ACADIAN

A BUBBLE IN LOW-VOL STOCKS OR LOW-VOL INDICES?

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OVER THE PAST FEW MONTHS, WE'VE HEARD A STEADY DRUMBEAT OF CONCERN FROM THE FINANCIAL PRESS ABOUT THE stretched valuations of low-volatility stocks.[1] As the narrative goes, their fast-growing popularity as a defensive investment and the appeal of bond-like stocks in a prolonged low-rate environment has inflated low-vol stocks' market prices to a point that cannot be justified on the basis of fundamentals. As a result, low-volatility strategies no longer offer the extra margin of safety that investors seek, and they're vulnerable to the piercing of a bubble.

But a closer look at the evidence doesn't support that conclusion. Rather, we argue here, it exposes shortcomings of simplistic, smart beta implementations of low-volatility investing: 1) they fail to utilize the full opportunity set of low valuation stocks in order to to find attractive valuations, and 2) they take unnecessary risks, most notably interest rate exposure.

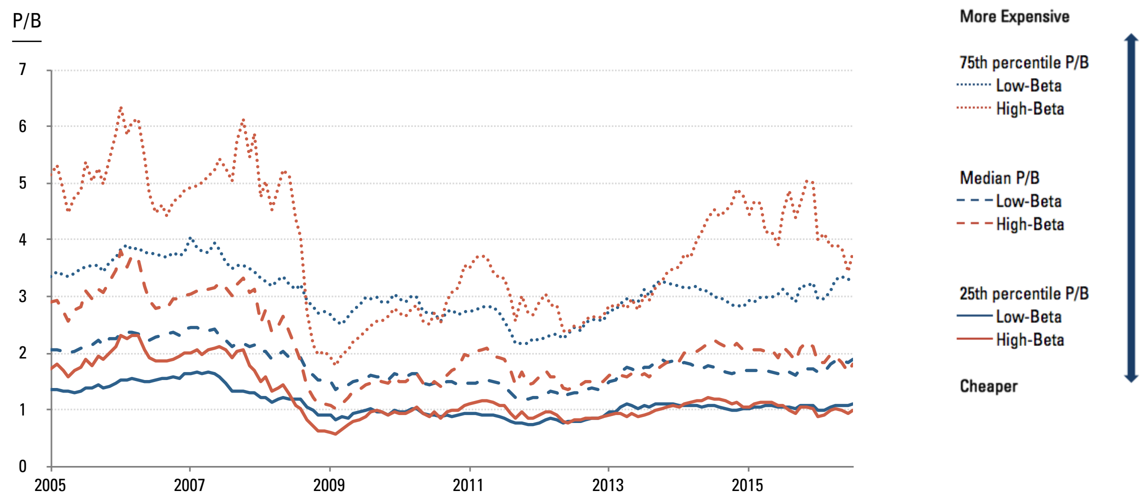
Anxieties over low-volatility strategies, therefore, are misdirected. The problem actually lies with deficiencies of inherently restrictive smart beta investment processes, not low-vol investing as a whole. The logical solution, in our view: a careful, active, implementation of low vol.

LOW-VOL VALUATIONS: A MORE COMPLETE PICTURE

Recent analyses of low-volatility stocks' valuations have tended to focus on mean or median multiples within cap-weighted indices (e.g., the S&P 500) and popular smart beta low-volatility indices (e.g. MSCI Minimum Variance). But in forming investment portfolios, the breadth of the full opportunity set is more important than the mean or median valuation within any particular benchmark.

FIGURE 1

Valuations of low-beta vs. high-beta equities
Stocks in Acadian investment universe from MSCI World countries with market cap > $100MM*



* Betas are relative to MSCI's World equity index, according to an investment-caliber risk model that incorporates (only) information that was known on each respective date. Estimation uses daily returns and a rolling four-year lookback period. Sources: MSCI. Copyright MSCI 2016. All Rights Reserved. Unpublished. PROPRIETARY TO MSCI. P/B and market capitalization calculated by Acadian based on data from Bloomberg and WorldScope.

For illustrative purposes only. This chart does not represent characteristics of an actual portfolio but rather Acadian's investment universe of securities for the period specified in the chart. These attributes are not achievable via actual trading; they do not reflect transaction cost or other implementation considerations. Characteristics of the investment universe may change. Past performance is no guarantee of future results. Investors have the opportunity for losses as well as profits.

[1] For example, Lahart, Justin, "Two Strategies, One Crowded Trade," *The Wall Street Journal*, August 22, 2016.

With that in mind, Figure 1 compares distributions of P/B ratios among high and low beta quintile stocks across Acadian's full equity universe ($100MM+). Overall, valuations look quite similar. Of special interest in the search for cheap low-vol stocks, high- and low-beta 25th percentile valuations are nearly indistinguishable. What's more, the valuation range of low-beta stocks doesn't look narrow by historical standards. In sum, it appears that we have plenty of attractively valued low-vol stocks from which to choose. Said differently, by incorporating an explicit sense of valuation, an active manager should be able to form a low-vol portfolio with a reasonable multiple.

A study we published earlier this year squares this result with the flawed popular narrative.[2] In our prior analysis we found evidence that constituents of MSCI's Minimum Volatility Index indeed have higher P/B multiples than other stocks. But looking across the broader equity universe, we found no statistically significant association between beta and valuation at the stock level, and the data actually suggested a tendency for lower-beta industries and countries to have relatively low multiples. In other words, our research shows it is smart beta low-vol implementations that have become expensive, not low-vol stocks in general.

INTEREST RATE EXPOSURE: AN UNNECESSARY RISK

Our previously published analysis does support the conventional wisdom that bond-like stocks, as a whole, now have relatively high valuations. But we don't believe that it's necessary or valuable for low-vol portfolios to take on active interest rate risk relative to market benchmarks. In fact, we explicitly constrain active exposure to an interest rate factor in forming our Managed Volatility portfolios. We do so because we view bond-like stocks as having no special relationship to the low-volatility mispricing. As a result, we see this restriction as having only a modest impact on our opportunity set, a price well worth paying to neutralize a material, but incidental, risk.

CONCLUSION

Based on our research, lower-beta stocks don't appear overvalued relative to higher-beta stocks, on the whole. Misplaced concerns over low-vol valuations and interest rate exposure actually reflect drawbacks of smart beta implementations. Specifically, artificial restrictions on the investment universe, lack of an explicit sense of valuation, and rudimentary risk management may impede smart beta's ability to exploit a broader opportunity set and to avoid valuation, interest rate, and other unintended exposures.

We believe that low volatility investing will endure, because it reflects a mispricing that is deeply rooted in behavioral biases and protected by asset owners' ongoing, broad commitment to capitalization-weighted benchmarking. In our view, the appropriate inference from a closer look at the popular narrative around low-vol valuations and rate risk isn't to abandon the strategy but rather to go with an active implementation.

[2] Acadian Asset Management, "Beta, Indexing, and Valuations," May 2016.

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