Desperately Seeking Low Volatility

Published July 23, 2020

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This article is relevant to financial professionals who are considering offering model portfolios to their clients. If you are an individual investor interested in WisdomTree ETF Model Portfolios, please inquire with your financial professional. Not all financial professionals have access to these model portfolios.

All my friends know the low rider
The low rider is a little higher

Low rider drives a little slower
Low rider is a real goer

Low rider knows every street, yeah
Low rider is the one to meet, yeah

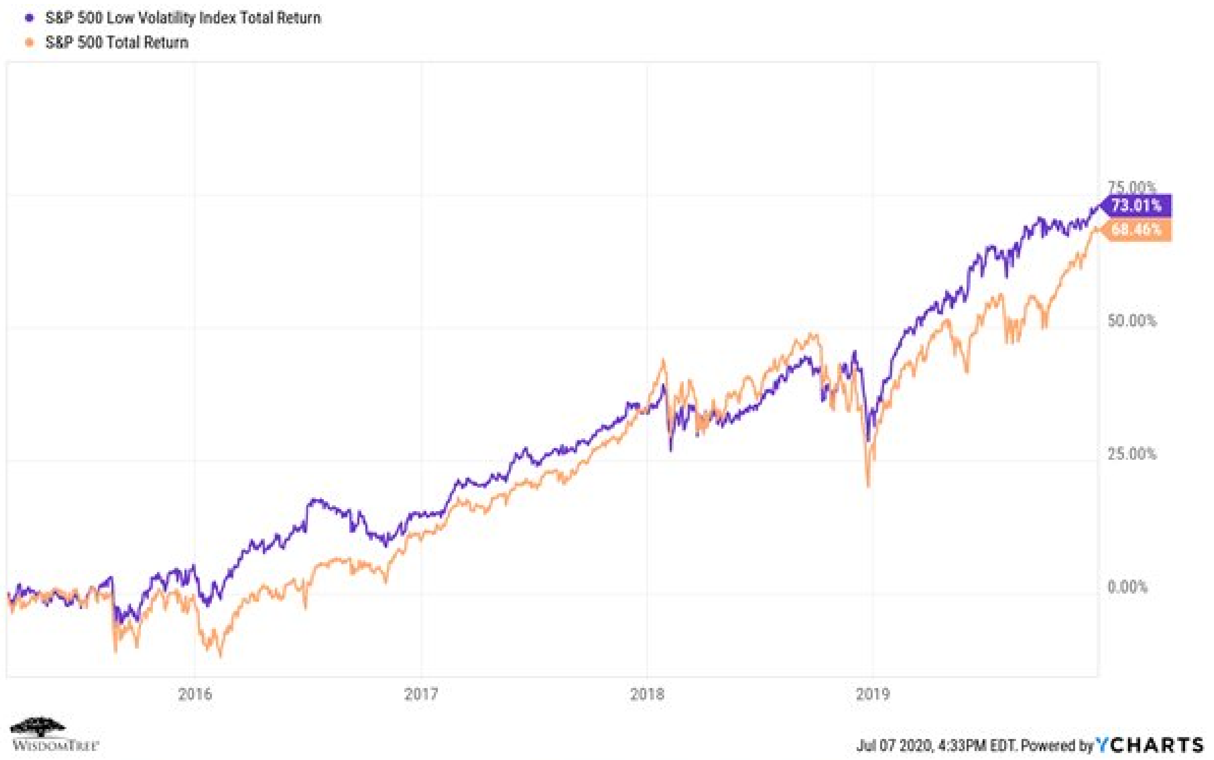
Low rider don't use no gas now
Low rider don't drive too fast

Take a little trip, take a little trip
Take a little trip and see

Take a little trip, take a little trip
Take a little trip with me

(From "Low Rider (On the Boulevard)," performed by War, 1975)

One of the more popular investment risk factors over the past 3–5 years has been "low volatility." Classic investment theory suggests that stocks with lower volatility should also have a lower expected return, but for the past five years up until the end of 2019, that simply was not the case:



Source: YCharts. Data from 1/1/ 15–12/31/19. You cannot invest in an index, and past performance is no indication of future returns.

For definitions of indexes in the chart, please visit our glossary.

That outperformance, however, has broken down in 2020, no doubt influenced by the virus-induced market disruptions:

Source: YCharts. Data from 1/1/20–7/6/20. You cannot invest in an index, and past performance is no indication of future returns.

As we have written about before, risk factors rotate in an out of favor just like asset classes do, and “low vol” is no exception (it is the bright yellow box in the “performance quilt” below):

Currently Displaying: Universe: WTUSMFU - Quartile: 1st Quartile - Weighting: Factor - As of: 2020-06-30

2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020 YTD
Momentum (-1.4%)	Value (46.32%)	Correlation (24.04%)	Quality (15.8%)	LowVol (19.36%)	Quality (10.93%)	LowVol (-23.16%)	Value (58.13%)	Quality (25.67%)	LowVol (12.31%)	Quality (18.82%)	Value (44.52%)	LowVol (17.2%)	Momentum (7.46%)	Value (19.44%)	Quality (25.42%)	LowVol (-1.27%)	Size (28.03%)	Correlation (-2.31%)
LowVol (-2.96%)	WTUSMFU (38.38%)	Multifactor (21.42%)	Value (15.24%)	Momentum (17.42%)	Correlation (7.33%)	Momentum (-25.75%)	WTUSMFU (40.14%)	WTUSMFU (23.23%)	Momentum (12.06%)	Value (17.73%)	Size (35.77%)	Multifactor (16.54%)	LowVol (5.32%)	WTUSMFU (13.9%)	Size (22.21%)	Momentum (-2.14%)	Quality (27.97%)	Size (-6.44%)
Multifactor (-2.87%)	Correlation (34.08%)	Value (19.65%)	Correlation (15.0%)	Value (17.36%)	Size (7.18%)	Multifactor (-32.59%)	Quality (38.07%)	Value (20.57%)	Multifactor (10.85%)	WTUSMFU (17.2%)	WTUSMFU (35.31%)	Correlation (15.55%)	Quality (1.8%)	Quality (13.23%)	WTUSMFU (19.63%)	Correlation (-3.67%)	Value (27.76%)	Quality (-8.18%)
Correlation (-7.41%)	Quality (32.93%)	LowVol (18.51%)	Multifactor (14.05%)	Multifactor (15.41%)	Multifactor (5.85%)	Quality (-35.06%)	Correlation (32.81%)	Correlation (20.12%)	Correlation (4.41%)	Size (16.7%)	Correlation (34.81%)	Momentum (15.32%)	Size (0.66%)	LowVol (13.06%)	Value (19.1%)	Multifactor (-6.01%)	LowVol (27.45%)	Momentum (-9.53%)
Quality (-8.27%)	Multifactor (30.97%)	Quality (17.46%)	WTUSMFU (11.18%)	WTUSMFU (14.4%)	WTUSMFU (5.77%)	Size (-36.67%)	Size (32.79%)	Momentum (17.56%)	Quality (3.4%)	Multifactor (15.67%)	Quality (35.78%)	Size (14.29%)	Multifactor (0.55%)	Size (11.59%)	Momentum (18.77%)	Size (-4.38%)	WTUSMFU (27.1%)	WTUSMFU (-10.46%)
Value (-15.47%)	Size (30.18%)	WTUSMFU (17.44%)	Size (7.59%)	Size (13.38%)	Momentum (5.59%)	Value (-38.47%)	Multifactor (24.59%)	Multifactor (17.38%)	Size (1.05%)	Correlation (15.52%)	Multifactor (32.23%)	Value (13.58%)	WTUSMFU (-1.31%)	Momentum (9.95%)	Multifactor (17.32%)	Quality (-6.65%)	Momentum (26.01%)	Multifactor (-11.18%)
WTUSMFU (-17.97%)	LowVol (27.01%)	Momentum (17.02%)	Momentum (5.58%)	Quality (12.57%)	LowVol (1.14%)	WTUSMFU (-38.05%)	LowVol (20.2%)	LowVol (15.94%)	WTUSMFU (0.13%)	Momentum (13.15%)	Momentum (27.99%)	Quality (13.52%)	Value (-6.9%)	Multifactor (7.97%)	LowVol (17.24%)	WTUSMFU (-7.85%)	Correlation (23.15%)	LowVol (-13.36%)
Size (-22.11%)	Momentum (25.97%)	Size (13.16%)	LowVol (5.07%)	Correlation (11.24%)	Value (0.27%)	Correlation (-41.0%)	Momentum (15.13%)	Size (14.5%)	Value (-1.34%)	LowVol (12.9%)	LowVol (23.72%)	WTUSMFU (12.72%)	Correlation (-7.79%)	Correlation (7.59%)	Correlation (13.51%)	Value (-13.2%)	Multifactor (30.11%)	Value (-22.17%)

Source: WisdomTree Asset Management. Data as of 6/30/20. You cannot invest in an index, and past performance is no guarantee of future returns. The starting universe for the referenced "factor portfolios" consists of the 800 largest companies listed in the U.S. Securities in the Low Correlation portfolio are selected based on their trailing 6- and 12-month correlation versus the broad market. Securities in the Low Volatility portfolio are selected based on their trailing 12-month standard deviation. Securities in the Momentum portfolio are selected based on their trailing 6- and 12-month risk-adjusted performance. Securities in the Quality portfolio are selected based on stronger current and historical (three-year) measures of profitability compared to their peers in the same GICS industry using four main variables: return on equity, return on assets, gross profits over assets and cash flow over assets. Securities in the Value portfolio are selected based on more attractive valuation metrics compared to their peers in the same GICS industry using six main variables: sales-to-price, book-to-price, earnings-to-price, estimated earnings-to-price, EBITDA-to-enterprise value and operating cash flow-to-price. Securities in the Size portfolio are selected based on their market capitalization compared to their peers in the starting universe. Securities in the Multifactor portfolio are selected based on a composite score calculated by equally weighting their low correlation, momentum, quality and value scores. Risk factors can toate in an out of favor just like asset classes do, performing better or worse in certain years.

Another characteristic of "low vol" investing is that its recent popularity with investors has driven the valuations of "low vol" stocks sky-high. The current P/E ratio of a popular S&P 500 "low vol" ETF is trading at only a slight discount to the P/E ratio of the mainstream S&P 500 Index ETF itself. And remember that the mainstream ETF includes what we view to be hyper-valued large-cap tech stocks. For now, dividends for the sector appear safe to us, providing a key level of near-term valuation support. But, nonetheless, "low vol" investing has become expensive.

Put differently, investors seem willing to "pay up" for a low-volatility allocation within their portfolio, but, as we know, the future potential performance of any investment is a function of how much you pay for it today. If you pay a high multiple today, your future potential performance typically is reduced.

We have written before about the inclusion of lower-correlated strategies into portfolios as a way of improving overall diversification, and we make those strategies explicitly available in our Endowment Model and our Volatility Management Model.

But there is another way to lower portfolio volatility without overpaying for "low vol" stocks. As a part of our Outcome-Focused Model Portfolio sleeves, we offer three versions of a "smart beta" or "multifactor" model portfolio—one each for the U.S., developed international and emerging markets. All these portfolios are designed specifically to deliver a high level of risk factor diversification, thereby potentially lowering the overall volatility of a broader portfolio.

Each of these models could be used as a stand-alone equity portfolio—they are geographically specific in nature, but within each region they are diversified across asset classes, styles and risk factors. But each of them (or a combination of them) can also act as a complement to an existing equity portfolio for advisors seeking to reduce volatility without having to make wholesale reallocations.

Currently, each of these the multifactor models has explicit allocations to a variety of risk factors, including:

- Value
- Size (both large cap and small cap)
- Quality
- Dividends
- Momentum, and
- Growth

As with all WisdomTree Model Portfolios, these models are “open architecture” (that is, they include both proprietary and third-party products), and they carry no strategist fee.

The inclusion of one or more of these models into an overall portfolio can help achieve a similar outcome to allocating to “low vol” stocks, *but at much more attractive valuation levels*.

For some perspective, consider the performance of the dark green “Multifactor” box in the risk factor performance quilt above. That box does *not* reflect the actual performances of the model portfolios—those boxes reflect index-level performances, and you cannot invest in an index, nor is past performance any guarantee of future results.

But you can get a sense of the historical improved performance consistency by incorporating multiple factors into a portfolio (that is, the green boxes tend to cluster around the middle of the performance quilt).

Just like with asset classes, when certain parts of the market are rallying strongly (e.g., large-cap tech), a more diversified portfolio will generally not keep up with that sector or risk factor.

But we believe we may have entered a new market regime, driven by both the ongoing pandemic and corresponding governmental intervention, that will be characterized by increased volatility.

For advisors seeking to improve the risk factor diversification of their overall portfolio and thereby potentially lowering portfolio volatility—but without “paying up” for “low volatility” securities—the WisdomTree multifactor models may be worth looking into.

Important Risks Related to this Article

There are risks associated with investing, including the possible loss of principal. Diversification does not eliminate the risk of experiencing investment losses. Using an asset allocation strategy does not ensure a profit or protect against loss.

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