Amundi ASSET MANAGEMENT | Smart Beta

Viewpoint

Minimum volatility equity strategies. A good time to implement in your portfolio?

Key takeaways

The market environment of 2023, featuring higher interest rates and inflation risks, along with a noticeably higher market concentration, has brought a certain amount of skepticism on defensive equity strategies, especially minimum volatility strategies. The contrasted performance of those strategies in H1 2023 has cast some doubts on their relevance in the current market conditions and has raised concerns about their ability to deliver outperformance going forward.

Despite this context, the four arguments listed below highlight why we should be confident about those minimum volatility equity strategies and why we believe this is a good timing to reconsider them, and in particular Amundi Global Equity Conservative:

- Extreme market concentration, embedded in particular in market cap indices, while low volatility strategies are based on risk-management and diversification and are less exposed to concentration risk
- Attractive valuations of low volatility strategies, both in absolute and relative terms
- Attractive “Low Vol” risk premium, after its recent depreciation
- Reduced sensitivity to interest rates: the current environment exhibiting high interest rates is less problematic compared to recent history. In the meantime, structural high rates may lead to sharp increase of market volatility, which minimum volatility solutions can well handle.

We believe that the Equity portfolios of long-term investors should be adjusted accordingly by reinforcing their exposure to minimum volatility solutions such as Global Equity Conservative strategy. By doing so, we believe that investors could maintain their existing Equity allocation and hence benefit from the Equity premium over the long-term while mitigating the losses and diversifying their sources of performance.

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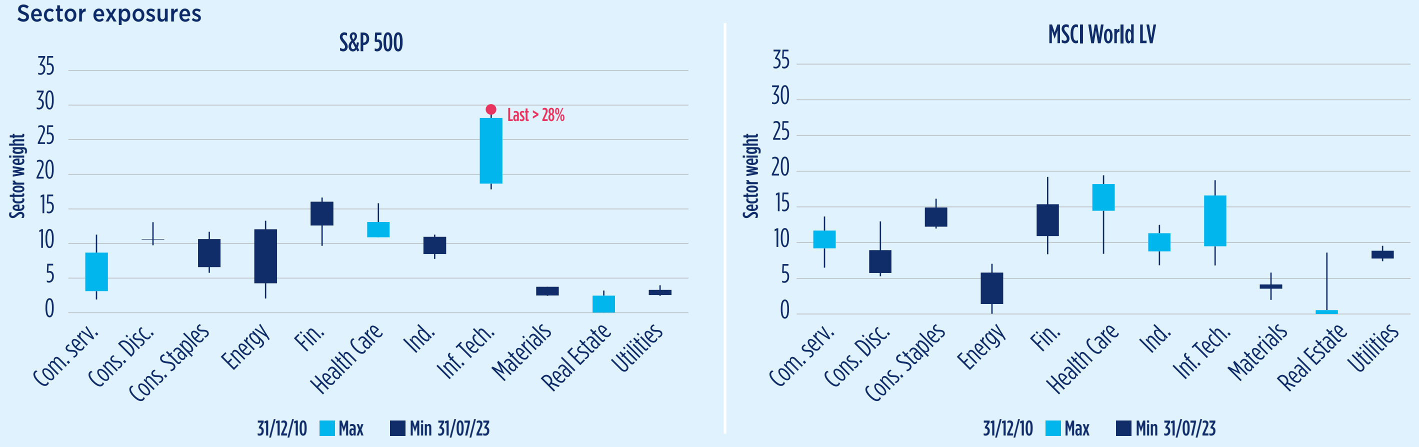
1/ Extreme market concentration

Global Equity minimum volatility strategies tend to have a significant exposure to the US market. For instance, Global Equity Conservative strategy has an allocation of 69% in the US which is the same level as the MSCI World index (as of the end of July 2023).

The stock market in the US is experiencing an unusual episode of concentration, which has never been seen in two decades. This concentration is mainly driven by Information Technology stocks, which represent for instance more than 28% of the holdings of the S&P 500 (as of July 2023). This is obviously an adverse configuration for minimum volatility strategies since they build on diversification principles and, therefore are better balanced compared to the index (see figure 1). Indeed, they target not only low volatility stocks but also the less correlated ones, which makes them less exposed to one single sector. ■

Figure 1.

Sector exposures



Source: Factset, Amundi Analysis over the period from 12/2010 to 07/2023.

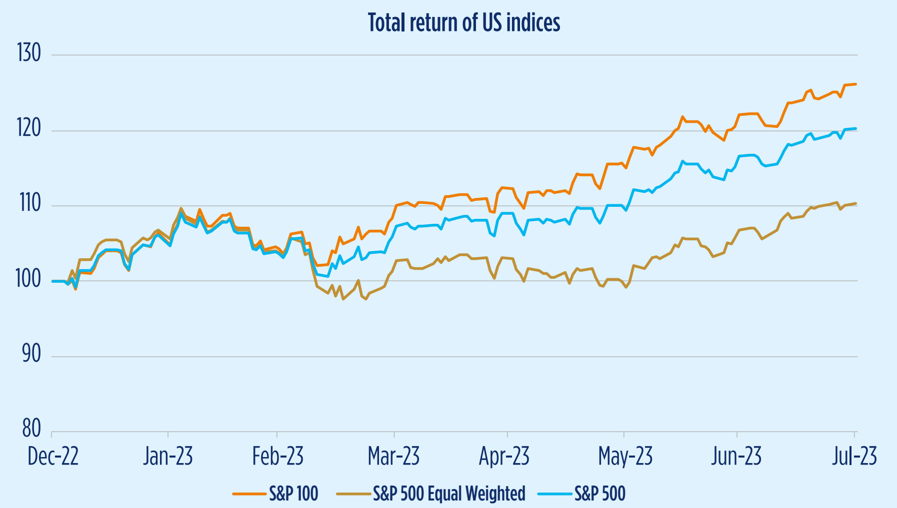
Behind this huge performance of IT stocks, there was a significant "Big size" effect as the so-called "magnificent 7" drove majority of the market return between 31/12/2022 to 31/07/2023.

The figure 2 illustrates the dominance of a few mega-cap stocks in the US Equity market when looking at the recent past performance. Indeed, the S&P100 index composed of the 100 largest companies has significantly outperformed the S&P500 index in H1 2023. In the meantime, the S&P500 Equal Weight index, which has a mid-cap bias, underperformed the S&P500 index.

One may question the sustainability of such market concentration and dominance linked to just a few stocks. As rational investors, we could ask ourselves if this level of concentration doesn't lead to a very high idiosyncratic risk associated to the future persistence of the underlying oligopolistic business models.

Figure 2.

Performance of S&P500, S&P100 and S&P500 Equal weight index



Source: Factset, Amundi from 12/2022 to 07/2023.

For sure, when concentration risk is so high, equity markets can't absorb any disappointment or adverse market context as we experienced in 2022: the Nasdaq 100 has dropped then by nearly -32% over this year. ■

2/ Attractive valuations

The next aspect pleading for a regain of interest for minimum volatility strategies pertains to valuations. The charts in figure 3 below demonstrate attractive levels of valuations of a mainstream global minimum volatility strategy, both in absolute and relative terms (i.e. compared to the S&P 500), according to price to earnings (PE) and to price to book (PB) criteria. The attractiveness of valuations extends to 2024 and 2025 according to analyst consensus estimates (I/B/E/S estimates). ■

Figure 3.

Valuation ratios.

Source: Factset, Amundi

Analysis over the period from 12/2010 to 07/2023. PB: Price to Book ratio. PE: Price to Earnings ratio. 2023, 2024 and 2025 figures are based on aggregate analysts' forecasts (i.e. I/B/E/S consensus).

The attractive valuations – both absolute and relative – make a good case for Minimum Volatility strategies today. ■

2. Direct + First Tier Indirect Trucost carbon intensity

3/ Attractive patterns of the "Low Vol" risk premia

Another argument is about the attractiveness of the risk premiums offered by minimum volatility strategies. The analysis depicted in figure 4 represents a risk-adjusted return ratio that aims to compare the relative values of the excess returns and of the 6-factor alphas (i.e. the returns adjusted to the contributions of 6 risk factors including the market) for the MSCI World LV index. The curve clearly shows a decoupling of the risk premium and the excess returns since the beginning of the year (a bottom level of the ratio). This configuration is usually predictive of a reversal of excess returns (see outlined historical periods where the bottoming of the ratio is usually followed by an upside reversal). It could be indicative of performance reversion to positive territories for minimum volatility strategies. ■

Figure 4.

MSCI World LV index risk-adjusted return ratio.

Source: Factset, Amundi analysis over the period from 12/2010 to 07/2023. The risk-adjusted return ratio is based is the quotient of the 6-month excess return (relative to the parent index) and the 1-month 6-factor alpha. The 6-factor alphas are computed based on a regression of the MSCI World LV index daily returns against Fama-French factors' returns augmented with the momentum factor over 6-month rolling periods. Factor returns are from K. French data library.

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4/ Easing exposure to interest rate risk

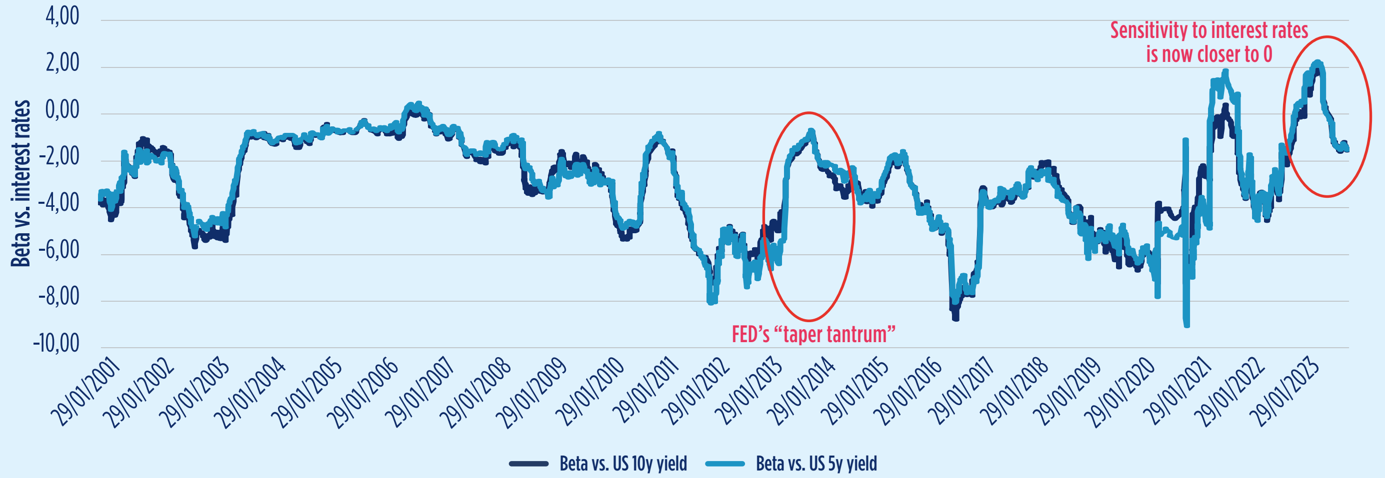
It is often said that rising interest rate environments are very challenging for minimum volatility strategies. Indeed, those strategies tend to have higher sensitivity to interest rate risk due to their structural exposures to companies such as those from the Utilities sector for example[i].

But it seems that those strategies are more resilient to the current high interest rate configuration.

For instance, the chart in figure 5 denotes a negative correlation between excess returns of MSCI World LV index and the variations of US interest rates. The latest period outlined in the chart (from January to August 2023) shows that the exposure of the strategy to interest rate risk has relatively diminished, which might be indicative of its resilience to the current high interest rates. ■

Figure 5.

MSCI World LV index exposure to interest rate risk.



Source: Factset, Amundi

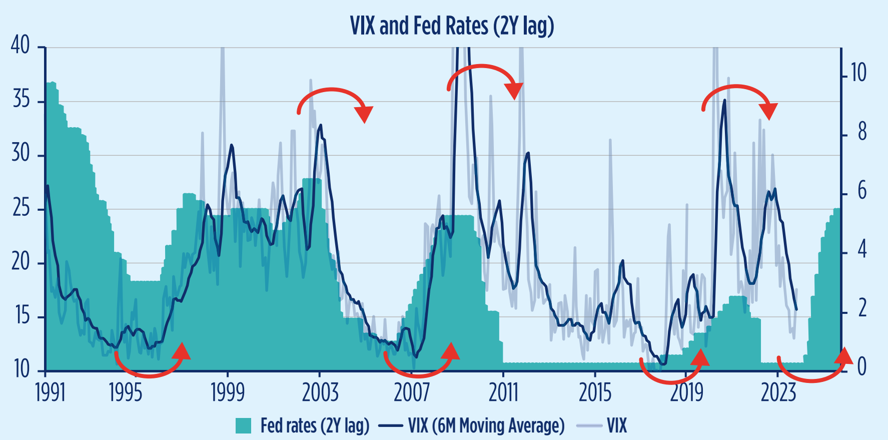
Analysis over the period from 12/2010 to 07/2023. The betas are based on the MSCI World LV index excess returns relative to its parent index. They are computed against daily variations of the US 5y and 10y T-notes yields over 6-month rolling periods.

In the meantime, high interest rates may lead to much higher market volatility in the near future.

It is generally observed that equity volatility follows the monetary policy with a 2-year lag, as illustrated in the figure 6. Following this script suggests a bottoming out of volatility in 1H24.

Figure 6.

Relationship between VIX and interest rates.



Source: Datastream, Amundi Institute, September 2023.

While Minimum Volatility strategies are exhibiting more resilience to the current high interest rates, their natural low volatility features make them well positioned to mitigate a future increase of market volatility driven by the current high interest rates and their potential negative impact on the US economy.

Conclusion

We believe that the current market conditions should provide a good opportunity for Minimum Volatility strategies.

An active risk can deliver superior outcome compared to a passive Minimum Volatility solution.

We believe that thanks to the comprehensive risk analysis carried out by an experienced Portfolio management team, Amundi Global Equity Conservative should outperform MSCI Min Vol index in the future.

For instance, over the last 5 years, the Global Equity Conservative strategy outperformed MSCI Min Vol index (see figure 7), with no compromise on the risk-efficiency of the solution, as illustrated by the risk indicators –Volatility and drawdowns- on figure 7.

Figure 7.

Performance and risk indicators of Amundi Funds Global Equity Conservative strategy over the last 5 years.

Amundi Global Conservative GIPS Composite in USD as of 30/09/2023	5Y Return p.a.	5Y Volatility	5Y Sharpe Ratio	5Y Max Drawdown	5Y TE	2022
MSCI World	7.26 %	18.48 %	0.29	-34.03 %	7.23 %	-18.14 %
MSCI Min Vol	3.99 %	15.65 %	0.14	-29.27 %	2.94 %	-9.80 %
Global Conservative GIPS Composite	5.42 %	13.92 %	0.26	-29.26 %		-9.58 %

Source: Amundi AM. Performance data in USD as of 30/09/2023 of the Global Conservative GIPS Composite.

Past performance is not a reliable indicator of future results or a guarantee of future returns.

In conclusion, we believe that this is definitely a good timing to reconsider Minimum Volatility strategies and an active solution such as Global Equity Conservative strategy is well equipped to navigate the Equity markets in the near future.

(i) For more information, please read our White paper:
https://research-center.amundi.com/article/analysing-exposure-low-volatility-equity-strategies-interest-rates

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Composite Name: Conservative Global

Benchmark: MSCI WORLD

Reporting Period: 1 January 2013 to 31 December 2022
Reporting Currency: USD
Composite Creation Date: 17 September 2012
Composite Inception Date: 1 August 2012

Period	Composite Gross Return (%)	Composite Net Actual Fee Return (%)	Composite Net Model Fee Return (%) **	Benchmark Return (%)	Composite 3-Yr Standard Deviation	Benchmark 3-Yr Standard Deviation	Number of Portfolios	Internal Dispersion (%)	Composite Assets (Millions)	Firm Assets (Millions)
2022	-9.58	N/A	-9.91	-18.14	15.70	20.72	≤ 5	N/A	545	1,190,399
2021	16.50	15.85	16.07	21.82	12.79	17.30	≤ 5	N/A	608	1,264,636
2020	9.29	8.66	8.89	15.90	13.11	18.53	≤ 5	N/A	341	1,255,960
2019	23.97	N/A	23.51	27.67	8.64	11.29	≤ 5	N/A	367	1,104,104
2018	-4.16	N/A	-4.51	-8.71	8.74	10.53	≤ 5	N/A	300	1,051,994
2017	17.41	N/A	16.97	22.40	8.08	10.38	≤ 5	N/A	226	911,366
2016	8.72	N/A	8.32	7.51	8.45	11.08	≤ 5	N/A	219	706,043
2015	1.15	N/A	0.77	-0.87	8.79	10.96	≤ 5	N/A	114	610,461
2014	7.27	N/A	6.87	4.94	N/A	N/A	≤ 5	N/A	106	654,151
2013	24.90	N/A	24.44	26.68	N/A	N/A	≤ 5	N/A	86	660,596

** Composite Net Model Fee Returns are presented as supplemental information, effective 1 January 2020 on a prospective basis. See the Performance Calculation disclosure for more information.

Compliance Statement: Amundi claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Amundi has been independently verified for the periods 1 January 1994 to 31 December 2021. The verification report is available upon request. A firm that claims compliance with the GIPS standards must establish policies and procedures for complying with all the applicable requirements of the GIPS standards. Verification provides assurance on whether the firm's policies and procedures related to composite and pooled fund maintenance, as well as the calculation, presentation, and distribution of performance, have been designed in compliance with the GIPS standards and have been implemented on a firm-wide basis. Verification does not provide assurance on the accuracy of any specific performance report.

Firm: For the purpose of GIPS® compliance, as of 1 January 2021, the Firm is defined as «Amundi» and includes the following: Amundi Asset Management, Société Générale Gestion, Amundi (UK) Ltd, Amundi Ireland Limited, Amundi SGR SpA, Amundi Deutschland GmbH, Amundi Austria GmbH, Amundi Japan Ltd, Amundi Hong Kong Ltd, Amundi Singapore Ltd, Amundi Malaysia Sdn Bhd, and Amundi Asset Management US, Inc. With respect to the Amundi firm history, on 1 January 2011, the asset management activities for third-parties represented by Crédit Agricole Asset Management and Société Générale Asset Management merged to form Amundi Asset Management. On 1 April 2011, Amundi Alternative Investments merged into Amundi Asset Management. On 1 October 2013, Amundi Asset Management acquired Smith Breeden Associates, Inc. and renamed it Amundi Smith Breeden LLC. On 1 January 2014, the firm was expanded to include Amundi Japan Ltd and Amundi Singapore Ltd. On 3 July 2017, Amundi Asset Management acquired Pioneer Investments and renamed it Amundi Pioneer. Following the acquisition, on 1 January 2018, the Firm was redefined to include Amundi Pioneer. Amundi Smith Breeden LLC merged with and into Amundi Pioneer Institutional Asset Management, Inc. with the latter entity surviving the merger. The Firm expanded to include Amundi SGR SpA, Amundi Deutschland GmbH, and Amundi Austria GmbH. On 1 January 2021, Pioneer Investment Management, Inc. merged with and into its affiliate, Amundi Pioneer Asset Management. Inc. and the surviving entity changed its name to Amundi Asset Management US, Inc. With respect to the Pioneer Investments firm history, between 1 January 2010 and 31 December 2015, Pioneer Investments was redefined to only include assets managed exclusively by Pioneer Investment Management, Inc., Pioneer Institutional Asset Management, Inc., and Pioneer Investment Management Limited, and on 1 January 2016 reintegrated the assets of Pioneer Investment Management Sgr p.A. Lists of composite descriptions, limited distribution pooled fund descriptions and broad distribution pooled funds are available upon request.

Composite Description: This composite is made up of actively managed portfolios offering exposure to Global equities with solid fundamentals and with a reduced portfolio volatility. Important risks materially relevant to strategy include Credit risk: risk associated with an issuer's sudden downgrading of its signature's quality or its default. Liquidity risk: in case of low trading volume on financial markets, any buy or sell trade on these markets may lead to important market variations/fluctuations that may impact your portfolio valuation. Counterparty risk: risk of default of a market participant to fulfil its contractual obligations vis-à-vis your portfolio. Operational risk: risk of default or error within the different service providers involved in managing and valuing your portfolio. Minimum Account Size: The minimum asset level for inclusion in this composite is 15,000,000 EUR.

Performance Calculation: Gross-of-fees returns are presented before management and custodial fees but after all transaction costs. Composite Net Actual Returns are net of actual fees, starting from composite gross returns, by subtracting fixed and variable management fees of all of the underlying portfolios. Composite Net Model Returns are net of model fees and are calculated, starting from composite gross returns, by geometrically subtracting the highest tier model fee for institutional segregated accounts. The Composite Net Model Returns are presented as supplemental information. Policies for valuing investments, calculating performance, and preparing GIPS reports are available upon request.

Fee Schedule: The current standard annual investment management fee schedule for institutional separate accounts is 0.37% on the first 50 million; 0.27% on the next 50 million; 0.22% on the next 100 million; 0.20% thereafter.

Internal Dispersion: Dispersion is defined as the standard deviation of the annual gross returns of all portfolios that were included in the composite for the entire year. For those years when five or fewer portfolios were included in the composite for the full year, no dispersion measure is presented.

Three-Year Annualized Standard Deviation: The Three-year Annualized Ex-Post Standard Deviation measures the volatility of gross returns for the composite and benchmark over the preceding 36-month period, and is not applicable for performance periods with less than 36 months of returns based on the composite's performance inception date.

Benchmark Description: The benchmark of the composite is MSCI WORLD.

Past performance is not indicative of future results.