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Roy Maslen
chief investment officer, Australian equities
AllianceBernstein

The upside of less downside

The AB Managed Volatility Equities Fund shows defence can win the long game in Australian equities

The disruption to global and Australian equities through February was a stern reminder to investors that market fluctuation is common and investment portfolios need protection against downside risk.

Australian equities are much loved because the asset class historically delivers income and capital growth. However if an investor enters at the wrong time or makes an error in judgement, the effects can cost thousands and damage any desired investment outcome.

Research from AllianceBernstein shows that in two of every three years Australian equities experience a peak to trough fall of 10% or more. And over the last 75 years, about every five years there has been a material correction where markets fall close to 30%.

These events can have a serious impact on everyday investors. AllianceBernstein (AB) chief investment officer for Australian equities, Roy Maslen, explains by providing examples of three types of investors:

1. The buy and hold investor

Let's say this investor was unfortunate enough to invest $100,000 in an index on the eve of the GFC in Australia – they clearly participated in the big fall of the value of their investment. But through to 2013, if they held, they would have made that money back again.

2. The retiree

A retiree invests in the same index as above, getting the same return for that $100,000, but now they're spending $10,000 a year to live off. Because they've spent some of their capital they don't participate in the rally as much. Over the same period with the same returns they're only left with $85,000 including the amount they've spent and the amount still invested.

3. The fearful saver

Again they invest $100,000, they watch the markets fall and the fear and panic and emotion about the markets makes them concerned. It makes them see the opportunity to invest in term deposits. If they sell out towards the bottom of the market, then at the end of that period over the same time they've only got $78,000 and are significantly worse off.

"All three investors had different outcomes and a different ride in terms of emotions. It's a challenge for clients and financial advisers as well," Maslen says.

The fund manager says the underlying causes of these market dips or corrections have been a result of five recurring themes, most and potentially all of which are relevant today:

- Asset bubbles – In the early 1990s there was a commercial real estate boom in Australia, and currently there may be concerns about Australian housing
- Debt and over leverage – There are a lot of governments around the world that have high levels of sovereign debt and the Australian consumer is highly exposed
- War and conflict - Unfortunately there are geopolitical tensions in a number of arenas around the world
- Technical shocks – Such as the wave of selling that rapidly pushed equity markets down in October 1987. The end of quantitative easing potentially coming this year could be a concern as well
- Rising inflation – Historically the rise in inflation has been really challenging for equity markets and inflation expectations are starting to rise again

And there's a real possibility all five of these underlying causes could be relevant to current stock movements. The challenge for financial advisers and self-directed investors in the short-term is where to place capital when it's likely that markets will fall.

The AB Managed Volatility Equities Fund aims to reduce market volatility by investing in "high-quality listed equity securities that have reasonable valuations, high-quality cash flows and relatively stable share prices." The objective is to lose less in market downturns, and therefore have less to recover when markets rebound.

When investors think about managing risk in Australian equities, Maslen says the traditional approach of trying to manage alpha over and above a benchmark may not be right.

"If our markets fall 20%, and your portfolio is down 18 to 19%, that is alpha. But it may be seen as failure by many clients. So we think measuring success needs to focus on downside and how far a portfolio falls when the market is down," he says.

"When markets are up the fund may not capture all of the upside, but that can help smooth the ride in Australian equities.

"If I take a hypothetical portfolio and go all the way back to 1990, if you fell half as much as the market and captured 80% of the upside, you would be in front by more than 3% per annum."

The quote

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Watch the video on www.fsitv.com

As Maslen explains, there are strategies which are particularly helpful in managing downside risk. A good place to start is to ask the investor what kinds of stocks they wish to invest in.

"If you're looking to generate alpha over and above the benchmark there are a range of strategies you can employ. You could be value, growth or momentum. But if you're interested in strategies that fall a lot less when the market is down, we think that needs to be anchored in the concept of price stability," Maslen says.

"Strong, stable companies typically have share prices that fall less than the market – that can be measured with low volatility or low beta. We also think those characteristics need to be combined with a view on quality and a reasonable valuation. Those are the kind of stocks that you want to own."

This approach also needs to be mindful of volatility traps – or when something inside a respective industry impacts cashflows, earnings and share prices. A reasonable example is the price competition between supermarkets.

Maslen says company balance sheets must also be considered. If a balance sheet becomes stressed "that's typically bad for shareholders" and REITs were an example during the GFC. The fund manager then looks at event risk.

"Events are often known to be coming up, whether its government policy or regulation or a clinical trial for a health care company – but if they go against you it can be negative," Maslen says.

This underpins the need to diversify in Australia. Maslen adds while the local equities market includes world class companies, they don't cover all sectors.

Finally Maslen says markets move around with macroeconomic events – whether it's interest rates or currency or elections – "so you want to be thoughtful about how macro issues will impact a portfolio and look to build a scenario where you are pretty robust against different outcomes."

To this end the AB Managed Volatility Equities Fund is designed to have a simple, transparent long-only portfolio where 80% is dedicated to stocks on the ASX and 20% is invested overseas.

Launched in March 2014, the fund aims to achieve returns that exceed the S&P/ASX 300 Franking Credit Adjusted Daily Total Return Index (Tax-Exempt) after fees over the medium to long term. **FS**