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A cycle too short for minimum volatility indexes

*Featuring: **Mark Carver**, Managing Director, Global Head of Equity Factor Products*

***Ashish Lodh**, Vice President*

Interviewer: Last year during the height of COVID-19 and record market drawdowns, investors sought defensive equity strategies like minimum volatility to help reduce risk and lower volatility. Despite an impressive track record of outperformance during turbulent markets, minimum volatility underperformed during a period of strong market rebounds in 2020, leaving investors wondering, have minimum volatility strategies fallen out of favor? Joining us today is Mark Carver, Managing Director, Global Head of Equity Factor Products, and Ashish Lodh, Vice President Research at MSCI, to discuss if minimum volatility actually underperformed in 2020, or if the factor simply performed as expected. Mark, Ashish, thank you so much for joining us.

Mark Carver: Thank you for having us.

Ashish Lodh: Thank you.

Interviewer: Mark, now, in a year like 2020, where there was a high concentration in global equity markets and tremendous volatility, did style factors really matter and are they still relevant?

Mark Carver: Thanks for the question [inaudible], and truth the answer is they are more relevant and they mattered more. What people will remember from 2020, as they look back at the year and analyze the behavior will be two things. The insight that factors provided to explain the performance that clients and investors were observing on their screens. Particularly in the heart of the pandemic when things were spiraling downhill, people looked to factors to try to understand the prices that they were observing that maybe didn't seem to make sense. The result of that was the opportunity that they seize by rebalancing portfolios. What was really interesting is that factors went through a rotation throughout 2020. At the beginning of the year defensive factors like quality and minimum volatility performed really well, particularly in the drawdown mid-February to the end of March. And then the rest of the year, momentum. Value started to perform well, value especially at the end of the year. And so what we observed is that clients needed the insight that only factors can provide in terms of what's happening to asset pricing, and they were rebalancing portfolios to be opportunistic to take advantage of that rotation that was so plain to see throughout the year.

Interviewer: During 2020, investors also expressed concerns about minimum volatilities underperformance relative to the market. Mark, could you provide some insight into minimum volatilities performance in relation to market volatility?

Mark Carver: Sure, of course clients would look at something like minimum volatility in a period like 2020, because we'll remember it for the incredible volatility. But what we sometimes forget is that markets were volatile first with the incredible drawdown and they were volatile the rest of the year with the incredible rebound from the market bottoms. And so what happened with strategies like minimum volatility is they performed well during the drawdown, from February 17th to March 23rd or whatever date we pick for the market bottom. But then the rest of the year, very risky strategies that took on more beta, higher volatility, those were the strategies, those were the factors that won the day.

Ashish Lodh: Yeah, and building on Mark's comment, I would just like to add that the performance of main-pool in 2020, was exactly one would expect in the market conditions. So the index is designed to reduce risk and provide downside protection, and with a strong defensive nature, with a beta of about 0.65, it is expected to liken performance during extreme market rallies. And it was not an unprecedented event either. In fact since the launch of the index in 2008, it has experienced more than 15% drawdown four times, each time coinciding with extreme market rallies.

Interviewer: That's interesting Ashish, that you say that it's exactly what markets would expect. The perception that minimum volatility disappointed last year, doesn't seem to be reflected in your observations. Based on your research, what can investors reasonably expect from a minimum volatility strategy?

Ashish Lodh: Yeah, I mean, if we take a step back and think about the objective of the minimum vol index, so the minimum vol index is basically a defensive factor index and it plays a very important role in the asset allocation process, where it's designed to provide equity like returns with a lower risk than markets over long term. And historically, it has done a very good job in providing low risk. And another reason why investors use min vol is due to its factor diversification properties. It has very low correlation to factors like value and momentum, which makes it a very good addition to multifactor allocation. And speaking specifically of performance, the low beta nature of the index means that it doesn't fully capture the equity market upside, when the markets are bullish. But at the same time it provides a relatively larger downside protection when the markets are falling. And this performance asymmetry means that over long investment horizons that spans through multiple market cycles, the min vol index ends up out of family market. And that is what we refer to as the low volatility factor premium.

Interviewer: Finally Mark, what are you hearing from clients, because minimum volatility is obviously on the minds of a lot of investors?

Mark Carver: Yeah, it's interesting that today what clients are asking about is both minimum volatility and in periods where markets have been extremely strong, high risk stocks have been extremely good performers should they hold on to their minimum volatility position. And we know that a lot of investors have used it in an asset allocation context for a way to get equity exposures, but with a more defensive posture. But the number one question that clients are asking is around value investing. And we've seen a lot of interest in value, we see flows to value strategies in public funds that are linked to MSCI value indexes, but our institutional clients are asking about value. And they're positioning the portfolios with the hope that with all the great news around vaccines, with economies opening up, we'll have an economic recovery, which historically has been a good period for value investors. So that's what on the mind of clients. Do I want to be more defensive with my equity allocation, or do I want to take advantage of what may be a macro improvement in the economy, and as a result get something that is more pro-cyclical like value strategies.

Interviewer: Well, Mark, Ashish, thank you so much for joining us and explaining your thoughts on minimum volatility performance in 2020, and what investors can expect from a minimum volatility strategy of a different market and macro-cycles. Thanks for joining us.

Mark Carver: Great to be here. Thank you.

Ashish Lodh: Thanks for having us.

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