifteen years with Candriam. Our quantitative models are closely supported by our in-house team of investment engineers, also averaging more than fifteen years with Candriam.

Optimum Quality Actively-managed volatility control

We do believe that low-trend markets require high-conviction investing. Our solution to expose a portfolio to European Equities in 2019 and beyond is to identify high-fundamental-quality, low-volatility names, an investing style which we believe has shown its value in academic studies. We believe that applying an optimiser to a fundamentally-generated list of target investments substantially addresses many of the concerns of purely quantitative min-var portfolios. Adding drawdown protection should further enhance the risk/return trade-off for investors anticipating volatile markets with only modest return. We innovate products by listening to investors' needs, because they are the "raison d'être" for everything we do at Candriam.

Source:

1 For a detailed analysis of the low-risk anomaly, including references to the relevant financial literature, please refer to Smart Beta, A new way to invest in stocks aiming for Lower Risk and Higher Quality, Koes Van de Maele, CFA and Sébastien Jallet, Candriam.com February 2015