Investment Insights
Managed Volatility Equities: Q&A

BESSEMER TRUST

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Highlights

- Equity market volatility has escalated of late and we expect this trend to continue
- As such, we have taken steps to reduce volatility in client portfolios by allocating to an equity portfolio with a quantitative lower volatility strategy
- We believe changing the composition of equity portfolios is a prudent first move in reducing overall risk
- While we are in the later stages of the economic cycle, our analysis continues to indicate a low probability of global recession

What portfolio adjustments did we make and why?

For many investors, 2015 marked the return of volatility to equity markets. Even though the S&P 500 Index ended the year down less than 1% in price terms, it fluctuated between a high of 2,131 and a low of 1,922 during the year, the widest range since 2011. While we do not believe we are near the end of this economic expansion (particularly given the still-robust consumer), we are cognizant that the majority of returns in equities are most likely behind us. Whereas many years of this expansion have been characterized by double-digit stock-market returns and single-digit volatility, we expect that the year ahead will see the reverse; that is, single-digit returns and double-digit volatility.

The specific risks around China policy missteps, oil price declines, and the Fed tightening backdrop are potential catalysts for such tactical market swings, as could be politics (including U.S. election speculation and a British vote around European Union membership) and geopolitics (including the Middle East and Russia). As a result, we think it is an appropriate time to begin "de-risking" the equity exposure within the equity portfolio as we prepare for the latter stage of this bull market. The investment teams are NOT reducing equity exposure at this point but rather are lowering equity (and in turn, the portfolio) volatility. Specifically, we have allocated a 3% equity position within Balanced Growth to a lower volatility portfolio, "Managed Volatility Equities" (internally referred to as MVP GEM).

What is MVP GEM?

MVP GEM is a minimum variance portfolio that uses our internal global equity model (GEM), launched in 2009, and quantitative models. GEM narrows down the global equity universe to only companies we find attractive based on certain factors. Then, using optimization, a portfolio is created from those attractive stocks that has an average volatility notably lower than the global equity index (in this case, MSCI ACWI). Since 2011, there has been an MVP GEM sleeve running within the Strategic Opportunities mandate. It is worth emphasizing that this is not a portfolio necessarily full of what may traditionally be considered defensive stocks, such as utilities and consumer staples. Many of those stocks today are highly valued; investors are already paying a premium for that sort of "portfolio insurance." MVP GEM, as stated above, gets its defensive posture in part from security selection but equally from diversification gained by holding a particular group of securities.

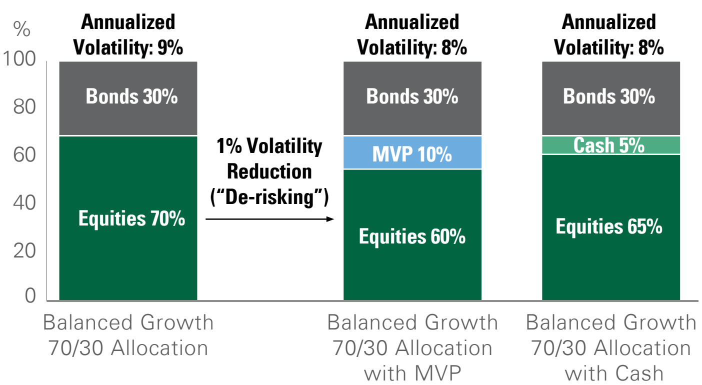
Why did we reallocate within equities rather than to cash or bonds?

While we constantly reassess our views, for now we continue to believe that equity markets can post positive returns this year and that cash or bonds over this horizon would detract from portfolio performance. Specifically, the U.S. economy shows few signs of recession on the horizon and corporate profitability looks poised for improvement in 2016. (Within that economic view, we would highlight that despite the pain from lower energy prices and exports weighing heavily on manufacturing and industrial sectors, the U.S. consumer shows momentum, and the labor market remains strong.)

Especially given the low yields on cash and bonds in this environment, we do not believe the level of insurance they provide is necessary at this stage. We acknowledge the increase in financial market volatility over the past year and feel that changing the composition of equity portfolios is a prudent first move in reducing overall risk, while still providing some exposure to equity markets — allowing us to participate in any equity recovery from the latest selloff. Exhibit 1 is an illustrative example of how moving exposure from equities to MVP can accomplish a similar objective of reducing volatility as adding cash and bonds.

Exhibit 1: Annualized Volatility Comparison

Key Takeaway: Adding a minimum variance portfolio (MVP) strategy to a 70/30 stock/bond portfolio can achieve the same expected volatility reduction as adding an allocation to cash.



Source: Bessemer Trust.

As of January 10, 2016. FOR ILLUSTRATIVE PURPOSES ONLY. Quoted volatility numbers are hypothetical and do not reflect any specific portfolio or analysis.

How does MVP differ from the Large Cap Core equity mandate?

The Large Cap Core equity mandate seeks to generate attractive returns while focusing on volatility. The Core mandate has a bottom-up process for choosing securities and on average will seek to have volatility 5% to 10% below benchmark levels. MVP, in contrast, has a relatively more quantitative security-selection process and targets volatility some 30% to 40% below benchmark levels.

Why put MVP in the Large Cap Strategies mandate rather than Core?

We view the Large Cap Strategies mandate, which holds different “sleeves” reflecting different investment styles and geographies, as the most efficient vehicle through which to reflect more tactical views and fine-tune equity exposures. Further, by funding the MVP strategy through higher-volatility sleeves held in Large Cap Strategies, a Balanced Growth portfolio receives a larger risk-reduction benefit.

What would we suggest for clients who still have cash on the sidelines?

Our research has shown that at least historically, investors got the most attractive long-term returns from their portfolios by moving cash into the equity markets in a few tranches (if not all at once), but within a relatively short period (often three to six months). Clearly, equity markets currently are very unsettled — it is tempting to just stay on the sidelines in cash. Such a strategy could easily backfire — a market recovery could easily unfold given the already extreme bearish sentiment and low valuations across a number of cyclical assets. Clients need to do what gives them peace of mind, of course, but our recommendation would be to tranche into equities over the coming months.

What are likely next steps with regards to MVP?

As we believe we are in the later innings of the economic cycle, we would anticipate considering additions to MVP over time, funded by higher-volatility equity portfolios. Our analysis suggests that the probability of a recession remains at relatively low levels, partially due to the strength of the U.S. consumer and seemingly contained spillovers from global economies and manufacturing and energy sectors. However, just as the Federal Reserve remains "data dependent" for tighter monetary policy, the economic and market environment will undoubtedly evolve over time. As these changes occur and the economic cycle ages further, MVP will serve as one of many tools we can use to dampen volatility and protect client assets during market selloffs.