COLUMBIA THREADNEEDLE INVESTMENTS

Playing defense: Allocating to equity in volatile markets

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A systematic approach to establishing equity allocations can help investors avoid making short-term mistakes.

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Market volatility resulting from the coronavirus has evolved into the most serious risk event since the 2008 financial crisis. In response, investors have been frequently reminded to stay focused on their long-term goals amid this shorter term disruption. It's good advice. Because in a volatile market, there's a strong urge to move to a "safe" asset, like cash. And for many, it's a mistake.

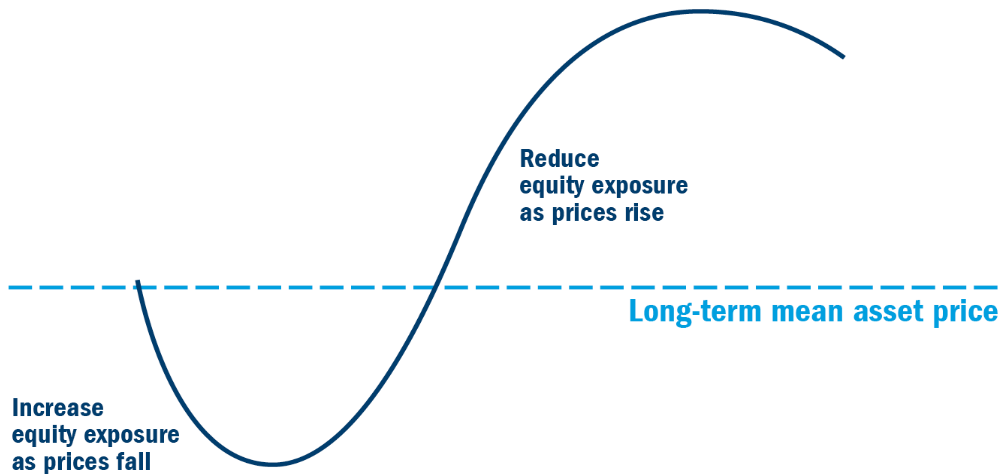
If there was ever a time for a strategic policy portfolio, this is it. It can act as a baseline and a bulwark if the target mix of asset class exposures is based on investor goals, risk tolerance and time horizon. This baseline approach can be even more effective when it has a dynamic component that can make adjustments to equity and risky asset exposures on a systematic basis — based on market signals — rather than relying on bad decisions borne out of panic.

But how does a portfolio manager build a resilient strategic portfolio that can help manage downside risks in a systematic fashion? What dynamic signals help inform the appropriate exposure to risky assets in a given market? We believe that there are several approaches to consider.

MEAN REVERSION IN THE STOCK MARKET

Most investors are familiar with the idea of momentum (the idea that a stock, or even an entire asset class, that's going up will continue go up). Momentum's opposite is mean reversion: the tendency of a security to fall back to its long-term historical average. Mean reversion is a far less common approach to systematic equity allocations, and it's the idea of buying a stock or asset as it's falling (with the intention of buying low and selling high). Mean reverting strategies can act as early indicators for investors, and they've been suggesting for some time that the market is due for a correction.

How mean reversion strategies work



If you had designed a portfolio employing mean reversion as a strategy for making changes to equity allocations, your policy portfolio would have been significantly underweight equities in mid-February (prior to the recent fall in stocks) and would still be underweight equity even through the current level of market turmoil. Most mean reversion strategies have underperformed since 2008 because the market has been rewarding as much equity as possible. But the current market demonstrates their value in determining the appropriate level of equity in a portfolio.

USING VOLATILITY AS A SIGNAL

There's a well-documented connection between volatility (measured by indices such as the VIX) and equity prices: volatility tends to go up when equity prices are falling. Some asset allocation models are based off volatility (selling equity when volatility is high and buying equity when volatility is low).

How volatility strategies work

This can be counterintuitive to seasoned investors, who see spikes in volatility as a buying opportunity and see a volatility approach as reacting to a market move after it's already happened. For the last several years, their skepticism has been warranted: markets rewarded taking risk immediately after mild volatility bumps. This sort of strategy might have been overweight equities going into the last week of February, but it would have quickly de-risked through the end of the month and largely avoided the market stress that ensued. A volatility-based approach like this is tailor-made for the kind of prolonged crisis that the coronavirus appears to be. It might not help catch the turn, but it may help avoid some damage as the market stress unfolds.

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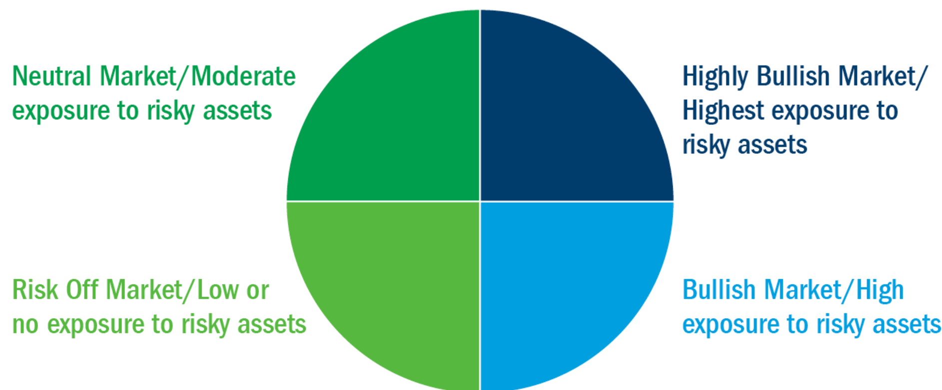
REGIME-BASED APPROACHES

Often incorporating the ideas above, as well as other macroeconomic variables, regime-based approaches consider a broader series of factors. They assess whether or not it's a favorable or unfavorable time for exposure to risky assets.

How regime-based strategies work



Our research has shown that abnormal levels of fixed-income yields can be an effective indicator for understanding regimes — whether yield curves have become inverted or real yields have become negative. (When real yields are negative, the nominal yield cannot keep up with the level of inflation.) When these yield dislocations occur alongside strong momentum and low volatility, it can indicate a good time to increase exposure to risk. But when they occur alongside higher volatility, it's a warning sign, indicating a much more defensive stance. We saw this warning sign beginning in January of this year, with U.S. yields falling below inflation levels and volatility quite high.

One of the advantages of a regime-based approach is that it's not based on a single pattern or environment that can prevail for extended periods. At certain times, a regime-based approach goes into a defensive mode. But at other times, it may ride the wave of market momentum. If we acknowledge that momentum-based strategies will do well in many environments, a regime-based approach gives investors multiple opportunities to participate in the upside, while mitigating risk on the downside.

With any of these indicators, there are exogenous factors that may derail the best intentions of a systematic approach. And in certain cases, the extended duration of one pattern over another may result in underperformance. But having a well-defined, repeatable process to calibrate the appropriate amount of equity exposure is essential during periods of heightened market volatility, allowing portfolio managers and investors to take the guesswork and emotion out of their playbook.

Bottom line: A systematic approach may seem confusing, but it's important to understand how repeatable, observable signals can form the basis of asset allocation decisions. Taking the emotion out of deciding when to add or reduce equity exposure can help investors meet their long-term goals — even amid a shorter term disruption.

Disclosures

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