Minimizing the Market's Peaks and Valleys

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December 26, 2011

Hello. My name is Daniel Morillo. I am the head of investment and research at iShares. As part of that job, we spend a lot of time talking with clients. One of the questions that we get a lot recently is, how do we think about minimum-volatility and low-volatility strategies that have become reasonably popular of late.

So what I want to do today is spend just a couple of minutes explaining how do those types of portfolios work and how you want to think about using them as part of your own portfolio construction and allocation.

So to start out with, the way you want to think about these portfolios is you don't want to think of them as just a volatility portfolio. But you want to think of them as a beta bet, in effect. So when you have a minimum-volatility portfolio, you are overweight low-beta stocks. And you're underweight high-beta stocks as compared to a typical [cap-weighted] benchmark.

As you know, beta is a measure of how far stocks move together with the market. So high-beta stocks are those stocks that move more than the market when the market moves. And low-beta stocks are those that move less than market when the market moves.

So being overweight low-beta and underweight high-beta means that, when the market goes up, these portfolios will go up somewhat less than the market. But also, when they go down -- when the market goes down, they will go down less than the market, therefore less volatile. Right.

So low-volatility or minimum-volatility portfolios. Now, what's interesting about these is that not only are they less volatile, but they actually don't give up as much return per unit of volatility as the market does.

So they are somewhat less volatile than the market. But per unit of that risk, per unit of that volatility, they actually generally give better returns than the market. Now, this is not mechanical. It's not simply just because they're long low-beta and short high-beta.

This happens, we believe, because the market tends to somewhat overvalue high-beta stocks, right. There's a premium that people pay for high-beta stocks for various reasons. They tend to be more [growth] stocks.

They tend to be sort of the types of stocks that many institutional investors might find attractive when they do target-risk type portfolios. So that overvaluation of high-beta stocks is something that these types of portfolios take advantage of by being long low-beta stocks and short the high-beta stocks.

So you get slightly better return per unit of risk. Now, what's interesting about this is that they can be a useful tool for improving your overall strategic allocation. So when you think about a typical strategic allocation where you've made a choice between stocks and bonds and potentially other asset classes, you've made a choice between risk and return.

So if you have high risk tolerance, for example a young person with a very long investment horizon, you might take some for a better risk, and you would expect to get paid some for that risk. So you have lots of equities, maybe lots of high-yield securities.

A more conservative person, say a person about to retire, might take less risk. They don't have as long of an investment horizon, fewer equities, maybe more bonds. So they take less risk. They receive less return for that on average.

Now, once you think about what a minimum-volatility portfolio can do for you, basically think of it as a replacement a little bit for your equity allocation or at least part of your equity allocation. What that does to your portfolio is it shifts this trade-off line up a little bit.

Because you get slightly better return per unit of risk, what that means is that, for example, this person here, this young person with high risk tolerance can take the same amount of risk but get more return for it. They would do so by just getting more of the equity in the form of a minimum-volatility portfolio.

Or that person might decide, actually, I'm comfortable with this level of expected return. But now, I'm going to take [somewhat] less risk to get there. Right. So simply leave my equity allocation intact but take it partly in the form of a minimum-volatility portfolio that gives me similar return but for a lower level of risk.

So in general, again, what I want to highlight of this is that, even though the name volatility is part of this sort of strategy, you don't want to think of it just as a volatility play. You don't want to buy it just because the market is highly volatile now, and this is a way of reducing your risk.

That's perfectly reasonable to do it for that reason. But you also want to think of this as potentially something you want to use as part of your strategic allocation as a way of really enhancing this trade off between risk and return.

I think that's basically the summary of it. It's not really any more complicated than that. Thank you.

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