Global Matters Weekly

13 May 2024

Hidden assets

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Recent years have demonstrated the flaws of a traditional 60/40 equity/bond portfolio. Such portfolios suffered one of their worst years on record in 2022, when accelerating inflation and rapidly rising interest rates proved a hostile environment for both global equities and global bonds. [1]Whilst the asset class mix arguably still serves well as a starting point in portfolio construction, we have long pursued greater diversification than that which a simple 60/40 portfolio composition offers.

In equities, we focus on complementary factors (value, growth, momentum etc) and seek boutique equity managers that invest in portfolios with high active share i.e. portfolios that differ substantially from regional or global benchmark indices. In addition, we have used alternative asset classes, such as infrastructure, property, royalties and specialist lending to avoid too much concentration in bonds. And even within our bond exposure, we have invested in niche strategies, such as short duration high yield, non-rated bonds and asset backed securities.

One more recent investment provides exposure to a hidden asset that many may not have contemplated before - volatility. Its adjective is often used to describe markets, particularly during periods of market stress and equity market declines, but seldom do people realise that it is also an investible asset class in itself.

Many investors have probably read or heard about the VIX, often referred to as the 'Fear Gauge'. VIX is effectively a measure of how volatile traders expect the S&P 500 to be over the next 30 days. The figure is actually reverse engineered from quoted option prices on the S&P 500.

Futures contracts are tradable on the VIX enabling investors to gain direct exposure to volatility. The beauty of having exposure to VIX is that it typically does the opposite to equity markets i.e. when equity markets fall, VIX usually rises and often spikes. Its inverse correlation to equity markets is what makes it a useful diversifier in multi-asset portfolios.

The problem with using VIX futures, however, is that there is a significant cost to holding the position. This is because VIX futures typically trade at a premium to VIX itself. VIX today trades at 13.2, whilst the futures contract expiring 18 June trades at 14.7 i.e. an 11% premium. [2]If VIX doesn't move between now and when the June contract expires on the 18th, then the futures contract will expire at 13.2 i.e. 10% below the level paid for it (14.7). That's a heavy loss to incur in just a little over five weeks and an expensive "cost of carry" which requires very good timing to ever make money!

We have found a strategy that has the benefit of providing exposure to volatility but without suffering an expensive cost of carry. The Alpha Volatility strategy is run by German-based Assenagon Asset Management S.A. and is essentially a dispersion strategy. What is dispersion when it comes to the stock market, I hear you ask. Dispersion is the average absolute difference between the return of each individual stock in a basket of stocks and the return of that basket of stocks as a whole.

Imagine a basket of 10 equally weighted stocks. If all 10 stocks are up 10% in one month's time, then the overall basket will have returned 10%, however, the dispersion of returns will be 0%. This is because each individual stock has returned the same as the overall basket – 10%. However, now imagine that 5 of those stocks rallied 10% and 5 fell 10%. In this instance, the overall basket has returned nothing, however, the dispersion of returns is 10%. This is because the absolute difference between each individual stock's return and the return of the overall basket is 10%.

Now imagine that 5 of the stocks fell 10% and 5 of the stocks fell 30%. The overall basket will have fallen 20% but the dispersion of returns will still have been 10%. This is because the absolute difference between each individual stock return and the basket return is 10%. Some stocks fell 10% and some fell 30% but, in both cases, the absolute difference between the negative return of the stock and the basket's return of -20% is 10%.

So, what we have observed is that the dispersion of returns can actually be positive when markets fall (when the basket fell 20%, the dispersion of returns was +10%) making it a great diversifier. The strategy employed by Assenagon has been actively managed since 2011 using a proprietary database and trading platform. It essentially takes positions in individual stocks that enable it to benefit when the dispersion of returns between those stocks is greater than what the market was expecting.

Whilst we do not wish investors to suffer volatile markets, it's useful to know that there are strategies out there that typically benefit from such market environments and offer investors a useful way to further diversify portfolios.

[1] *Momentum Global Investment Management, 60% MSCI World, 40% US Treasuries, USD TR, 1977-2022*

[2] *Bloomberg Finance LP, 9 May 2024*

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Important notes