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Aurora Updates
Defensive Strategies and Low Volatility

13 August 2014

Executive Summary

1. Markets are firmly in a **low volatility part of the investment cycle**. Risk assets (such as equities) have performed well over the last 2 years. Multiple signals all point to significant investor complacency – measures of volatility, market valuations, credit spreads, sovereign spreads, …

2. A number of **potential triggers** exist that may cause a rapid and significant change in investor confidence. We list a number of relevant triggers. More importantly, **how can investors position portfolios for a potentially rising volatility environment?**

3. Most risk assets, and surprisingly many alternative assets, bet on market stability. These investments should perform poorly when volatility rises. Data over a full investment cycle agree. Defensive assets (eg bonds) have little exposure to volatility.

4. However, some investments have demonstrated a tendency to perform well in rising volatility environments. Aurora Fortitude Absolute Return Fund is an example. Such investments can be **part of an overall strategy to limit diverse total portfolio underperformance in rising volatility environments**.

5. Also, this example shows that investors need to be careful allocating to some alternative asset classes as **investments are far from homogeneous**. In many traditional asset classes such as equities, the benchmark performance/risk swamps the manager active component. Collectively, these asset managers appear as one asset class. The same is not true for alternative asset managers such as hedge funds.

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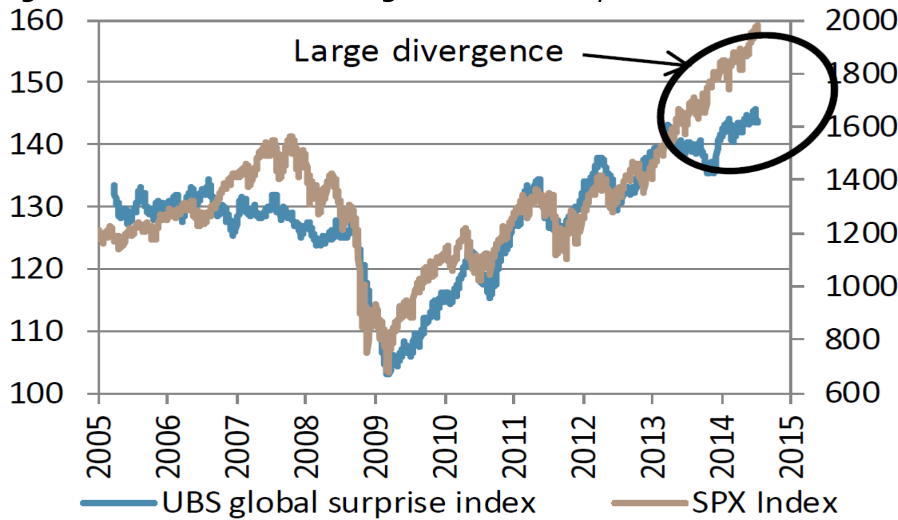
Low Volatility Environment

Markets are firmly in a low volatility part of the cycle.

A. **Risk assets** have performed well having risen 39% since the low of May 2012.

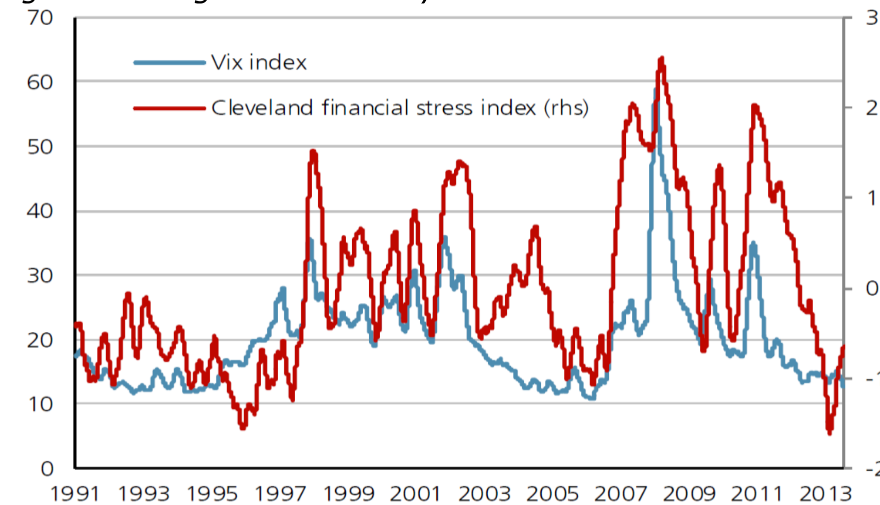
Figure 1: Risk Asset Pricing and UBS Surprise Index



Source: UBS

B. The Australian equity **volatility index** is at 9.6 and the bottom end of the range since calculation started in 2008. The widely followed VIX[1] is at 12.2 again near the all-time low of 9.9 and well off the high during the global financial crisis of 80.9.

Figure 2: Long Term Volatility Index and Financial Stress

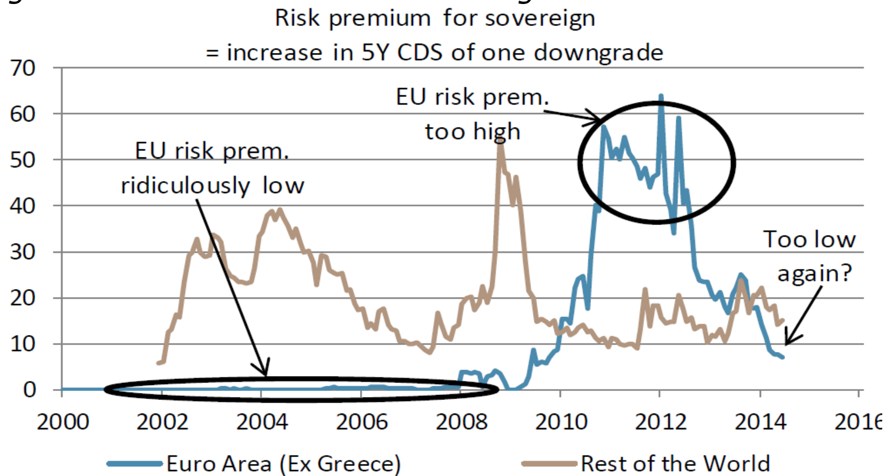


Source: Cleveland Fed, Bloomberg

[1] Volatility Index published by S&P as a measure of short dated implied volatility of S&P 500 listed put and call options. The VIX index is a commonly used barometer of market sentiment, market risk appetite and investor confidence.

C. **Credit spreads** have tightened in line with other investments that access corporate cash flows such as equities. Also spreads on **non-investment grade sovereign bonds** have considerably narrowed from the very wide levels seen during the multiple sovereign debt crises over the last five years.

Figure 3: Risk Premiums for Sovereign Issuers



Source: UBS

Investor Challenges Due to Low Volatility

Investors have increasingly shifted funds out of low yielding bonds and into a) lower grade / higher yielding credit investments without the duration risk and b) defensive equities. While there is no disputing the historic performance of this strategy over the last two years, investors today are faced with a number of conundrums:

1. Hindsight investing is an unsustainable strategy. Investors should be **focused on making good decisions about future returns**, not the illusive perfect past decisions. Good investment decisions are clearly based on risk adjusted future returns, not past returns.

2. Investors **trying to pick the top and bottom of markets** are on a 'hiding to nothing'. Yes we have all heard about investors or managers that picked the high and lows of markets *in the past*. With such a large number of managers, statistically there will always be a couple who have bought at the perfect time and sold at the perfect time in the past. The real issue investors should focus on is the ability of an individual or organisation to pick highs and lows *in the future*.

3. **Classic defensive strategies** have lost their ability to protect and diversify portfolios in the future. Australian government bonds are currently yielding 3.00%-3.50% (5-10 year). With little room for rates to move on the downside, there is limited opportunity to protect all but the most conservative of portfolios.

4. To change **overall portfolio risk levels**, investors need to consider asset allocation shifts. Choosing different equity managers or changing stock selection strategies will only have limited ability to change total portfolio risk levels.

Potential Trigger Points

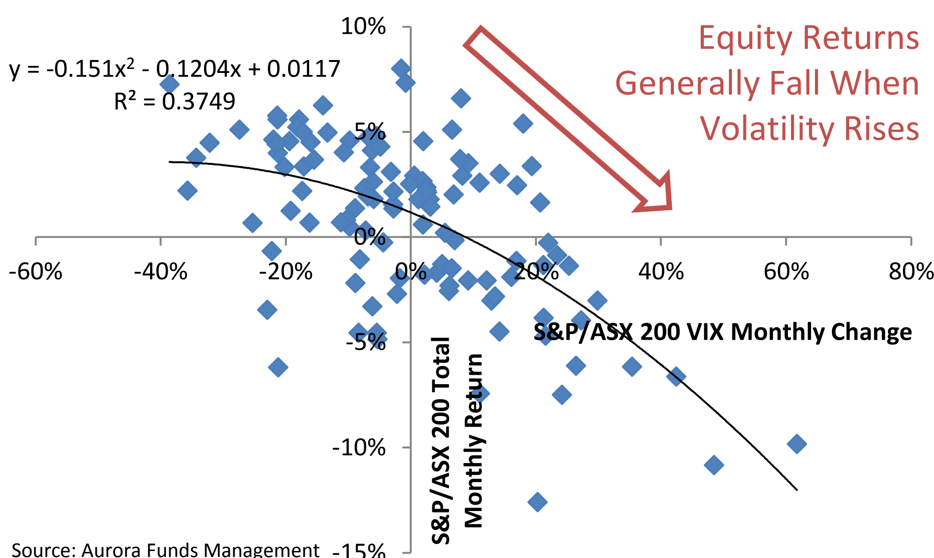
Despite the low levels of recent past volatility, forward looking risk triggers continue to be potential challenges for the markets to deal with in the future:

1. End of quantitative easing in the US.
2. Changes in US Federal Reserve response to crises with a new Chair Yellen.
3. Risk of a hard landing in China in the near term impacting all risk assets, in particular global resources stocks, Chinese property prices, …
4. Continued geopolitical risks in energy states (Iraq, Syria, Russia, …).
5. Overly complacent sell side analysts in an environment of stretched valuations for core asset classes of equities and bonds.
6. Liquidity issues in the secondary markets for major risk asset classes (equity, investment grade credit, high yield credit) potentially magnifying any future drawdowns. Additionally, in such an environment, liquidity drives up correlations and so diversification evaporates.

Defensive Strategies when Volatility is Low

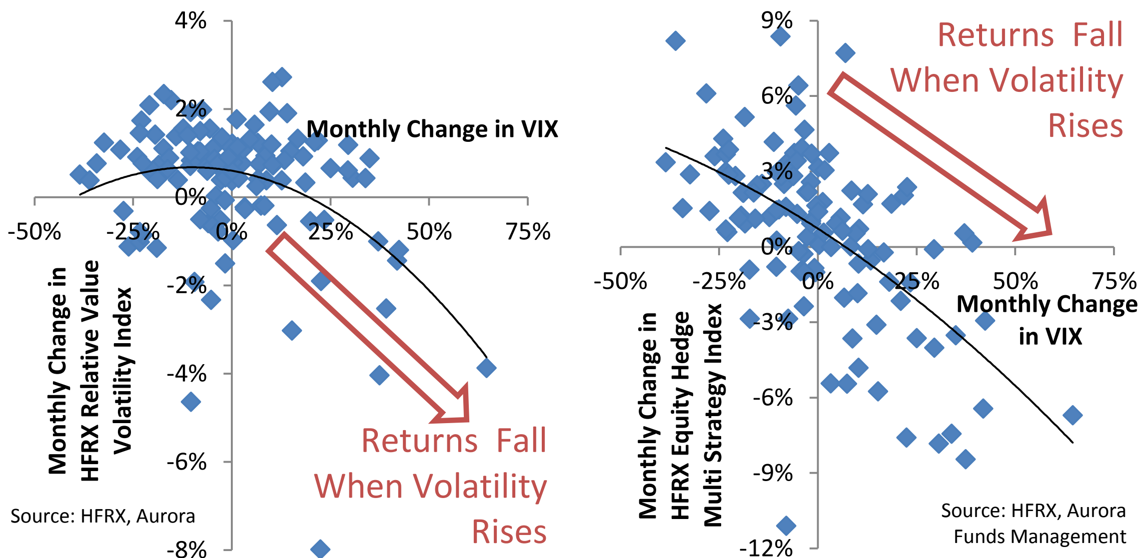
In rising volatility environments, most risk assets (for example equities) perform poorly due to the negative correlation between risk assets and volatility. See Figure 4. Essentially volatility risk premium, or a bet on market stability, is part of the collection of risk premia buyers of risk assets access.

Figure 4: Risk Assets Perform Poorly in Rising Volatility Environments



More surprisingly, many supposedly alternative strategies also perform poorly in rising volatility environments. Figure 5 below shows the sensitivity of the HFRX[2] Equity Hedge Multi-Strategy Index[3] and the HFRX Relative Value Volatility Index[4] to monthly changes in the level of the VIX index. This analysis shows in particular a key driver for most multi-strategy equity hedge funds is the volatility risk premium. Hence many of these funds will be expected to perform poorly when volatility rises or markets move.

Figure 5: Some Alternative Assets Perform Poorly in Rising Volatility Environments



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[2] Hedge Fund Research, www.HedgeFundResearch.com

[3] Hedge Fund Research describes this index as 'Managers [that] maintain positions both long and short in primarily equity and equity derivative securities. A wide variety of investment processes can be employed to arrive at an investment decision, including both quantitative and fundamental techniques; strategies can be broadly diversified or narrowly focused on specific sectors and can range broadly in terms of levels of net exposure, leverage employed, holding period, concentrations of market capitalizations and valuation ranges of typical portfolios. [Equity Hedge] Multi-Strategy managers do not maintain more than 50% exposure in any one Equity Hedge sub-strategy.'

[4] Hedge Fund Research describes this index as 'strategies [that] trade volatility as an asset class, employing arbitrage, directional, market neutral or a mix of types of strategies, and include exposures which can be long, short, neutral or variable to the direction of implied volatility, and can include both listed and unlisted instruments. Directional volatility strategies maintain exposure to the direction of implied volatility of a particular asset or, more generally, to the trend of implied volatility in broader asset classes. Arbitrage strategies employ an investment process designed to isolate opportunities between the price of multiple options or instruments containing implicit optionality. Volatility arbitrage positions typically maintain characteristic sensitivities to levels of implied and realized volatility, levels of interest rates and the valuation of the issuer's equity, among other more general market and idiosyncratic sensitivities.'

However, alternative assets, even within seemingly narrowly defined groups are not all homogeneous. As an example, the Aurora Fortitude Absolute Return Fund has historically had a positive response to rising volatility environments over the full cycle since February 2005. See Figures 6 and 7 below. Investments with this characteristic can be viewed as more defensive strategies in rising volatility environments. Such investments have the ability to offset the dominant equity risk in most portfolios.

Figure 6: Aurora Fortitude Absolute Return Fund has Performed Well in Rising Volatility Environments

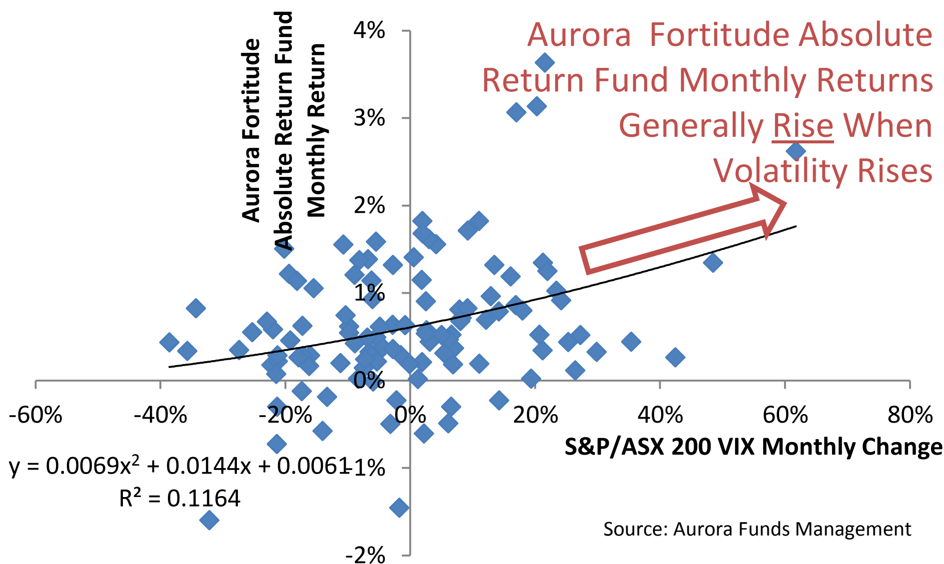
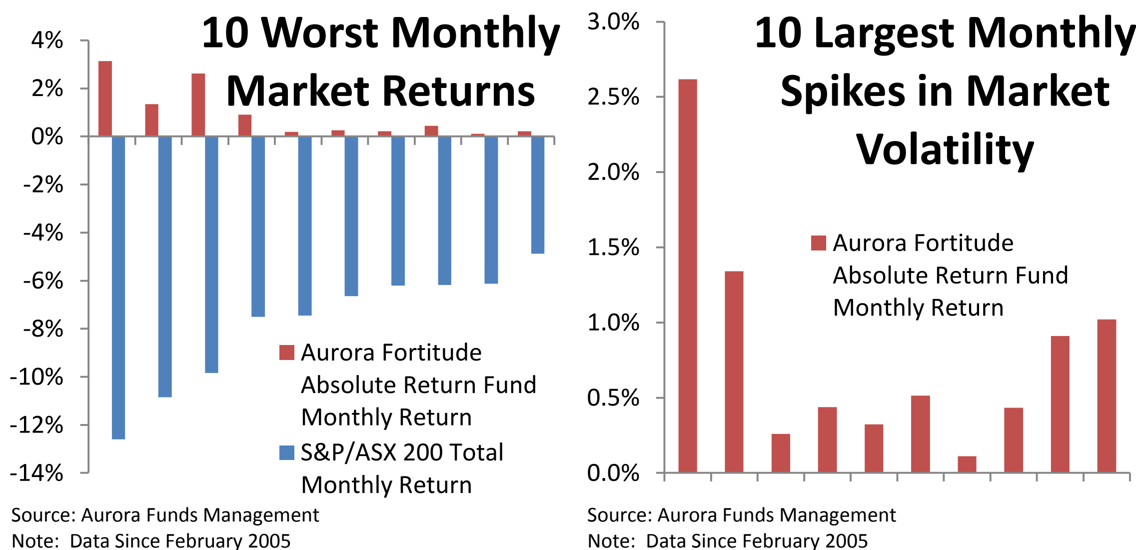


Figure 7: Aurora Fortitude Absolute Return Fund has had Robust Outperformance through Significant Market Falls and Rises in Volatility



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Note

The Aurora Fortitude Absolute Return Fund (ARSN 145 894 800, APIR Code AFM0005AU) has been issued by Aurora Funds Management Limited.

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