


The case for global low volatility equity investing

For wholesale advisers

When clients transition from accumulation to decumulation, this usually means a reallocation of assets and a change to their overall portfolio construction. Addressing key risks a retiree faces while also meeting their income needs can be challenging, but there are effective investment strategies you can consider.

Volatility goes hand-in-hand with equity investing

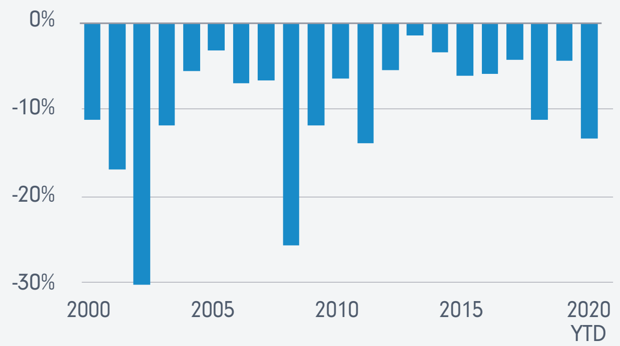
While investing in equities should provide strong capital growth over the long term, the Global Financial Crisis (GFC) and COVID-19 pandemic highlight just how volatile markets can be. And while markets usually recover to go beyond previous highs, managing equity risk and volatility is a critical factor for advisers in optimising portfolios for their clients.

Figure 1 highlights why drawdowns happen frequently. Over the past 20 years, the returns on global equity markets, as measured by the MSCI World Index, have been negative 41.8% in 244 monthly periods. In 15 of these months, losses were greater than –5%. In other words, investors experience a negative monthly return of greater than –5% around three times in every four years. The significant impact of these frequent losses can be tempered by investing in stocks with low volatility characteristics.

Drawdowns happen frequently

Figure 1. MSCI World maximum drawdown each calendar year since 2000

Since January 2000, the MSCI World has experienced a negative monthly return in 41.8% of monthly periods



MSCI World NR AUD, 1 January 2000 – 30 April 2020.
Source: Morningstar Direct.

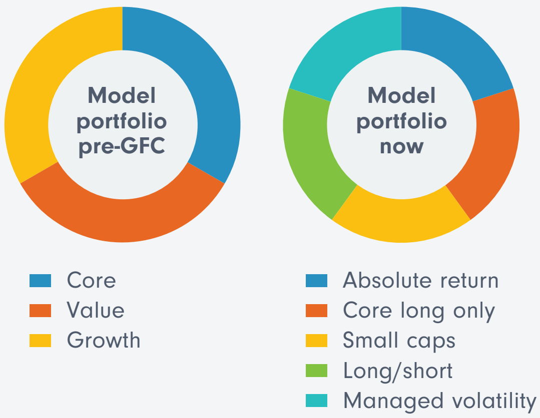
And while managing downside risk is crucial for all clients, for your retiree clients, it's even more important to have a plan in place to make sure they aren't forced to sell when investments are down, because the impact on a portfolio can be material. This is commonly referred to as sequencing risk.

To help address this, portfolio construction has evolved since the market volatility of the GFC, as Figure 2 shows. Many investors have been diversifying equity portfolios not only across asset classes, but within asset classes – to include specialist, outcome-based strategies.

Risk-reduction strategies such as long/short funds, absolute returns funds and managed volatility funds have been included with the aim to produce a more efficient portfolio with less risk.

Portfolio construction has evolved since the GFC

Figure 2. The evolution of portfolio construction



Source: Lonsec, May 2020.

Addressing the challenges of investing for retirement

Let's turn now specifically to the three key risks advisers address when considering the portfolio construction for clients investing for their retirement, which help to explain the rising popularity of low volatility investing:

1. **Sequencing risk:** A high proportion of negative returns in the beginning years of retirement will have a lasting negative effect and reduce the amount of income clients can withdraw over their lifetime.
2. **Inflation risk:** The risk that your clients' savings are eroded over time by inflation. Assets like cash and bonds are unlikely to provide the inflation hedge for pre-retirees and retirees as they have in the past due to our low-interest-rate environment.
3. **Longevity risk:** This relates to the risk of clients outliving their savings. Longevity risk is a big issue for retirees because they face two big unknowns – how long they will live and how investment markets will perform. Without any additional savings to top up their investment, this risk is heightened for retirees.

Why low volatility equity investing?

In a low-growth, low-interest-rate environment, traditional allocations to cash and bonds may no longer work – with clients living longer and needing capital growth in their portfolio to cover their needs. Low volatility equity strategies are an effective way to help clients earn meaningful equity investment returns while reducing the downside risk of the investment.

Low volatility equity investing is based on the premise that by losing less in down markets, clients can achieve the equity returns they seek, with lower volatility than the market. These funds invest in low volatility stocks, which typically fall less than other stocks in down markets.

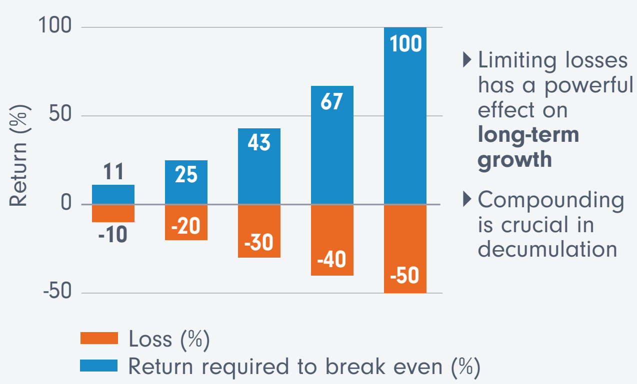
And while clients may have to forgo some upside when markets rise, the capital preserved in down markets can have a material impact on returns over the long term. This is because protecting from losses, or reducing those losses, in falling markets leaves more capital to grow when markets rise again, contributing to faster recoveries and the potential to generate significant market outperformance through the power of compounding.

The upside of downside capture

Consider this example, outlined in Figure 3: A loss of 10% in the market requires a subsequent 11.1% gain to break even and recover the value that was initially lost. This asymmetry increases sharply as the loss increases; a 50% loss requires a subsequent 100% gain to break even. This is because of the way the mathematics of compound interest works and is often misunderstood.

Winning by not losing

Figure 3. Limiting the downside loss has a greater impact than participating in 100% of gains of the market



Source: Fidelity International, for illustrative purposes only.

Understanding downside and upside capture

Understanding the importance of the upside and downside capture spread of your clients' investments is key – particularly when investing for retirement. To address inflation and longevity risk, retirees still need to take appropriate investment risk – but it's important to sensibly manage it.

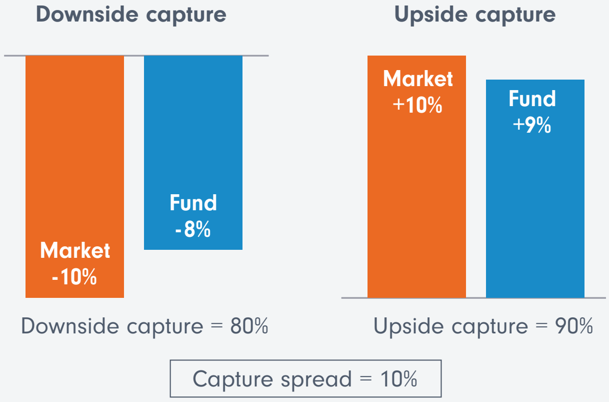
Figure 4 depicts downside and upside capture ratios for illustrative purposes only. The market is indicated in orange – down by 10%, while the example fund (in blue) is down 8%. The difference means that the example fund has an 80% downside capture ratio.

On the flip side, if the market is up 10% and the fund is up 9%, it has a 90% upside capture ratio. The difference is called the capture spread.

Low volatility strategies seek to provide clients with great downside capture (40%) and meaningful upside capture (80%) and, importantly, a wide capture spread (the difference between the two).

What are downside and upside capture?

Figure 4. Downside and upside capture ratios



Source: Fidelity International, for illustrative purposes only.

The right kind of equity risk in retirement should come with excellent downside capture to protect in down markets and a capture spread that enables sufficient participation in the market upswings. This approach has been shown to deliver better outcomes in retirement – see the example below.

The asymmetric relationship between gains and losses means that limiting losses during volatile markets has a more powerful effect on long-term growth potential than achieving the same nominal positive return.

Let's look at another example. From the low point of the GFC, when the MSCI World Index fell 30%, it took five years for the market to recover its losses. However, if an investor had realised only 50% of the loss of the MSCI World Index and then experienced 50% of the daily gains and losses of the index thereafter, it would have taken less than two years – 22 months – to recoup the market's losses. This example shows that limiting the downside loss has a bigger impact on overall long-term returns than participating in 100% of the gains of the market.

Applying downside and upside capture to performance

Managing volatility is critical as the timing and magnitude of annual changes to clients' investment performance can have a material impact on the long-term value of their portfolio, even when average returns are the same.

> "People sometimes think that defensive strategies only really deliver in a market crisis, but that isn't the case. This strategy has performed well in small corrections and participated nicely when markets appreciate. It's about providing a smooth ride over time and protecting capital when markets go down, whether it be a lot or a little."

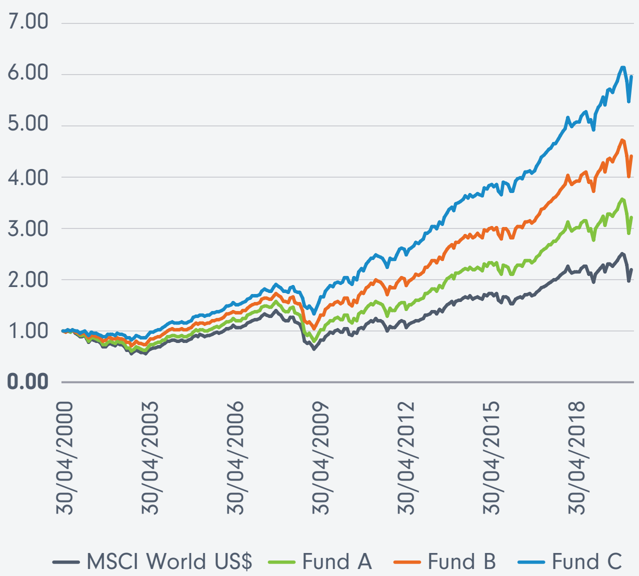
Benjamin Treacy
Institutional Portfolio Manager

If we back-test market returns 20 years, markets have been up 61% of the time and down 39% of the time. Suppose there are three investment funds with the following characteristics:

- **MSCI World:** Downside capture ratio of 100%, upside capture ratio of 100% (Index, passive fund) (capture spread of 0)
- **Fund A:** Downside capture ratio of 90%, upside capture of 100% (capture spread of 10%)
- **Fund B:** Downside capture ratio of 90%, upside capture of 110% (capture spread of 20%)
- **Fund C:** Downside capture ratio of 50%, upside capture of 80% (capture spread of 30%)

In Figure 5 below, Fund C, with the largest capture spread of 30%, has provided investors with the best return outcome over the 20-year investment period.

Figure 5. Managing equity risk
Cumulative investment returns



	Downside/upside capture	Capture spread
MSCI World	100%/100%	0%
Fund A	90%/100%	10%
Fund B	70%/90%	20%
Fund C	50%/80%	30%

	Frequency	Average size
Up markets	61%	+3.1%
Down markets	39%	-3.8%

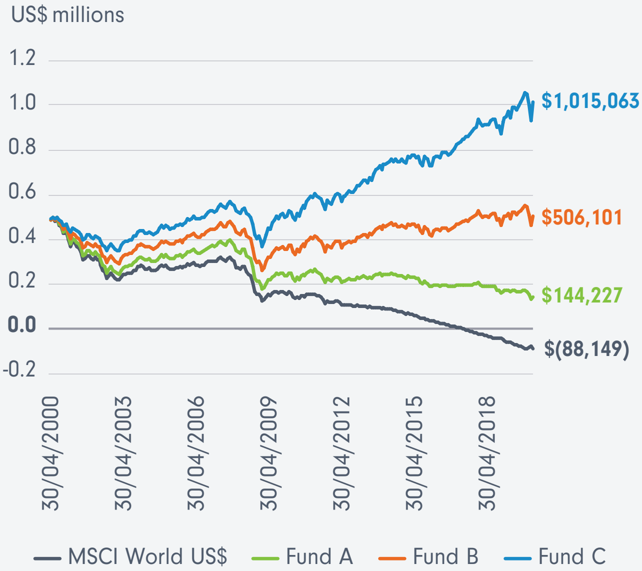
Source: Morningstar, Fidelity.
20-year period ending 30 April 2020.

Figure 6 below captures what happens to an investor in **decumulation**.

Figure 6 uses the same returns as Figure 5 – but is now expressed in terms of actual money outcomes for a retiree taking a regular income from their super balance.

In this example, consider a retiree with $500,000 withdrawing $2,500 per month to meet their income requirements. The fund with the largest capture spread of 30%, Fund C, again provides the best return outcome over the 20-year investment timeframe. But even more significant is the fact that both the index and Fund A fell below a zero balance (i.e. the money ran out) after 20 years. When constructing a portfolio for an investor who is withdrawing income in retirement and not adding to their investment balance, the importance of considering the upside/downside spread of an investment is critical to ensuring they have adequate income over their lifetime.

Figure 6. Decumulation – managing retiree risks
Decumulation outcome:
Start balance: $500,000. Withdrawal: $2,500 per month



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Source: Morningstar, Fidelity.
20-year period ending 30 April 2020.

Why the Fidelity Global Low Volatility Equity Fund?

Many low volatility equity strategies in the market are based on quantitative historical data, which is backward-looking. Fidelity's Global Low Volatility Equity Fund uses a combination of both quantitative (backward-looking) and fundamental analysis (forward-looking) to assess the risk profile of a stock and build its portfolio.

	Typical approach	Fidelity's approach
Stock selection	■ Style-based broad universe selection ■ Single over-arching model	■ Deep industry knowledge ■ Diverse investment themes from 400+ analysts
Risk management	■ Focused on standard deviation ■ Possible model errors in rare yet impactful events that elude historical testing	■ Focused on downside risk ■ Adaptive responses to rare yet impactful events with custom analysis

Source: Fidelity Investments.

The Fidelity Global Low Volatility Equity Fund aims to reduce the effect of down markets, outperform the index with improved compound returns over time.

Key features

A diversified, core portfolio of 100 to 250 global equities. It aims to achieve long-term capital growth with lower risk than the market.

Leverages insights from Fidelity's extensive global research platform, overlayed with sophisticated quantitative risk tools to build an optimal portfolio.

Aims to outperform the market with volatility of 60% to 80% of the MSCI World Index.

Access Fidelity's experience in managing low volatility funds

The managers of the Fidelity Global Low Volatility Equity Fund have a proven track record in managing a comparable low volatility strategy in the US over the past eight years. With a long-term track record of outperforming its peers in the US market, this Fund was launched to Australian wholesale and retail investors in 2019.

Like to know more?

If you'd like to know more about the Fidelity Global Low Volatility Equity Fund, visit our website or call or email one of our Wholesale Team in your local area:

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