SHOULD VOLATILITY DRIVE INVESTMENT ADVICE?

Joe Mottley
Principal, Clarus Investment Solutions

Paul McCarville
Principal, Clarus Investment Solutions

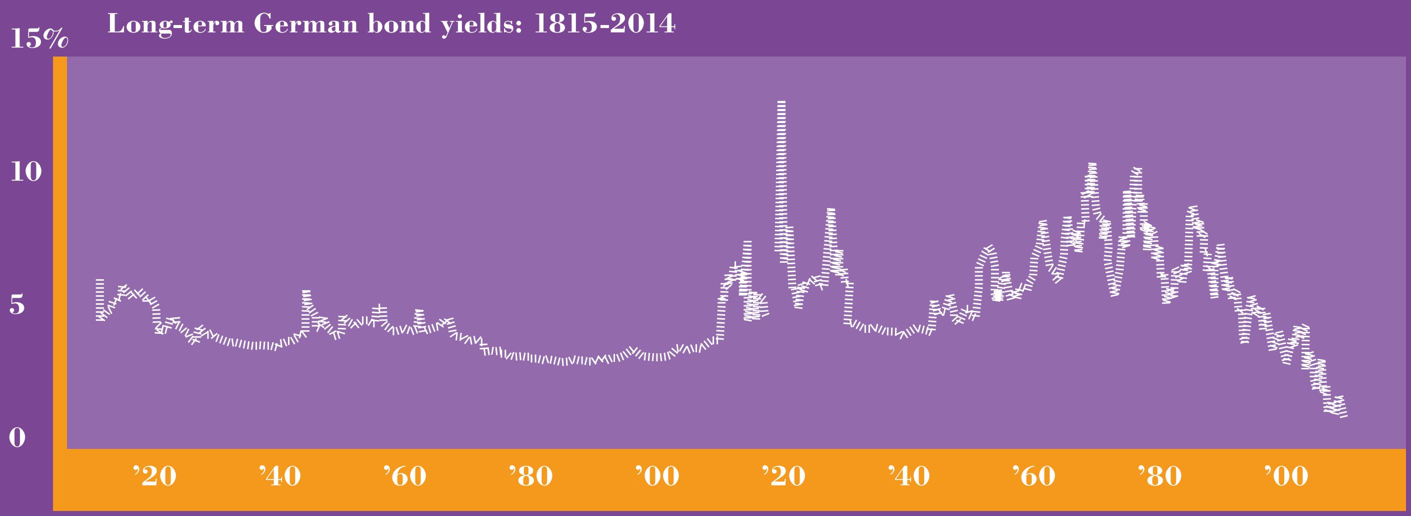
Funds targeting volatility (typically based around the European Securities and Markets Authority (ESMA) measure) are now the flagship offerings of most, if not all, product providers. They have seen large inflows and are clearly being supported by many advisers. Volatility is now front and centre-stage. Only the passage of several years will reveal how investment returns are affected by managing funds to produce particular volatility outcomes – this article looks mainly at the implications of allowing volatility to dominate the **investment advice process**. Yes, risk is central to the advice process and addressing it a regulatory requirement - **but should it drive the process**? And do we understand sufficiently how volatility helps some clients but can be very damaging for others?

The first and potentially most serious issue is the danger of focussing on volatility to a degree that eclipses discussion of return. Most clients need to achieve some level of return and assumptions in relation to return are embedded in financial planning. Surely return is important in the advice process?

Which brings us to the current 'elephant in the room'; are investors so keen on having volatility managed that they would **willingly** accept no return or even a significant possibility of loss?

With sovereign bonds in general yielding c. 1% and annual management charges typically at a similar level, a realistic assumption of the net return from the asset class over the next 5/7/10 years is **close to zero** – with the range of likely outcomes being biased towards the negative side. At the time of writing, about a quarter of all sovereign bonds have negative yields. How will lump sum investors react in 5/7/10 years' time when they find out that their low/low-medium risk investment, while staying in ESMA 2 or 3, delivered no return or even a loss? Where a conversation around return was eclipsed by one around volatility, or where return was discussed but was based on unrealistic growth projections, investors can be expected to question the advice.

The unfortunate reality is that bond yields are at or very close to all-time historic lows:



Quartz | qz.com Data: Global Financial Data

€500k invested	Zero Volatility (€000s)	Actual Volatility (€000s)	Difference (%)
Full return MSCI	1,008	1,008	NIL
Monthly drawing - **€2k**	661	585	-11
Monthly drawing - **€3k**	488	374	-23
Monthly drawing - **€4k**	315	162	-49

- Over the long term it is more normal for bond yields to be closer to 3% than 1% and a rise to this level would cause significant losses
- The European Central Bank's stated inflation objective is to have inflation close to, but below 2%: any prospect of this being achieved would see bond yields rise sharply
- From current yield levels, the 2.5% gross return projection permitted for bonds which may be used in Statements of Reasonable Projections (SORPs) and life product illustrations is wholly unrealistic for the lump sum investor
- In an environment in which negative yields persisted, credit risk would eventually come back into focus since it would almost certainly be associated with a lack of economic growth and/or deflation.
- Yes, a rise in bond yields will afford an opportunity to benefit from those yields as new money is directed into bonds – but the rise in yields will inflict permanent losses on existing holdings.

Of course lower risk funds are not fully invested in sovereign bonds – some will own other investment-grade bonds (which offer a small yield pick-up) as well as cash, an allocation to absolute return and some equities. The modest proportions held in equities will not be able to compensate unless they deliver stellar returns. *(The maximum growth rate for equities which may be used in SORPs was recently reduced from 6% to 5%.)* Moreover, assumptions that the portions allocated to absolute return can deliver cash + X% may need to be treated conservatively in the light of experience - the majority of absolute return funds have failed to meet their stated return objectives over recent years.

The use of unrealistic assumptions could also see many Approved Retirement Funds (ARFs) deplete well ahead of customers' expectations. Even though ARFs have a potentially long life, volatility is an inherently bad thing for depleting funds. To illustrate this we have shown how an ARF invested in the MSCI World index over the ten years to 30th June 2015 would have performed compared to a notional investment with the same return smoothed to zero volatility.

The interaction of volatility and depletion requires a bias towards conservatism where ARFs are concerned. However, where ARFs 'bomb out', the defence that the investment was selected on the basis of managing volatility may not be adequate where unrealistic return assumptions were used.

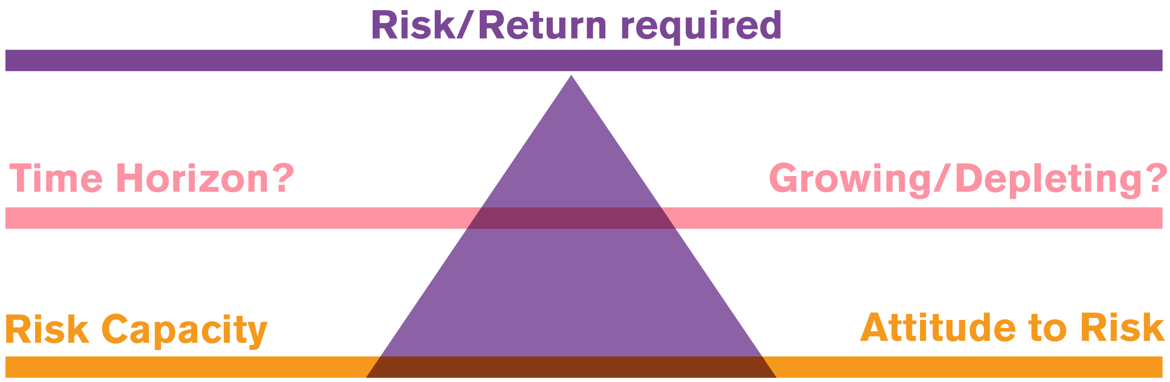
On the other hand volatility is actually beneficial for a fund which is receiving new money regularly, especially over a long period. The same simulation as before is shown below, but this time with regular contributions coming in to the fund.

So, the longer the time period, the greater the withdrawals/additions the more pronounced the effect of volatility. Time horizon and the scale of likely additions/withdrawals are huge factors in framing investment advice but are things which most Risk Profiling Tools (RPTs) do not (correctly in our opinion) even attempt to take into account. Neither do most RPTs attempt to gauge capacity to bear risk.

The all-too-common practice of mapping the outcomes of RPTs (especially when in the form of a number from 1-7) to funds targeting 1-7 scales of volatility **is a time-bomb for the advisory community**.

€500k starting investment	Zero Volatility (€000s)	Actual Volatility (€000s)	Difference (%)
Full return MSCI	1,008	1,008	NIL
Monthly contribution - **€2k**	1,354	1,431	6
Monthly contribution - **€3k**	1,528	1,643	7
Monthly contribution - **€4k**	1,701	1,854	9

It is based on a failure to understand risk profiling, and its lack of relationship with any particular volatility measure. It is flawed in by-passing a number of the key elements which should frame investment advice which we represent as follows:



Put another way, should someone with a lump sum and a time horizon of seven years and a 25 year old starting a pension fund really be directed to the same fund? They may have scored identically on an RPT but their circumstances are **utterly different**. More particularly, one will benefit from volatility and the other will not.

Unless the client can meet his or her objectives with a fund positioned broadly in line with their risk attitude/capacity, a crucial conversation needs to take place **and be documented**. They may need to be shown funds/portfolios which are higher up the risk spectrum, or accept a lower range of likely outcomes, or commit to saving more. Central to this is a thoughtful, understandable explanation of risk.

These are conversations which, far from being nervous about, advisers should relish – it is where they demonstrate their value.

The substantial support given by advisers to volatility-targeted funds echoes for us the enthusiastic reception of the Consensus fund concept 20 years ago. It is undoubtedly the case that a primary attraction of Consensus was the comfort afforded **to the pension trustees** – the fund would not be worse than mid-table in the surveys, keeping the trustees out of the firing line. Is there a parallel here in terms of a desire to head off future recrimination against the adviser? Or a misguided belief that the adviser will be able to satisfy the regulator whenever it comes to examine suitability? (To be clear, Consensus funds actually served investors well, especially those making regular contributions – they were just not diversified enough and therefore too volatile.)

To turn to the volatility-targeted funds themselves, it will be several years before we are able to form any meaningful view of investment outcomes. There will be a continuing difficulty in relation to comparability given that a number of providers have, for good reasons, adopted volatility bands different to those set out by ESMA. As something relatively new and which each provider may approach quite differently, it will be fascinating to observe. Key considerations for managers will be:

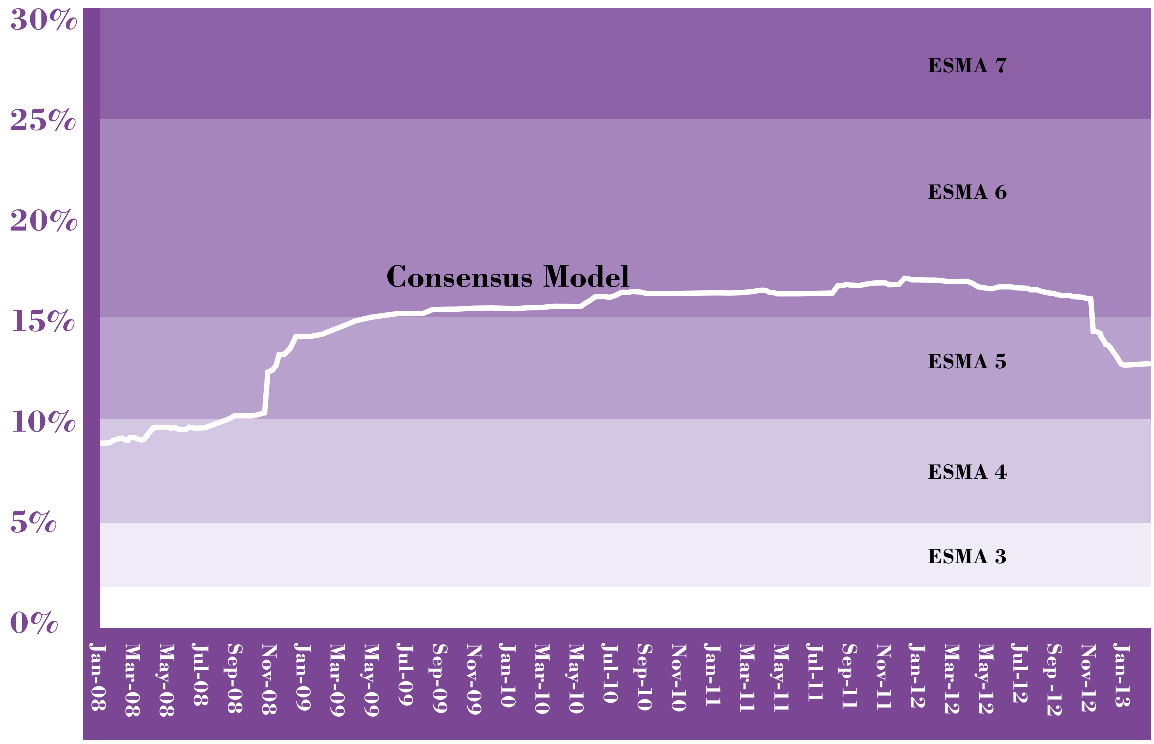
A. The intervals over which standard deviation are computed – weekly or monthly returns can produce quite different outcomes

B. The period over which to measure A. above

C. Other regimes which make the measure more stable

D. How returns might be impacted by the volatility management regime.

ESMA uses weekly returns over a five-year period: the measure it produces can be highly variable over time – as the chart opposite shows, Consensus funds would have migrated from band 4 to band 6 in quite a short period:



Tracking such a variable measure is likely to give rise to substantial portfolio restructurings from time to time, creating the possibility for significantly adding/destroying value. A volatility measure based on a longer period would be more stable and therefore more useful to consumers, advisers and the funds' managers. (The recently-published Canadian proposals are based on volatility over 10 years.)

Funds managed by people who understand volatility and have an intelligent approach to dealing with it could potentially deliver better risk-adjusted returns. Those with less understanding and crude approaches have the capacity to leave a lot of return behind - the most obvious way to destroy value is to sell risk assets which have fallen sharply (after spikes in volatility), and buy them back when volatility has subsided and after prices have recovered. We have already seen one manager make a fairly extreme asset allocation on the basis of historic volatility and a desire to 'fit' a fund into a volatility range (apparently) without any reference to valuation.

Although appearing to be relatively homogenous these funds are certainly not, starting with the risk measure they are seeking to manage. As ubiquitous as ESMA seems to be, several managers have adopted tweaks or in one case a substantial change. This is a fundamental point of differentiation. In all cases the key will be the intelligence, expertise and rigour applied by the manager.

To summarise:

- We have an open mind about the volatility-targeted funds themselves
- Such funds differ more among themselves than advisers realise
- Volatility itself is a boon to some investors but potentially very damaging to others
- Most RPTs do not attempt to capture more than attitude to risk and an RPT outcome alone is not enough to frame investment advice
- An advice process with an exclusive or excessive focus on the volatility of investment outcomes is incomplete and potentially unsuitable
- The failure to focus on return is the dog most likely to bark over the next 5/7/10 years.