

Managing for Volatility

Deanne Baker - Lonsec



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Managing for Volatility

April 2020 | Deanne Baker

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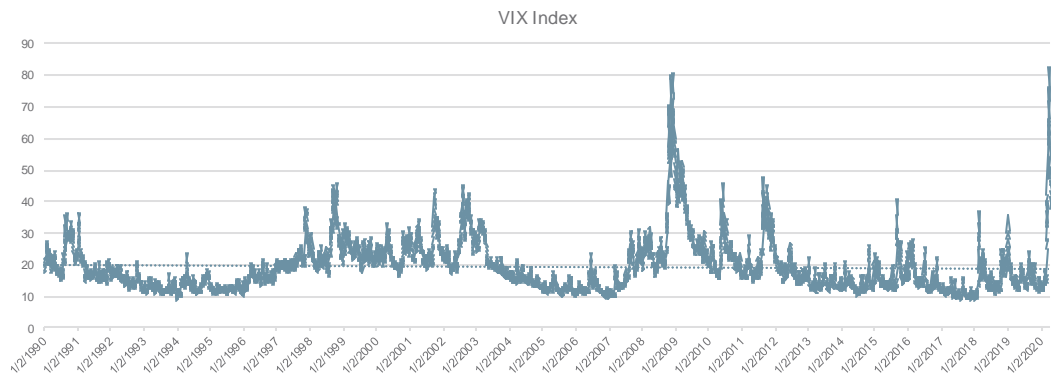
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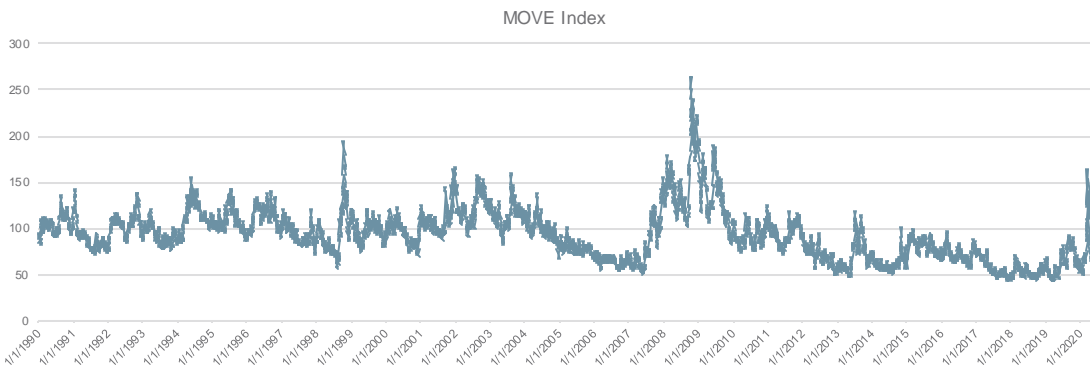
1. The Nature of Volatility

Equity Market Volatility



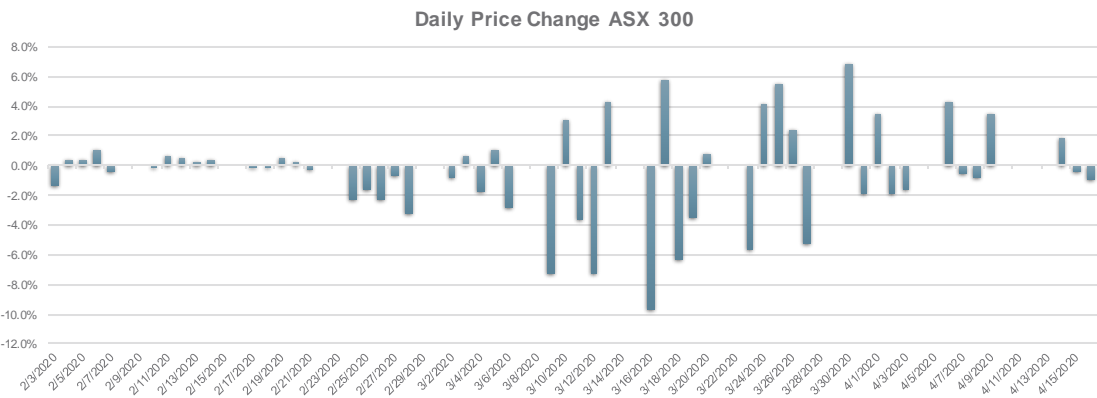
Source: Bloomberg

Bond Market Volatility



Source: Bloomberg

The Nature of Volatility



Source: Bloomberg

1 2. Diversification

The Importance of Correlations

03 Asset Class Correlation Matrix

	AE	ABC	GBU	GBH	GEM	AEJ	QBC	ALP	GLP	DP	GLJ	GA	CA	AFA	AFB	AFC	FRN	GFA	GFB	GFC	GHY	EMD	AU
Australian Equities (AE)	1.00	0.80	0.44	0.71	0.53	0.45	0.47	0.64	0.66	-0.12	0.60	0.05	0.01	-0.18	-0.21	-0.05	0.33	0.03	-0.10	0.34	0.61	0.45	-0.06
Australian Small Cap (ABC)		1.00	0.38	0.70	0.58	0.40	0.47	0.45	0.59	-0.08	0.47	0.06	0.04	-0.22	-0.25	-0.09	0.32	-0.01	-0.14	0.31	0.60	0.43	-0.06
Global Equities (GBU)			1.00	0.63	0.54	0.57	0.91	0.26	0.27	-0.15	0.38	0.11	0.05	-0.08	-0.10	0.04	0.14	-0.23	-0.26	-0.04	0.23	-0.05	-0.11
Global Equities (H) (GBH)				1.00	0.64	0.54	0.65	0.34	0.70	-0.11	0.69	0.01	0.02	-0.37	-0.40	-0.21	0.37	-0.13	-0.29	0.28	0.73	0.46	-0.01
Emerging Markets (H) (GEM)					1.00	0.83	0.52	0.24	0.41	-0.12	0.45	0.09	0.03	-0.16	-0.20	-0.01	0.25	-0.01	-0.14	0.29	0.59	0.42	-0.10
Asia Ex Japan (H) (AEJ)						1.00	0.55	0.19	0.33	-0.13	0.35	0.11	0.01	-0.07	-0.11	0.06	0.23	0.01	-0.10	0.28	0.45	0.28	-0.08
Global Small Cap (H) (GSC)							1.00	0.29	0.35	-0.15	0.33	0.20	0.12	-0.15	-0.17	-0.02	0.18	-0.26	-0.32	-0.04	0.29	-0.06	-0.06
Australian Listed Property (ALP)								1.00	0.62	-0.17	0.56	0.05	0.08	0.25	0.24	0.27	0.21	0.34	0.29	0.40	0.34	0.40	0.52
Global Listed Property (H) (GLP)									1.00	-0.10	0.76	-0.03	0.03	-0.03	-0.06	0.05	0.40	0.32	0.18	0.58	0.68	0.60	0.12
Direct Property (DP)										1.00	-0.15	-0.21	-0.30	-0.20	-0.17	-0.33	-0.35	-0.10	-0.05	-0.14	-0.22	-0.13	-0.21
Listed Infrastructure (H) (GLJ)											1.00	-0.13	-0.11	0.02	0.00	0.09	0.29	0.29	0.19	0.47	0.61	0.58	0.05
Growth Alternatives (H) (GA)												1.00	0.49	-0.03	-0.05	0.08	0.33	-0.12	-0.15	-0.07	0.06	-0.10	-0.17
Conservative Alternatives (H) (CA)													1.00	0.10	0.09	0.25	0.55	0.09	0.04	0.10	0.12	0.57	0.33
Australian Fixed Aggregate (AFA)														1.00	0.00	0.93	0.05	0.69	0.73	0.40	-0.18	0.15	0.23
Australian Fixed Sovereign (AFS)															1.00	0.91	0.00	0.67	0.72	0.36	-0.22	0.12	0.21
Australian Fixed Credit (AFC)																1.00	0.30	0.63	0.61	0.48	0.01	0.22	0.31
Australian Floating Rate Note (FR)																	1.00	0.22	0.05	0.48	0.61	0.42	0.57
Global Fixed Aggregate (H) (GFA)																		1.00	0.96	0.63	0.20	0.52	0.26
Global Fixed Sovereign (H) (GFS)																			1.00	0.68	-0.02	0.36	0.22
Global Fixed Credit (H) (GFC)																				1.00	0.63	0.72	0.23
Global High Yield (H) (GHY)																					1.00	0.77	0.17
Emerging Market Debt (H) (EMD)																						1.00	0.15
Australian Cash (AU)																							1.00

Source: Lonsec Investment Solutions

One of the most important fundamentals of investing is diversification. And that is, you can improve your risk adjusted performance by combining a range of asset classes that have correlations that are less than one – and the lower the correlation, the greater the benefit for portfolio construction purposes. Which is why as multi asset investors we invest across equities, fixed income, real assets and alternatives.

It's important to remember however, that correlations can be very unstable and particularly so in periods of heightened volatility. Assets can become highly correlated when you least want them to be and diversification can fail over short periods of time. So while the long-term 'mean' correlation between assets is important for building your long-term strategic asset allocation, it is also important to understand what is going on in the tail of that distributions as well.

The correlations matrix attached is based on the historical monthly return series of each asset class for the 10 years to June 2019.

Volatility Regimes

Volatility Factor						
	Annualised Return			Correlation		
	Low	Neutral	High	Low	Neutral	High
Equities	22.2%	9.4%	-43.8%	-0.55	-0.69	-0.80
Private Equity	18.6%	14.5%	-68.6%	-0.61	-0.58	-0.64
Bonds	-1.3%	-0.2%	0.4%	-0.04	-0.05	0.09
Trend Following	5.1%	2.3%	8.3%	-0.07	-0.03	0.14
Gold	10.5%	4.6%	30.0%	0.17	0.24	0.35

Source: Bloomberg, Lonsec Investment Solutions

At Lonsec we supplement our correlation matrix above with an assessment of how individual assets perform under different macro regimes. We do this for inflation, liquidity, growth and volatility factors. In this case, we are focused on volatility regimes.

Based on historical data and shows the performance and correlation of each asset to volatility itself (as measured by the VIX). I’ve split up the results into periods when volatility is high, normal and low and I have annualized the monthly results here, really just for greater effect. You should not expect to generate these kind of returns in real life as we wouldn’t expect volatility to remain in the high regime for 12 months – we know it tends to spike then come back down.

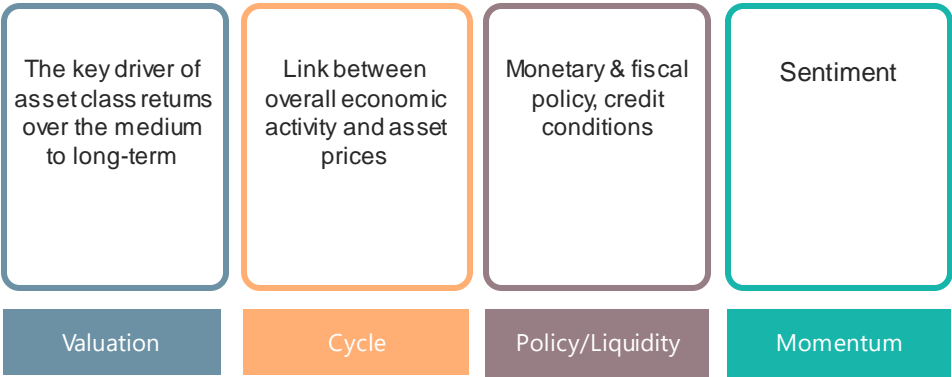
Important to look at how each individual asset class performs and correlates in high volatility regimes. It’s a good idea to have some allocation to those assets that are positively correlated to volatility – that is, their prices go up when volatility goes up. Think of these as your flight to quality assets.

| 3. Framework & Discipline

Have a framework for decision making



Lonsec DAA process



Global Equity Model

	Valuation	Cycle	Policy/Liquidity	Momentum
Jan 2020	--	0	+	++
Feb 2020	0	-	++	--
March 2020	+	--	++	--

4. Opportunities



The Z-score, is the number of standard deviations a given data point lies above or below the mean.

On the vertical axis, greater than zero is considered cheap, less than zero is considered expensive.

1 5. Liquidity

High Yield



Source: Bloomberg

1 6. Summary

Managing for Volatility

- Accept volatility as a part of investing
- From a structural perspective, hold truly diversifying assets
- Have a robust investment framework for active decision making
- Be open to the opportunities that will emerge
- Liquidity is key to taking advantage of those opportunities