INVESTMENT INSIGHTS

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The conundrum of disappearing market volatility

Volatility in the U.S. stock market has hovered at historically low levels, even as valuations increase and the Federal Reserve embarks on its project of winding down QE. Jeffrey Knight, global head of investment solutions and head of global asset allocation at Columbia Threadneedle Investments, discusses the implications of low volatility, the interplay between volatility and valuations, and what catalysts might cause the volatility trend to reverse. In Knight's view, an adaptive approach to risk allocation is critical to successfully navigating the current environment, as well as a spike in volatility, should one occur.

|Q.| ***What's behind the low volatility that we have seen in markets?***

|A.| I think that there are two major drivers of low volatility: the first is aggressive interventionist monetary policies around the world and the ensuing liquidity these policies create; the second is that real world economic conditions are very stable. For example, economic growth, corporate profits and inflation have all been very consistent this year.

|Q.| ***The persistence of low-volatility has been unnerving for some. What does it mean for institutional investors seeking to put their assets to work?***

Knight: History does not support the idea that simply because volatility is low, the investment environment is imminently dangerous. In fact, the opposite is true. Low volatility supported by benign conditions tends to beget more low volatility. So I do not view it necessarily as a warning sign or a signal that the environment is about to get worse.

There is a very good analogy for the extended period of low volatility — the Cleveland Indians' winning 22 consecutive baseball games in September. Everyone knew that it could not go on forever, but during the streak, the probability of the Indians winning their next game was slightly higher, not lower, than you would have thought, because what the streak told us was that they were a really good baseball team. In a similar way, low volatility can indicate stable and positive real world conditions that are not highly likely to change suddenly.

But there is a caveat. Winning streaks do not go on forever, and we do not think that volatility, whether realized or implied, can get much lower than we are seeing currently. It is fair to draw the conclusion that the way forward is asymmetric from here — that incremental gains in asset prices, while probable, are likely to be smaller in magnitude than losses, should they occur. Markets have priced in a great deal of good news.

|Q.| ***What are the implications of that asymmetry for investors, and how does an adaptive approach help?***

|A.| The asymmetry is a challenge. If you stay fully invested and the prevailing trends stay in place, you may win a little. But if the trends reverse, you may lose a lot, and that is the conundrum. There is no reason to predict a reversal in volatility, but if one were to materialize, it could be significant. Our investment decisions must balance the high probability of ongoing gain against the high consequence of an unforeseen reversal. In that environment, we want to stay invested for the most likely scenario of gradually positive performance, but still have a mechanism or strategy for dealing with a less likely but more significant move lower.

Our answer to that challenge has two parts. First, we employ extended diversification — investing in lots of different asset types. Second, we invest with an adaptive methodology, which has specific thresholds and triggers that give us access to a capital preservation orientation when needed. As long as volatility is falling, we have a green light to be more aggressively positioned. But a pickup in volatility, in a fashion that exceeds our threshold, may force us to reposition the portfolio and prepare for an environment where taking risk off the table makes sense. Having access to a pre-considered de-risking strategy is more valuable today than usual because of the asymmetry of future returns.

|Q.| ***Do you think that investors should be more focused on the absolute level of volatility, or the rate of change that we may see?***

|A.| They are related. Because the level of volatility is low today, the threshold for what constitutes rising volatility is also low. If volatility was 10 and went to 12, that is not a high level of implied or realized volatility, but it is a 20% increase, and the market implications of that rate of change, as short-volatility positions unwind, has the potential to be disruptive.

|Q.| ***What should investors be watching that would indicate the environment is changing?***

|A.| I think that there are three things they should be watching for. The first one is the Fed. We all know that the Fed is likely to raise rates because they have been very clear about this, but one potential catalyst for elevated volatility would be a misalignment of Fed action with what the market has priced in — a more aggressive stance than the market expects — particularly if investors believe that the Fed has made a policy mistake. The

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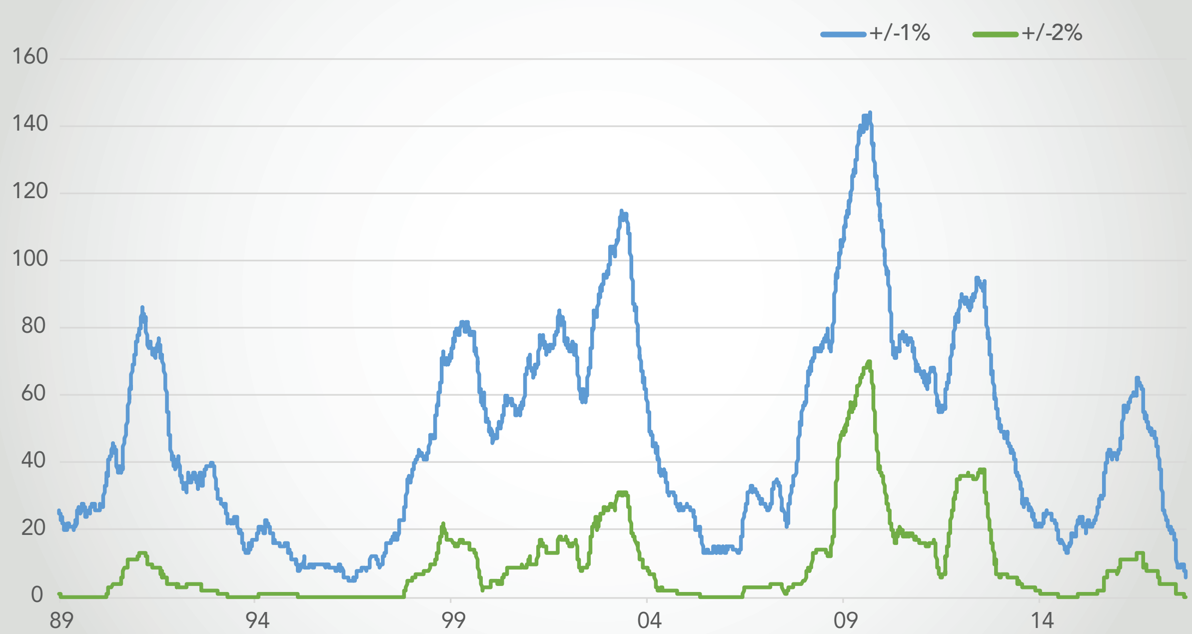
second is macro data, which continue to be very strong. Our team has some high-level gauges — we call them investment clocks — that respond to incremental economic data in a composite fashion. They are reassuring at the moment, but if we were to see a negative surprise in growth, or more significantly, a deterioration in growth, we would expect higher market volatility.

The third thing I would monitor is exchange rates. We have been in an environment where financial conditions have been easing in the U.S. as a result of the dollar weakening. Our tools that are focused on exchange rates are, if anything, pointing toward a weaker dollar, so we do not see anything at the moment to worry about there, but things could change. A strong U.S. dollar could be disruptive to today's benign financial conditions.

VOLATILITY, OR THE LACK THEREOF

MSCI ACWI Rolling 1 year sum of market closes



Note: MSCI ACWI = MSCI All Country World Indexm
Source: Columbia Threadneedle Investments and Bloomberg, Jan. 1, 1988–Sept. 30, 2017

Economic data and currencies are still flashing green on our screens. The Fed component comes across as a bit more yellow as we watch for upcoming policy decisions.

|Q.| ***How do you reconcile the low volatility and the high valuations?***

|A.| Valuation and volatility may be two sides of the same coin. At minimum, assets are fully priced relative to historical norms. Stocks and bonds are both a little expensive, and that fact diminishes our forward-looking expectation of return. In addition, speaking again to that asymmetry, it is generally true that asset prices go higher when volatility is falling and go lower, on average, when volatility is rising. So valuation and low volatility both reinforce the idea that prospective returns across asset classes should be low by historical standards.

|Q.|: ***You use a market-state-based approach to allocating risk. Do the elevated equity valuations and low volatility have implications for your determination of the market state?***

|A.| Valuation trumps volatility in our work. We cannot be positioned aggressively in risk assets under the condition of extreme equity overvaluation. Importantly, we are not at that point yet, as some valuation upside remains by our criteria. Remember that it is not simply prices going up that makes valuation appear extended; it is prices going up faster than intrinsic value, and given recent earnings strength, the intrinsic value of equities has risen. If low volatility were to stay in place and asset prices rose faster than intrinsic value, eventually our strategy would be locked into a more conservative stance until that overvaluation resolved.

|Q.| ***How have bond valuations impacted your approach?***

|A.| One of our goals is understanding markets in which bonds have diversifying power. If bonds become too expensive relative to growth and inflation, then we interpret that as the bond market having factored in an expectation of bad news. When that occurs, and there is bad news, the ability of bonds to offset losses derived from risk assets is compromised. We want to identify those periods ex ante and de-risk for those events. However, it is important to understand that the bond market is not always correct in its assessment.

Several times this year, bond yields have been too low relative to inflation trends, but the stock market has acted in an opposite, reassuring way — essentially saying that the bond market was incorrect. We saw this in the period leading up to and after the U.S. election, when the equity market convincingly argued that bond market pricing was wrong, that things were actually pretty good and that bond yields were too low. Having a mechanism that can identify this condition ex ante has been very important as it suggested concentrating more risk in equities, and looking back, it was the correct reading.

What is important to understand is that these are not subjective calls — they are rooted in an analysis of more than 40 years of market data and are determined by simple and intuitive market indicators.

|Q.| ***How does the withdrawal of quantitative easing impact the income portion of multi-asset investment portfolios?***

|A.| All the things that central banks have done since the financial crisis have been, on their face, good for asset prices. So the reversal is probably a headwind for financial asset prices.

|Q.| ***The multi-asset risk-based approach is underperforming a 60% equity/40% fixed-income approach this year. What are some of the drivers of that underperformance?***

|A.| A feature of a 60% equity/40% bonds investment strategy is that most of the overall portfolio risk is from equities. That is not necessarily bad, but it is certainly less diversified, and over the long run, less efficient than a strategy that is more deliberately balanced across risk assets. In any short window, that concentration could be a big advantage.

It has certainly been a big advantage since last summer, as equities have performed very well compared to other assets. Over the last year, being balanced has been less optimal than being concentrated in equities.

Our adaptive methodology has policy portfolios specifically designed for markets in which a concentration in risk assets makes more intuitive sense than simply applying parity, and I am happy to say that relative to parity, we have had a greater concentration in equities over the past year. Changing market environments is one reason we have an adaptive methodology — recognizing that being balanced is not always the best option. ■

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