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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 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 indexes, 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.

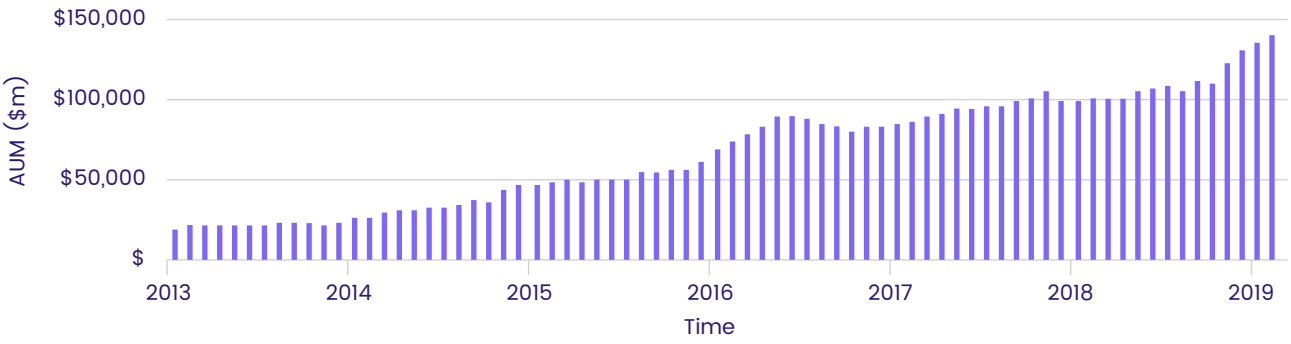
Contrary to classical finance theories, contemporary literature suggests that lower-volatility stocks generate higher returns. First documented by Black, Jensen and Scholes, and by Haugen and Heins in the early 1970s, there have been several attempts to explain this anomaly. The 'leverage aversion' hypothesis [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. Behavioral 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 indexes 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 tenfold to US$130 billion.

Chart 1 – Total AUM in USD millions invested in low-volatility funds



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

Chart 2 – Total number of EPFR-tracked low-volatility funds

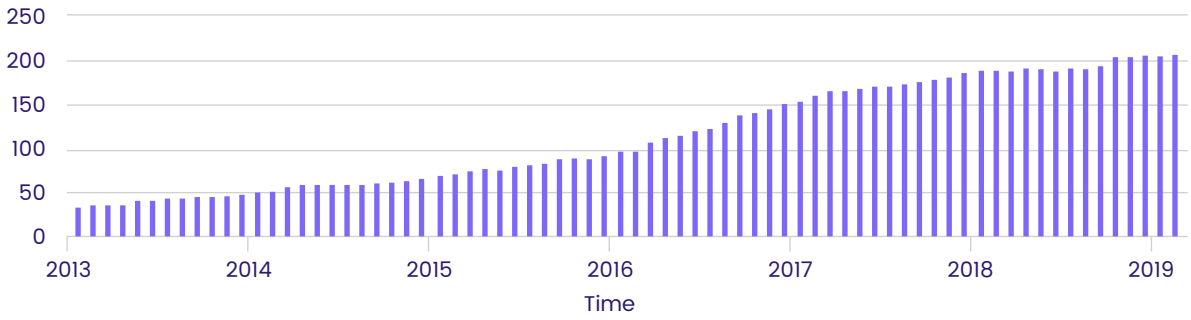
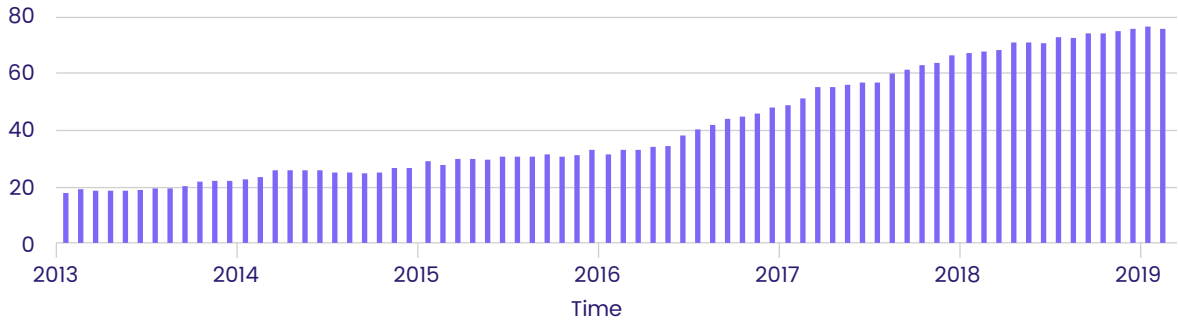


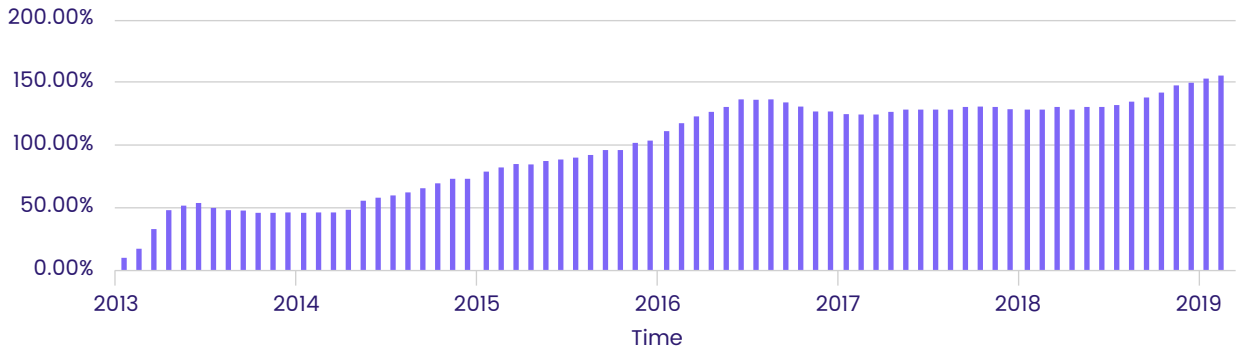
Chart 3 – Number of registered low-volatility fund managers



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.

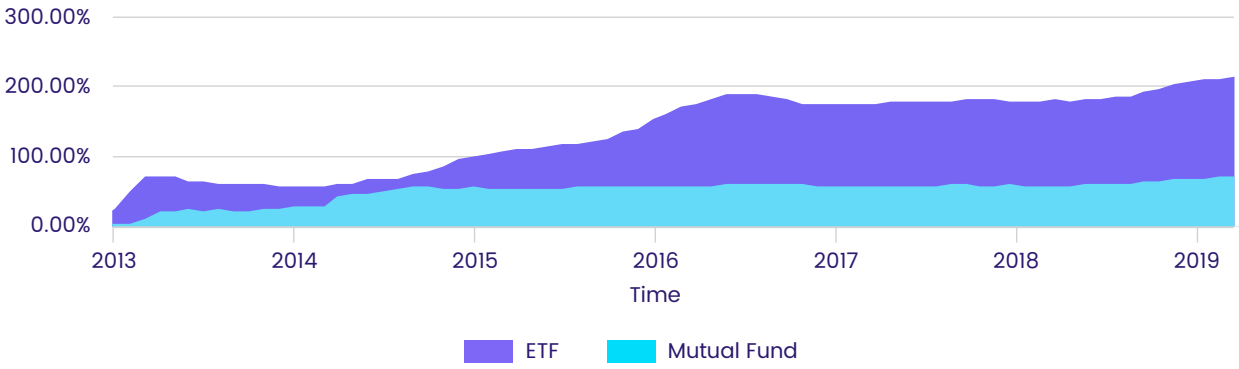
There has been a cyclical component to this growth, and the pace of growth throughout this period has, ironically, been variable. Chart 4 shows the rapid increase in flows to low-volatility funds during 2013. Those flows stalled until mid-2014, and then regained pace until the third quarter of 2016,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

Chart 4 – Cumulative flows (%) of AUM to low-volatility funds



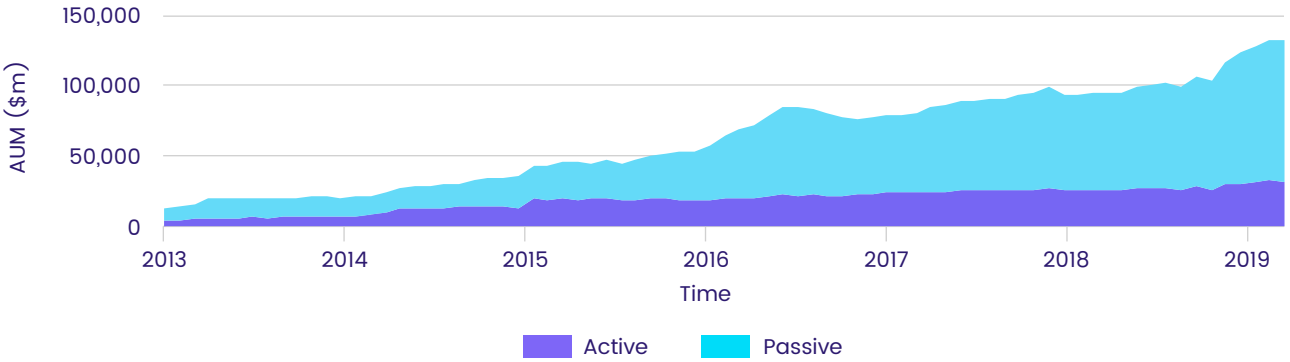
In Chart 5 (below), the cumulative flows for low-volatility funds are separated, showing the totals for ETFs and for mutual funds. Over this period, investors have preferred low-volatility ETFs to low-volatility mutual funds.

Chart 5 – ETFs versus mutual funds in terms of flows (%)



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

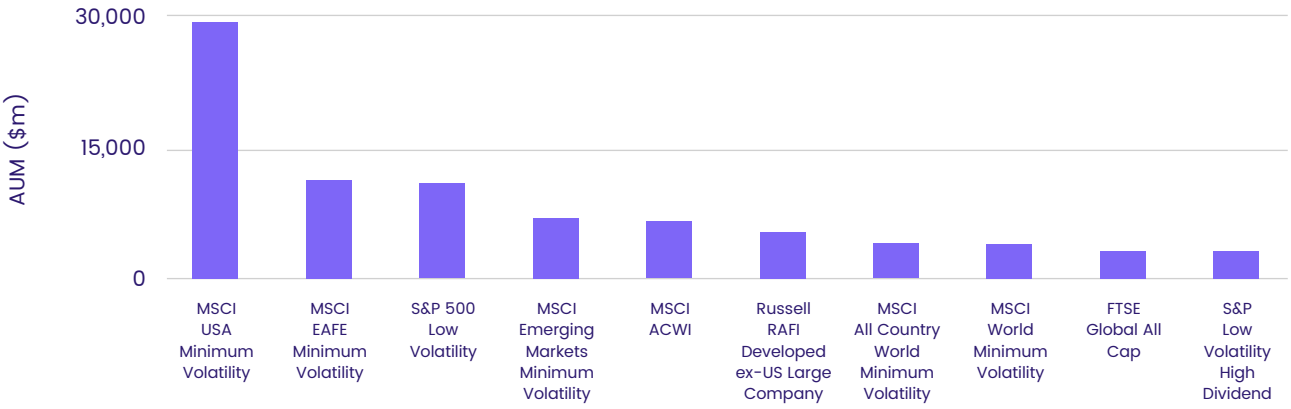
Chart 6 – Total AUM invested in low-volatility funds – Active versus passive



Benchmark indexes for low-volatility strategies

Benchmark providers started to construct indexes 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 indexes which are utilised by EPFR-tracked mutual funds and ETFs globally.

Chart 7 – Top 10 benchmark indexes 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 indexes 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 indexes in terms of AUM and number of funds.

Chart 8 – Top 10 benchmark indexes by tracked number of funds

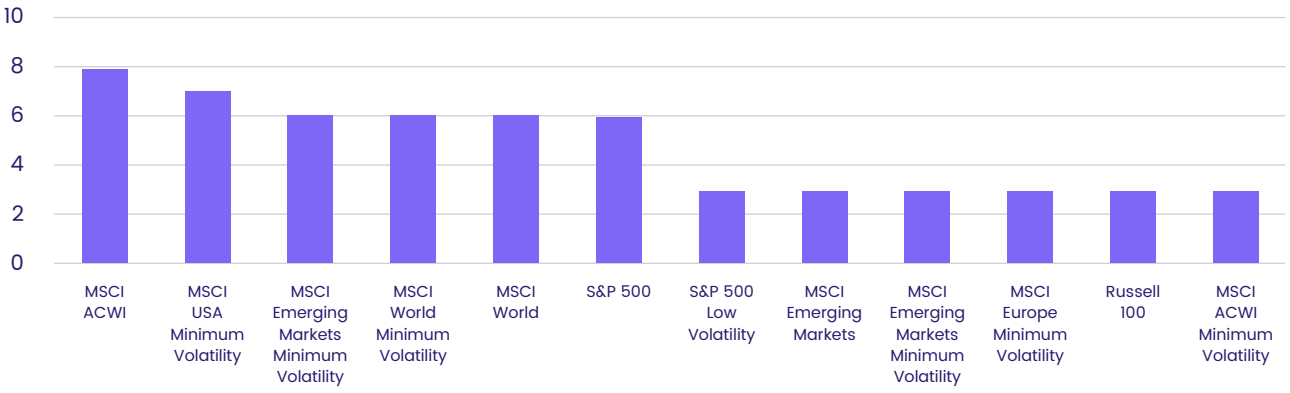
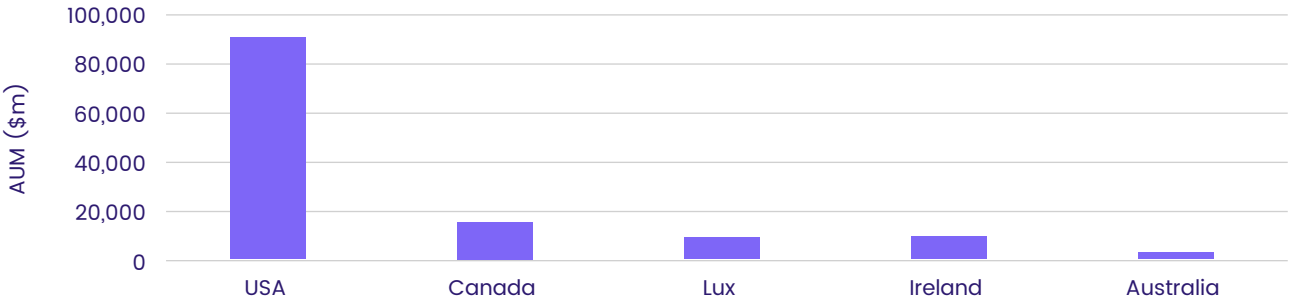


Chart 9 – Low-volatility fund domiciles versus AUM



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 geographical focus, 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 and 11).

Chart 10 – Total AUM by geographical focus of low-volatility mandated funds

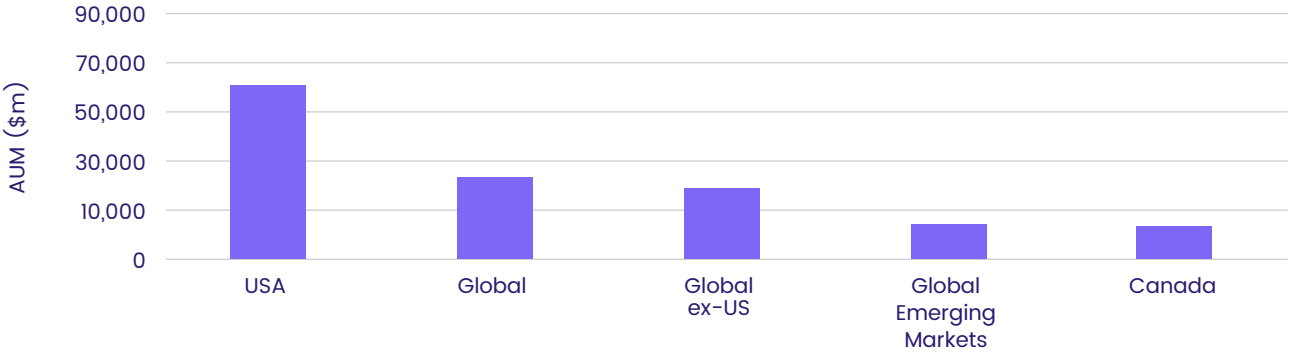
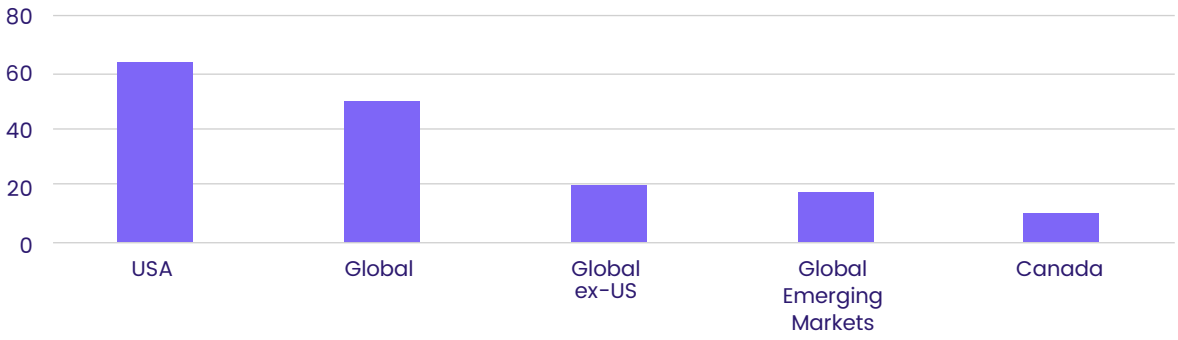


Chart 11 – Number of funds by geographical focus of low-volatility mandated funds



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 the growing, and increasingly diverse, range of benchmarks offered by index providers. Such 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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