



March 31, 2022

Research Paper



Revisiting Low Volatility Strategies

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I. Introduction and Sources

We collected papers that cover the theoretical foundations of low volatility (Low Vol) and papers in other categories that we view as essential. For ease of reference, we bolded the years for more recent papers in the literature review in the first section.

Articles were sourced via searching google scholar and SSRN and include publications from reputable journals, as well as white papers and publications by practitioners and academics. We have also included an opinion piece from the Financial Times.

II. Addressing Client Concerns

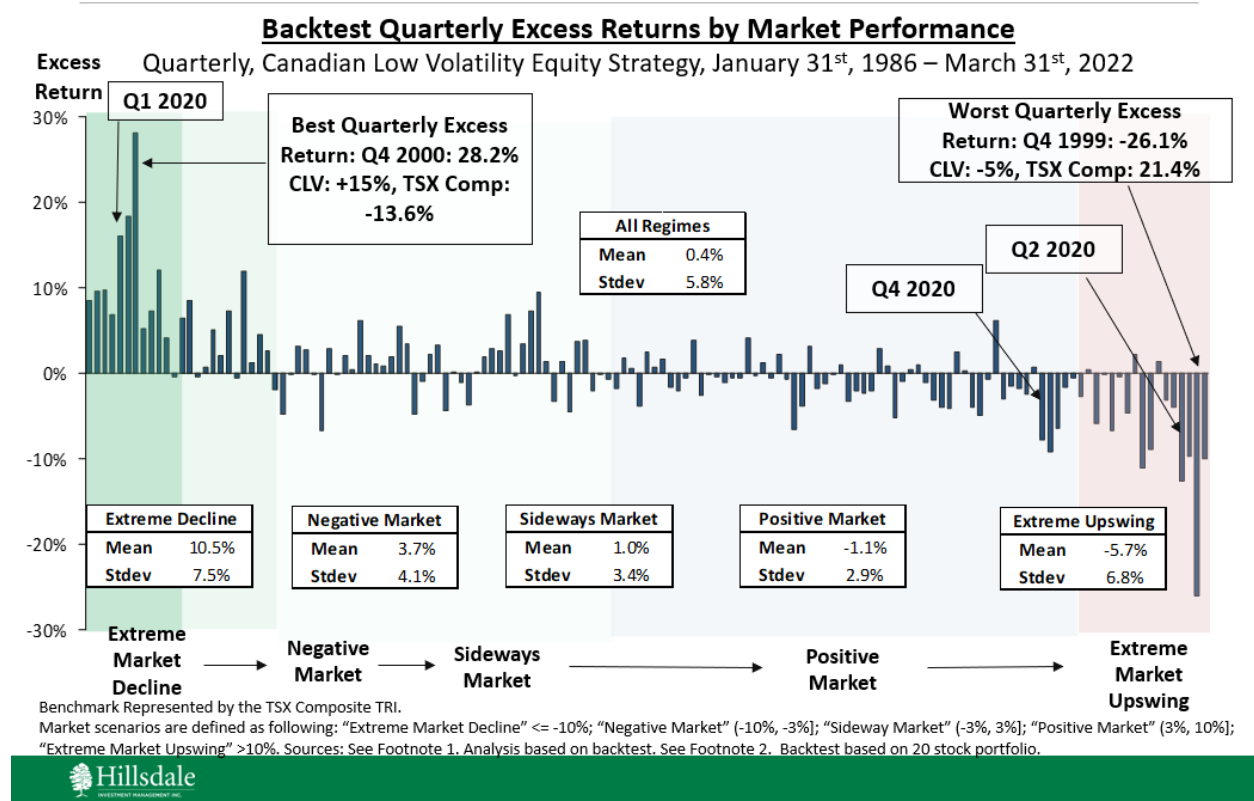
- *How valid is the concern that the low vol algorithms have been decaying?*
- *What confidence do we have in the efficacy of those algorithms going forward?*

Internal Evidence

To tackle these questions, we first review Hillsdale's research. Our backtest (see **Figure 1** below) of the Hillsdale Canadian Low Volatility Equity Strategy indicates that Low Vol outperforms in periods of extreme market declines and underperforms during extreme market upswings. This evidence suggests that Low Vol performance correlates with distinct market conditions. For example, in 2020, the underperformance of Low Vol corresponded with the sharp market rebound after the initial short-lived bear market decline at the onset of the Pandemic. There is no factual evidence that Low Vol decayed as an ongoing or future occurrence. Relative performance trends tend to be largely consistent across various market conditions.

Figure 1: Quarterly Backtest Performance of Hillsdale's Canadian Low Volatility Equity Strategy

Outperformance During Extreme Market Declines Backtest Results



Recent Publications on Low Vol

Since the seminal work of Haugen and Heins (1972) and Black et al. (1972) illustrating that Low Vol in U.S. stocks performed better than more volatile stocks, there has been a plethora of articles taking different views on the underlying drivers of what is referred to as the low volatility anomaly. Three articles addressing the client's first two questions are:

- 1) Bellone and Carvalho (2020) revisit BNP Paribas's Low Vol investment philosophy, which emanates from research published 10 years prior (in 2011). They initially found that the Sharpe ratios of Low Vol stocks were higher than most of their more volatile peers. They find that the low volatility anomaly across sectors is even more pronounced now than in the preceding decade. This paper displays confidence in Low Vol strategies and does not espouse the view of any sustained decay.

Bellone, B. and R.L.D., Carvalho. "The Low Volatility Anomaly in Equity Sectors—10 Years Later!" 2020, Available at SSRN 3697914.

- 2) Alquist et al. (2020) adopt a fact or fiction narrative to reinforce some of the generally accepted theoretical and practical views on Low Vol investing. They tackle Low Vol skepticism dubbed

'fictions' in their analysis. 'Facts' that they confirm include the following: 1) Low Vol has historically delivered better risk-adjusted returns, 2) Low Vol strategies have done well out-of-sample since the factor discovery, 3) Low Vol could underperform in down markets. They dispel misconceptions or 'fictions' by illustrating that 1) low-risk factors are empirically stronger than other standard factors, 2) low-risk investing does not require a high turnover, 3) Low Vol strategies are not just an industry (or bond market) bet, and 4) the strategies are not so expensive as to hinder performance.

The authors indeed display confidence in Low Vol strategies.

Alquist, R., A. Frazzini, A. Iltanen, and L.H Pedersen. "Fact and Fiction about Low-Risk Investing." *The Journal of Portfolio Management*, 46(6), 2020 pp.72-92.

- 3) Flint and Vermaak (2021) find that Low Vol along with pure Value and Quality factors are generally quite similar in terms of overall distribution shape and evolution over time, unlike other factors (e.g., Momentum) that decay significantly faster on average and show markedly different distributional shapes. They find that Value is the slowest decaying factor on average, followed closely by Low Vol.

Flint, E. and R. Vermaak. "Factor Information Decay: A Global Study." 2021 Available at SSRN.

- *How difficult is it to replicate these strategies with a smart beta algorithm?*
- *What improvements are necessary to implement to make those algorithms more robust?*

There is extensive literature (both older and recent) on smart beta strategies, their robustness, and which factor-based approaches outperform. Replicating any particular strategy is not in itself the most challenging task, which is why a healthy dose of understanding factor exposures, both explicit bets and cross exposure to other factors, is essential.

Although stock returns and the performance of Low Vol strategies garner much attention, it's important to underscore how well Low Vol correlates well with **low business risk** and low business risk factors. Indeed, Hillsdale considers and evaluates factors such as Sales Variability Rank and Current Year Coefficient of Variation in EPS Estimates in our Canadian strategies and various Earnings variability measures in our U.S. strategies. Hillsdale skillfully employs these factors, as is evidenced by our offerings and the demand for our customized strategies. For further discussion on low fundamental risk, see Alquist et al. (2020).

Alquist, R., A. Frazzini, A. Iltanen, and L.H Pedersen. "Fact and Fiction about Low-Risk Investing. " *The Journal of Portfolio Management*, 46(6), 2020 pp.72-92.

The answers to the two questions above are therefore more nuanced. Below are some articles that touch on these questions. We will start with more classic perspectives on implementing Low Vol from Clarke, de Silva and Thorley (2006) and then progress to a few more recent articles that show the nuances to consider when implementing such strategies.

- 4) Clarke et al. (2006) conducted an empirical analysis of various minimum variance portfolios and found that minimum-variance strategies perform better on a risk-adjusted basis than market cap-weighted strategies. They find minimum-variance portfolios typically portray both Value and small Size bias. They make the case that the right approach to Low Vol can be effective.

Clarke, R., H. de Silva, and S. Thorley. "Minimum-Variance Portfolios in the U.S. Equity Market." *The Journal of Portfolio Management*, 2006, pp. 1-14.

- 5) Barber et al. (2015) show that investment managers can resort to combining factor exposures (value, momentum, quality, and low volatility in a 4-factor approach) to achieve excess performance. Thus, tackling the question about potential improvements of Low Vol algorithms.

Barber, J., S. Bennett, and E. Gvozdeva. "How to Choose a Strategic Multifactor Equity Portfolio?" *The Journal of Index Investing*, 6(2), 2015 pp.34-45.

- 6) Amenc et al. (2018) argue that the market beta of a strategy leads to highly conditional performance profiles. In line with Hillsdale's internal research (discussed above), they find that Low Vol and low investment factors, which have negative market exposure in dollar-neutral form, exhibit poor performance in extreme bull markets and good performance in extreme bear markets. This, they contend, is a direct consequence of their negative exposure to the market factors. Thus, the answer to the client's question is not so much about whether Low Vol has lost its efficacy or whether it requires more robust algorithmic tweaks. The underlying concern might better be addressed under a different paradigm, namely the consideration of a conditional framework that is intrinsically linked to market conditions.

Amenc, N., F. Goltz, and A. Lodh. "Mind the gap: on the importance of understanding and controlling market risk in smart beta strategies." *The Journal of Portfolio Management*, 44(4), 2018, pp.60-70.

- 7) Alonzo and Nusinzon (2020) highlight the need for more scrutiny on the different methodologies used to achieve Low Vol exposure by evaluating empirical differences between some common approaches to low volatility. They find that traditional optimizer-based approaches have larger

sensitivities to the risk inputs and show that there are other more robust ways to achieve Low Vol portfolios without the burden of great input sensitivity (e.g., risk balancing approach to Low Vol).

Alonso, N. and O. Nusinzon. "The Devil Is in the Details: The Risks Often Ignored in Low-Volatility Investing." *The Journal of Portfolio Management*, 46(7), 2020, pp.58-70.

III. Literature Survey

In the survey that follows, we have bolded the year of publication for more recent articles.

A) Low Vol Theoretical Foundations

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B) Factor Bets

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IV. Product Methodology: eVestment Universe

In the following section, we present an analysis based on data from the Evestment database. eVestment does not directly categorize Low Vol products by typology. However, the narratives provide some insights into the methodology used. We list the Canadian Low Volatility Products as posted on eVestment, most of which utilize an optimizer. (For this information, please contact Harry Marmer hmarmer@hillsdaleinv.com)

Footnotes and References

Footnote 1

Data Sources: All data presented is from Hillsdale's proprietary database unless indicated otherwise. This open architecture database consolidates information from a variety of selected sources supporting Hillsdale's research, portfolio management, and reporting activities.

Inception Dates, Returns Disclosure: Inception of Hillsdale Canadian Equity Low Volatility is July 31, 2021. All returns are gross of fees and expenses. Past results are not necessarily indicative of future performance.

Footnote 2 – Backtest

Backtest performance data is shown for illustrative purposes only. Backtest performance data is not a guarantee of future performance. No representation is being made that the investment process will achieve similar returns in the future. The backtest results in any presentation are not an indication, assurance, estimate or forecast of future results. Backtest or simulated portfolios are used to test the hypothetical performance of an investment strategy using historical data to analyze its performance and risk characteristics. Backtested returns are based on a quantitative testing process where stocks are selected based on specific investment objectives, including both expected return and risk metrics. All backtested returns are shown gross of investment management fees and are calculated in Canadian dollars or another currency as indicated. Actual returns may differ materially from the returns shown for reasons including, but not limited to, investment restrictions and guidelines, fees and other expenses, cash flows, and trade execution timing. Assumptions are also made as to how often a portfolio is rebalanced (e.g., daily, weekly, monthly, etc.) and how long each position in a security is held. These parameter assumptions are specified in our backtests to closely reflect how the actual portfolio will be managed. Hypothetical investment performance incorporates a percentage slippage cost to every trade the simulation executes, which is based on actual realized costs. Commission fees are also added to every trade. Backtest strategy performance is shown gross of investment management fees.

Registrations: Investment Advisor with the SEC. Portfolio Manager with the OSC (Ontario), AMF (Quebec), NBSC (New Brunswick), NLSC (Newfoundland & Labrador), MSC (Manitoba) & SFSC (Saskatchewan). Exempt Market Dealer with the OSC, AMF, MSC, NBSC, NLSC, SFSC, ASC (Alberta) & BCSC (British Columbia), NS (Nova Scotia) and PEI (Prince Edward Island). Investment Fund Manager with the OSC, NLSC & AMF. Registered as an Investment Manager to Irish authorized Investment Funds by the Central Bank of Ireland.