



# Whitepaper:

# The Global Evolution of Low Volatility Investment in Asset Management

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## Executive Summary

**In recent years, investors scarred by the wild market and asset prices swings that followed the bursting of the dot.com bubble, the sub-prime debt implosion and the European debt crisis have developed a healthy – and growing appetite for low-volatility strategies.**

Asset managers are responding to this demand. According to data from Informa Financial Intelligence's EPFR, by mid-2Q19 there were 204 low-volatility funds globally with a total Asset under Management (AuM) of over US\$130 billion. US-based firms account for three-quarters of the current total, but interest is growing in other parts of the world and the number of globally mandated low-volatility funds has increased significantly in recent years. This has been accompanied by an increase in the number of benchmark indices, highlighting the fact that the current spectrum of low-volatility strategies is underpinned by multiple methodologies.

## Introduction

Assigning a higher weight to stocks whose historical returns show the lowest standard deviation, is the cornerstone of low-volatility investing.

Contrary to classical finance theories, contemporary literature suggests that lower volatility stocks generate higher returns. First documented by Black, Jensen and Scholes and by Haugen and Heins in the early 1970s, there have been several attempts to explain this anomaly. The 'leverage aversion' hypothesis (Black (1972); Frazzini and Pedersen (2011)) explained that most investors are leverage constrained and tend to bias their allocations to high volatility stocks in the belief that this will give them the best return on their investment, thereby creating a 'crowding' effect that causes a decrease in future returns. Behavioural economists, on the other hand highlighted investors' tendency to take risks and allocate a higher weight to stocks with a 'lottery-type of return' outlook, which reduces their future returns (Baker, Bradley and Wurgler (2011)).

This well-documented anomaly, and its attraction to investors, has garnered the asset management industry's attention. Asset management companies are allocating resources to build low-volatility portfolios and create funds that track low-volatility strategies. In addition, benchmark providers are constructing benchmark indices which systematically track low-volatility strategies.

## Total AuM and Cumulative Flows

Using EPFR's database, we searched for funds with low-volatility mandates. Going into the final month of 2Q19 there were 204 low-volatility funds globally. Since 2013 the assets managed by these funds have increased ten-fold to US\$130 billion.



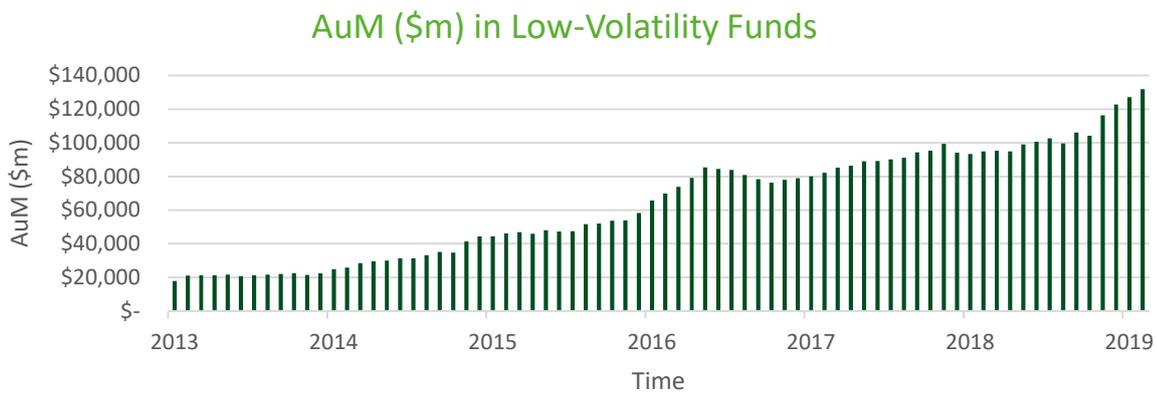


Chart 1- Total AuM in millions USD invested in Low-Volatility Funds

The number of low- volatility funds has also increased ten-fold since 2013 and the number of companies offering this product has more than tripled. (see charts below).

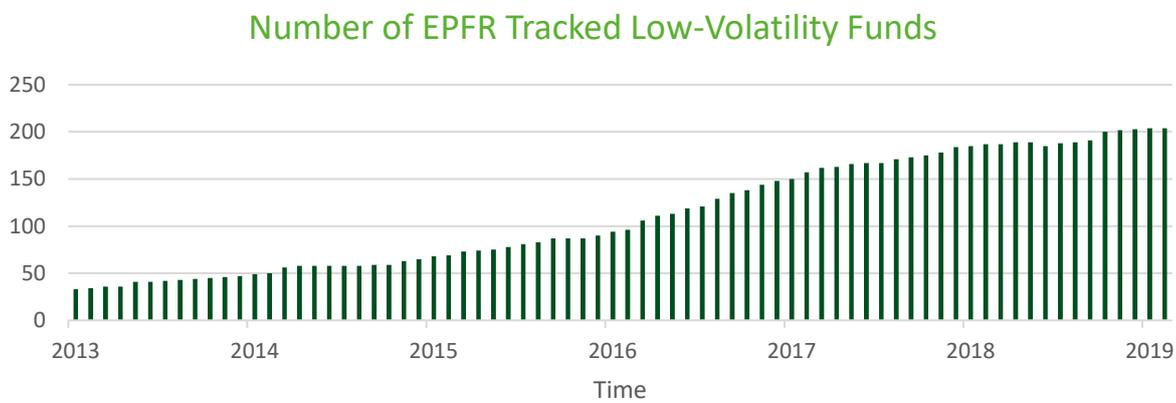
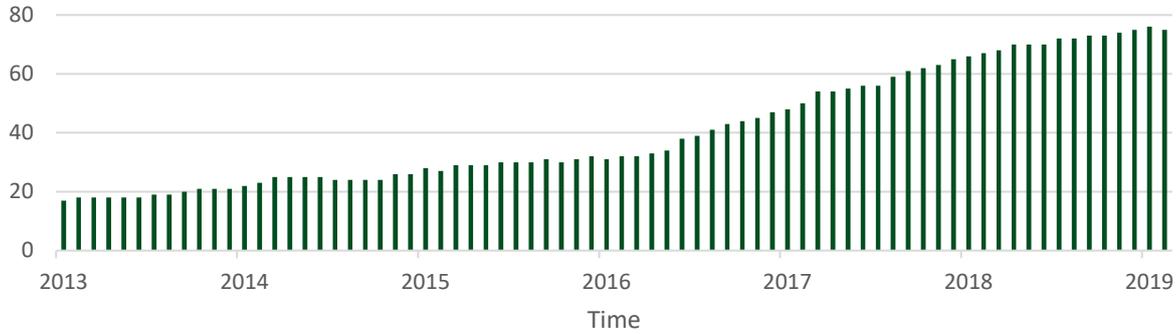


Chart 2 - Total number of funds tracking Low-Volatility Strategies



### Number of Registered Low-Volatility Fund Managers



These low-volatility products are finding plenty of willing subscribers. During the last six years, from 1Q13 to 2Q19, the cumulative flows to low-volatility funds equal 160% of their AUM at the start of 2013.

There has been a cyclical component to this growth, and the pace of growth throughout this period has, ironically, been variable. Chart 4 shows the rapid increase in flows to low-volatility funds during 2013. Those flows stalled until mid-2014, then regained pace until 3<sup>rd</sup> quarter of 2016 before taking off again in 4Q18.

### Cumulative Flow(%) of AuM to Low-Volatility Funds

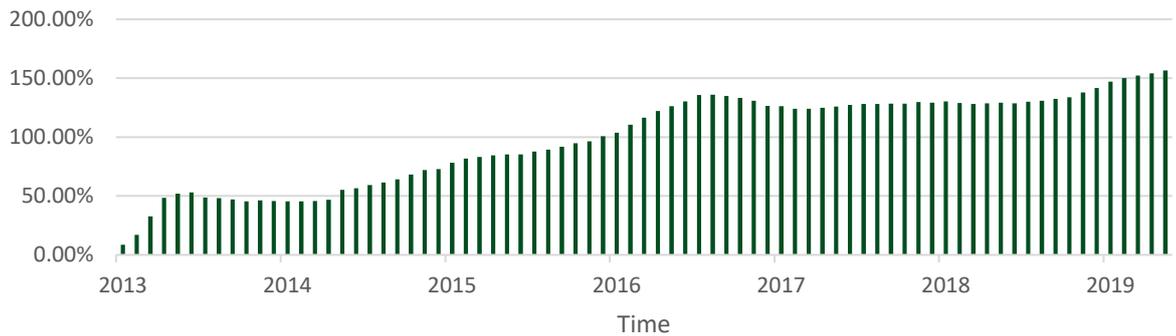


Chart 3 - Cumulative Flows (%) of AuM to Low-volatility Funds



In Chart 5 (below), the cumulative flows for low-volatility funds are separated, showing the totals for ETFs and for mutual funds. Over this period, investors have preferred low-volatility ETFs to low-volatility mutual funds.

### Cumulative Flow(%) of AuM to Low-Volatility Funds

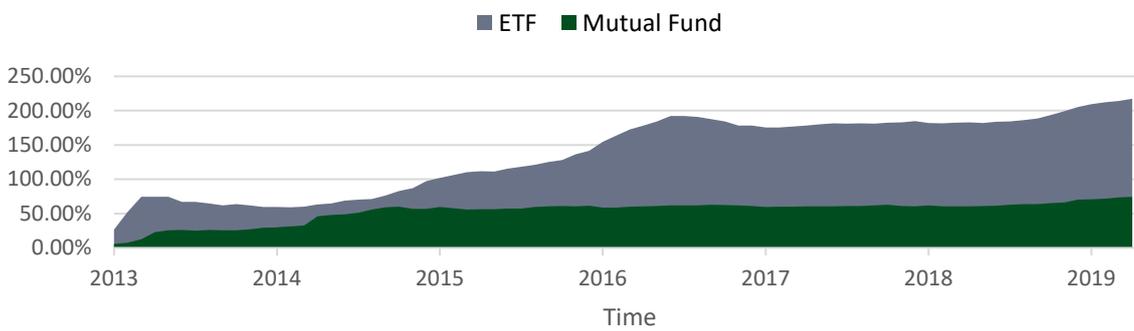


Chart 4 - ETFs vs Mutual Funds in terms of flows (%)

The increase in the AuM of low-volatility strategies appears to coincide with the increased overall interest in passive investing. Chart 6 below clearly shows that passive funds manage a larger portion of the investments in low-volatility strategies.



## Total AuM invested in Low-Volatility Funds

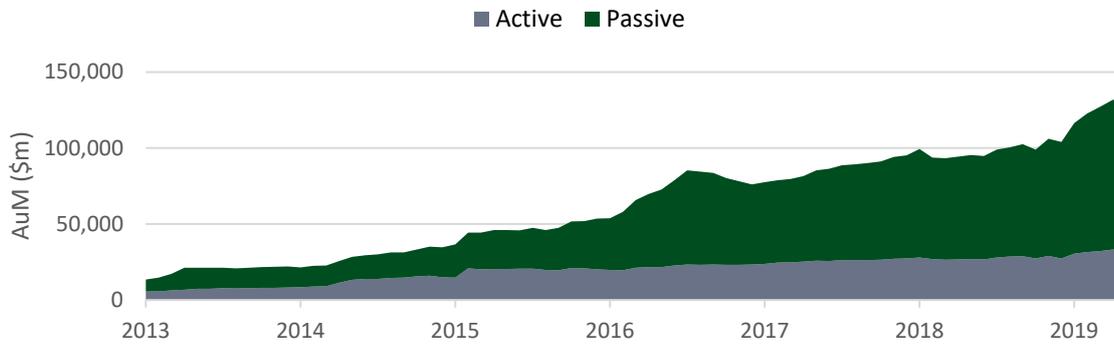


Chart 5 - Total AuM invested in Low-volatility Funds – Active vs Passive

## Benchmark Indices for Low-Volatility Strategies

Benchmark providers started to construct indices to generate an industry-level standard, as the trend in low-volatility investing continued to rise. MSCI introduced its first minimum volatility index in 2008 and S&P followed suit in 2011. During our research, we identified 74 different low-volatility benchmark indices which are utilised by EPFR-tracked mutual funds and ETFs globally.

### Top 10 Benchmark Indices by AuM

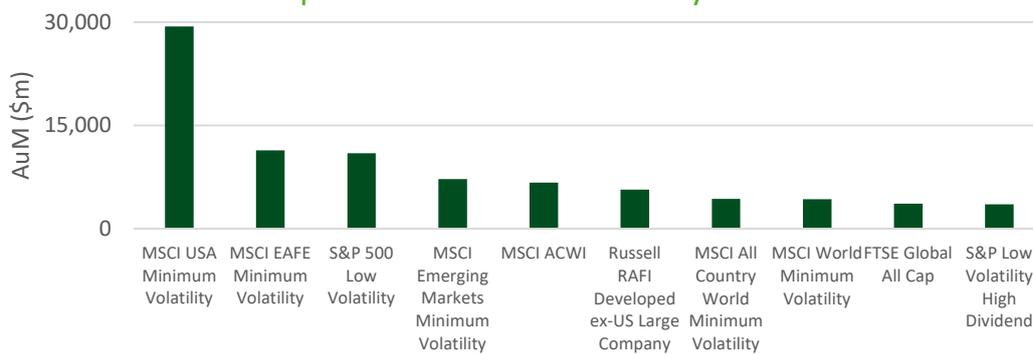


Chart 7 Top 10 Benchmark Indices by AuM



However, it is important to note that not all low-volatility funds have a low-volatility benchmark (See Chart 7 above). Some funds use classic market cap-based indices as their benchmarks while running a low-volatility strategy. Currently, the most popular benchmark index in low-volatility investing (in terms of total AuM invested) is the MSCI USA Minimum Volatility Index. In terms of fund count, the MSCI ACWI (a classical market cap weighted index) tops the list.

Chart 8, below, shows the top 10 volatility indices in terms of AuM and number of funds.

### Top 10 Indices Tracked by Number of Funds

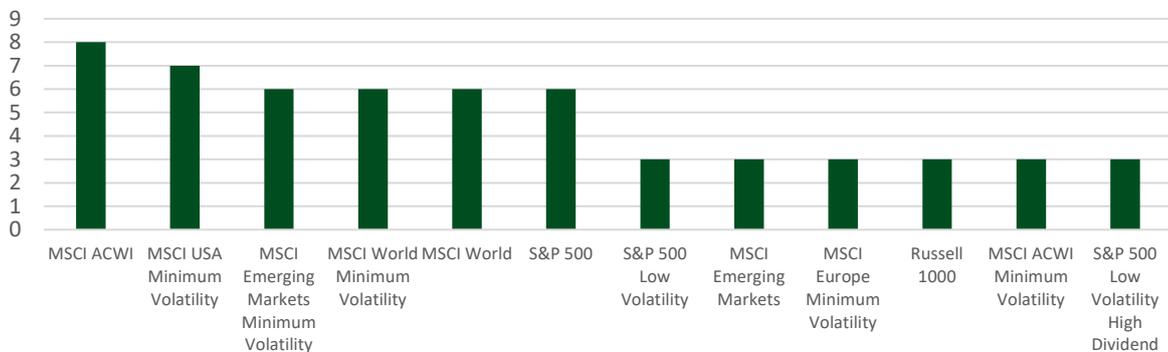


Chart 6 Top 10 Benchmark Indices by tracked number of funds



## Low-Volatility Fund Locations vs AuM

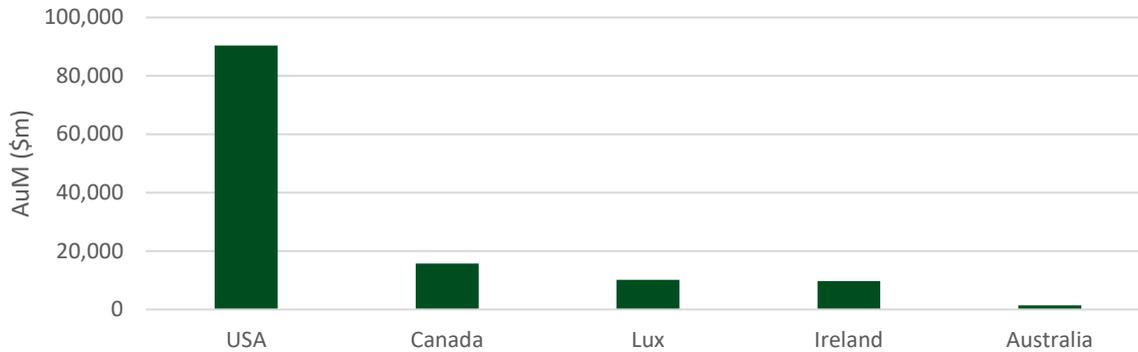


Chart 7 Low-volatility Fund Domiciles vs AuM

As with most of the current generation of index-based products, the US has led the way when it comes to the growth of low-volatility investing. In terms of the domicile, however, Canada, Ireland and Luxemburg also host a sizable number of low-volatility funds.

Overall, as interest in low-volatility investing has increased, the number of countries where these products are available have expanded. Currently, there are 15 different domiciles in EPFR's database that have at least one low-volatility mandated fund. Chart number 9 shows the top 5 domiciles and the total AuM invested in each domicile.

When ranked by geofocus, the US again tops the rankings. But, in terms of AuM, Global, Emerging Markets and Europe focused low-volatility funds combined are equal to those with US mandates, (see Charts 10 & 11).

## AuM by Geographical Focus

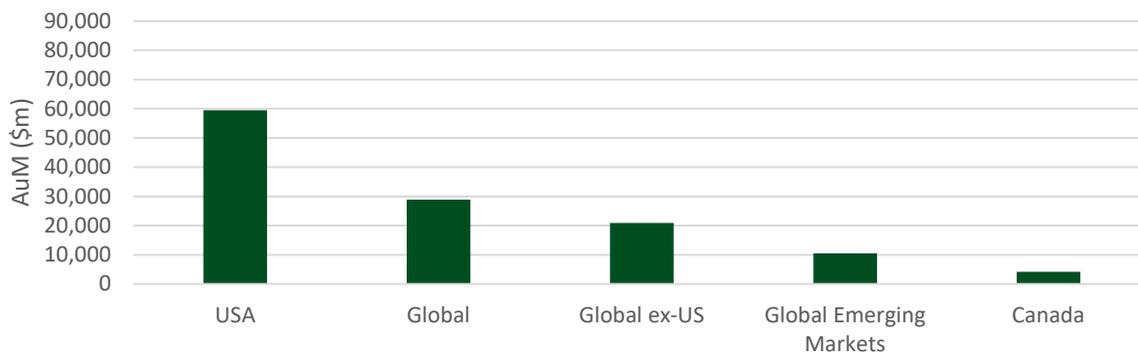


Chart 8 Total AuM by Geographical Focus of Low-volatility Mandated Funds



## Number of Funds by Geographical Focus

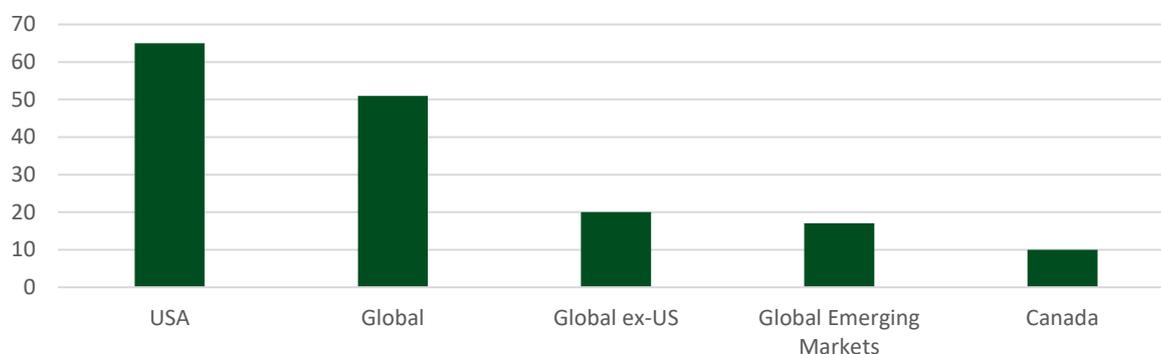


Chart 9 Number of funds by Geographical Focus of Low-volatility Mandated Funds

## Conclusion

Among the changes – and opportunities – currently confronting the investment industry is the growing appetite for low-volatility funds. Initially a US-driven phenomenon, these funds have enlarged their global footprint in recent years and taken advantage of a the growing, and increasingly diverse, range of benchmarks offered by index providers. This dispersion increases the likelihood of innovation and new approaches but carries the risk of over-complicating a product that attracts a client base seeking simplicity – and less volatility.

## References

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