Volatility on the Rise: Portfolio Themes for 2015

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When reviewing our model portfolios, Lonsec considers broad market and product themes that may impact the ability of the portfolios to achieve their objectives in the medium term i.e. next two to three years.

While we do not change the portfolios in response to short term market views, Lonsec considers market dynamics from a risk management perspective to ensure that the portfolios remain aligned to their underlying philosophy and are well positioned to meet their objectives, should one of the identified risks come to fruition.

This paper summarises our portfolio themes for 2015. For more information on Lonsec's model portfolios, please refer to the December 2014 model portfolio review available to subscribers on the Lonsec website under **Investment Strategy – Portfolios – Model Portfolios**.

Volatility on the rise

After an extended period of stability, market volatility has been increasing in recent months

Portfolio Positioning

- Diversification of asset classes and investment strategies
- Maintain a focus on downside risk
- Greater opportunities for stock pickers – benefits active managers

Return dispersion increasing

Following the GFC, QE and central bank policy have become the key drivers of market returns, while investment fundamentals and industry drivers have taken a back seat. While the leadership provided by central banks inarguably helped markets maintain some degree of stability as the world recovered from the GFC, it is also true that it has had some side effects.

In such an environment, it can be difficult for active managers to generate excess returns, as all investments tend to get bid up, regardless of their underlying quality or riskiness. Global equities for example has experienced very strong absolute returns (+21.5% p.a. over the three years to November 2014, AUD hedged), and many managers, particular those with a quality bias, have struggled to outperform as they tended to avoid the lower quality stocks that rallied the hardest.

Rather than being a sign that passive has won out over active management, we see this phenomenon more as a side effect of the central banked influenced, low rate environment that has prevailed in recent years. Importantly from a forward looking perspective, we believe that once these conditions shift, either through a change in central bank policy, or upside or downside surprises in interest rate expectations, economic growth, commodity prices, inflation, or any number of other factors, then the opportunity set for active management will expand.

We are starting to see some signs that the low volatility, QE driven environment outlined above is changing. Until recently, one of the most noticeable features of the market was how sedate it was, indicating how successful central banks have been in dampening volatility. As the chart below demonstrates, the VIX was near historic lows in 2013, akin to the levels seen just prior to the GFC, however it has risen noticeably this year.

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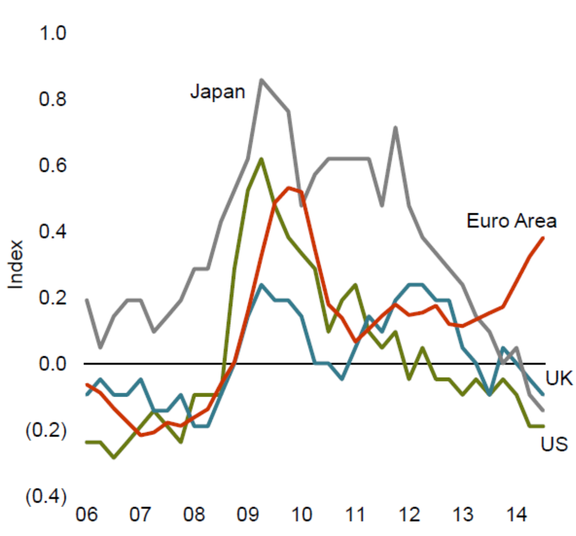
Source: Lonsec, CBOE

As an aside, it is worth analysing the potential causes of this rise in volatility. While it can herald a major market disruption, like in 2007/8, and result in significant portfolio losses and correlations moving to 1, we believe the current environment is somewhat different. Although there are likely several causes of this rising volatility, we believe the diverging fortunes of the major economies around the world is a key driver, rather than rising systematic risks as was the case in 2007 (although given the unconventional nature of central bank policy since the GFC, these cannot be entirely discounted).

The greatest divergence is emerging between the US, where QE has recently ended and where improving economic conditions mean that interest rates are likely to rise from here, and Europe, where deflation is threatening its fragile recovery and where QE is looking inevitable. In Japan, a QE program that is unprecedented in its size and scope is currently underway, but many questions remain over how effective it will be and its long term effects.

Deflation Risk Indices*



Source: Haver Analytics/AllianceBernstein

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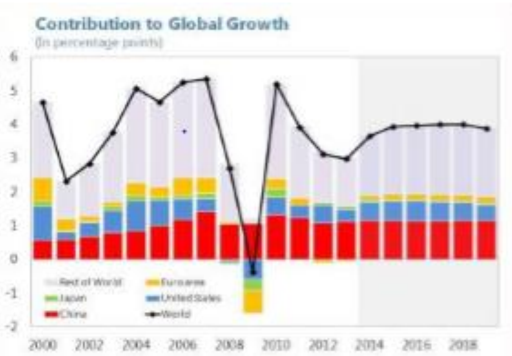
The tension between the economic fortunes of these regions will continue to impact markets into 2015, and will also have a number of indirect effects – the strengthening of the US dollar as a result of the economic recovery will affect a number of other currencies (including the Australian dollar), as well as emerging market economies which are closely tied to US demand.

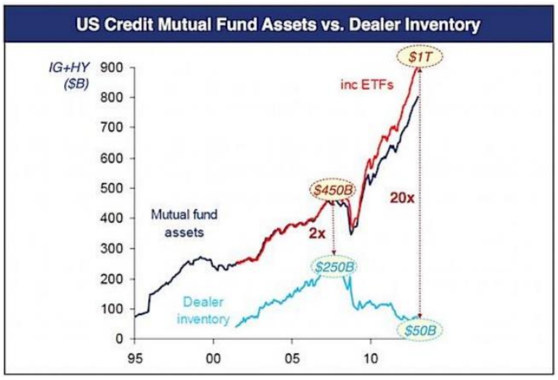
Another angle to consider is that while QE has successfully boosted asset prices, it has not actually created a lot of real economic growth. As QE draws to a close (in some parts of the world), volatility has been rising as investors focus increasingly on the anaemic levels of growth around the world, and how asset prices are going to be supported going forward as a result.



Source: IMF, World Economic Outlook and IMF staff calculations

This environment presents both opportunities and risks for investor portfolios. From an investor's perspective, one of the main risks is the greater chance of capital loss. This is a risk we are also concerned with, hence our use of strategies which specifically aim to reduce downside risk in our portfolios (such as variable beta strategies) where suitable.

At an asset class level, one sector which we believe may be hurt by rising volatility is global credit.



Source: ICI, NY Fed, Bloomberg, Haver Analytics, Citi Research

As the chart above demonstrates, due to regulatory changes in the US which prevent banking institutions from acting as market makers in credit markets, the divergence between dealer inventories and the amount of money invested into US investment grade and high yield credit has increased dramatically since 2009. In a low volatility environment such a discrepancy has minimal impact, but should volatility continue to increase and create greater demand for liquidity, then it may become problematic for credit investors.

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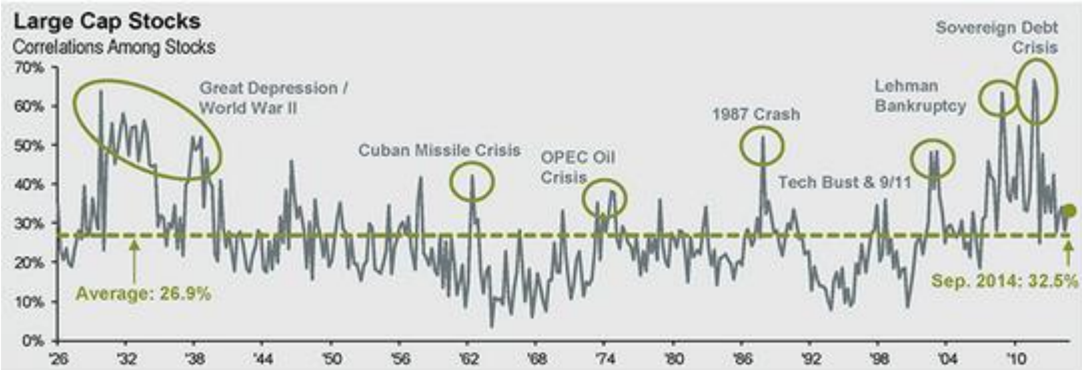
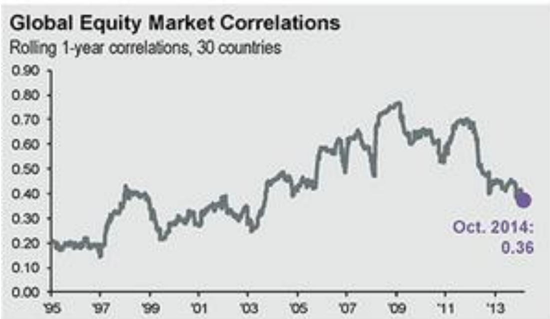
This type of scenario in our opinion supports the case for active management, as managers have the scope to assess the risk presented in the market and position their portfolios accordingly. This is especially true for fixed interest managers, as capital loss in the defensive component of an investor's portfolio has a much greater impact than in the growth component, particularly for more conservative investors. As a result, we have deliberately included more conservative managers, such as Schroders, which can their portfolios to minimise the risk of capital loss, given the current environment, even if short term performance may be impacted.

In terms of opportunities, we have observed that greater volatility is driving a greater dispersion of returns both between and within asset classes. This can be seen in the chart below, which suggests that correlations between large cap US stocks has been trending downwards, and in September 2014 was at its lowest level in several years.



Source: J.P. Morgan Guide to Markets Q4 2014

A similar trend is underway in global equities:



Source: J.P. Morgan Guide to Markets Q4 2014

This dispersion is creating greater scope for active managers to generate performance via security selection, rather than performance being driven by a handful of macro factors and correlations being high.

From a portfolio construction perspective, we continue to monitor these trends and discuss them with the managers in the portfolios, however ultimately it is impossible to predict what path markets will take. Although simple portfolio construction concepts, diversification (between asset classes and diversification of strategy within each asset class), along with regular rebalancing, provides some protection in an environment where a number of different scenarios are possible. At a fund level, we continue to focus on our portfolios' philosophy (see the December 2014 model portfolio review paper) and the role of each fund within the portfolios in supporting that philosophy.

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Low return environment
Asset class returns are expected to be lower than those pre GFC

Portfolio Positioning
- Remain mindful of the risks of chasing returns
- Diversification of investment strategies within asset classes, to avoid overconcentration in certain sectors/themes
- Use active managers who can access the best risk-adjusted opportunities in their asset class

Another effect of the GFC and post-GFC central bank policy has been the impact on asset class expected returns, namely that they are much lower than prior to 2008.

One of the most popular reactions to lower expected returns (and record low rates) has been the so-called 'hunt for yield', that is, investors buying up any asset class that provides tangible income at an attractive rate, such as high yield credit, emerging market debt and high dividend paying stocks.

However, Lonsec believes that such an approach can lead to a lack of diversification, for example overexposure to banks at a sector level, or concentration in asset classes that are positively correlated, such as credit and equities. Solely focusing on income return also ignores the impact of capital volatility on total returns – emerging market debt for example has historically offered good yields, however the asset class as a whole remains very volatile.

While a yield driven portfolio may work well under certain market conditions, it is highly sensitive to relatively few factors, so would suffer dramatically if any of these factors reversed, for example if markets started to worry about tapering again. We believe that tying portfolio performance to specific environments is not conducive to maximising total returns over the long term.

Lonsec has instead positioned the portfolios to have exposure to a variety of investment approaches, such as long/short and small cap equity strategies, to ensure portfolio performance is not tied to one specific market environment. Small caps for example tend to perform well in times of positive market sentiment and economic growth, while the ability to short enables long/short managers to capture opportunities on the downside. Growth Alternatives also offer exposure to non-traditional asset classes, such as private equity, and investment styles, such as global macro, further diversifying the portfolios' sources of return.

Secondly, managers have the ability to seek the best opportunities within their sectors at any given point in time. PIMCO for example has historically invested part of its portfolio in emerging market debt, but can vary its exposure depending on its attractiveness relative to other fixed interest sectors.

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