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Investors Poured Billions Into This Strategy. It's Not Panning Out.

Assets have surged into low vol funds, but so far investors are not getting what they thought, according to new research.

BY **JULIE SEGAL**

Northern Trust

Michael Hunstad, Ph.D., Northern Trust Asset Management

Investors expect low-volatility factor funds to give them most of the equity market's return during good times, while also softening the blow if there's a correction. But early indications show that these funds have been disappointing investors by massively trailing equity markets, a new analysis shows.

With low-vol strategies, investors are willing to give up some of the possible upside of stocks. But if the gap is too large, they could be better off in other conservative options, such as fixed income, according to an analysis by Northern Trust Asset Management.

The MSCI USA Minimum Volatility index returned 3.03 percent in the fourth quarter of 2019, almost 6 percentage points below the Russell 1000's 9 percent return, according to the analysis. The S&P 500 Low Volatility index's return lagged even further behind the Russell 1000, delivering 1.36 percent. Both indexes are the benchmark for billions invested in popular low-vol exchange-traded funds and institutional separate accounts.

For all of 2019, the MSCI USA Minimum Volatility index returned 27.77 percent, compared with the Russell's 31.24 percent.

"There's been talk of factors no longer working," said Mike Hunstad, head of quantitative strategies at Northern Trust's asset management division. "But it's not that. It's how these indexes and other products are designed. There's plenty of academic research that these premia work, but none of it tells you how to implement them in real life."

Hunstad said specifically that low-vol funds are being compromised by a lack of limits on risks, such as the size of bets on certain sectors of the markets. For example, low-volatility stocks are concentrated in stock categories such as real estate investment trusts, utilities, and consumer staples.

"These bets, though, are unintended," he said. "A lot of investors don't even know that their low-vol funds are also taking style bets like size and value. And these bets have not paid off." According to Hunstad, asset managers need to account for the unintended risks and create portfolios that better represent low vol stocks that investors expect.

Not all low vol funds missed the mark. The Northern Trust Asset Management Quality Low Volatility U.S. Large Cap Strategy delivered 6.53 percent in the fourth quarter, compared with the Russell 1000's 9 percent, according to institutional database eVestment. The Martingale Large Cap Defensive portfolio returned a net 6.11 percent in the fourth quarter of 2019, and 26.78 percent for the year. In addition, Acadian's US Managed Volatility fund returned 5.25 percent for the fourth quarter and 24.86 percent net in 2019, according to eVestment. The Northern Trust strategy's 2019 return was 30.71 percent.

As a result, there are significant gaps in the performance of low-vol strategies that look very similar when analyzed on a superficial level. "Without controls, exposures can run amok with sector, macro, and stock specific risks," said Hunstad.

For more on portfolio risk management, see the Digital Special Report: The New Way to De-Risk as featured in *Institutional Investor* or watch the featured webinar Strengthen Your Portfolio Core.