With Volatility Comes Opportunity

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Uncertainty continues to dominate global securities markets and heightened volatility is the result. Feifei Li, partner and head of equities, asks Rob Arnott, the founder and chairman of Research Affiliates, about the implications of increased volatility on investment strategies and where investors can find the best opportunities.

Feifei Li: What do you make of the current volatility environment?

Rob Arnott: Whereas heightened market turbulence can stir fear, panic is unhelpful. Volatility can be our friend if we're ready to reassess which markets or assets are newly formed deep-value opportunities and which remain fully priced and to trade accordingly. As I've frequently said, market volatility can serve investors well if viewed as a means to respond to opportunities.

Volatility has spiked. The VIX Index peaked above 80 on March 16, over fivefold higher than its long-term average level. Investors who average into markets that are priced to deliver attractive return prospects are reliably rewarded in the long run, as long as they are patient.

The COVID-19 pandemic is an unprecedented shock to the economy, but only one of the catalysts for the current market volatility. Prior to the virus' outbreak, we noted various warnings from the macroeconomy, credit conditions, and asset class valuations that indicated the capital markets may have been approaching an inflection point.

The extent and duration of market turbulence may depend in part on the level of contagion the shocks generate within the financial system and the response from governments and central banks. While many banks are much better capitalized today than they were during the global financial crisis, interest rates are already effectively at zero. Moreover, following more than a decade of global quantitative easing, sovereign debt in all the major economies is at historically high levels. If the responses from the government and central banks are not measured, the risk of inflation poses a potentially severe threat to sustained market volatility.

Feifei: In your opinion, which have been the worst performing strategies during the sell-off?

Rob: This has been a take-no-prisoners market crash; even countercyclical assets such as commodities are down big. Generally, the hardest-hit markets in the current crisis are those trading at high valuation levels and those with a high market beta, but there are a number of exceptions to this general pattern. Year-to-date through March 24, the US equity market, trading at extremely high valuation premiums relative to its own history and to multiple other developed markets, has plummeted by 24%, and over the same span, REITs are down 37%, emerging market stocks are down 28%, and commodities are down 21%.

Feifei: Some market pundits have accused alt risk premia (ARP) of being short vol in disguise. Has the recent sell-off given greater insight into whether this is true for any of the most popular factors?

Rob: Funds with high leverage, optionality, and allocation to illiquid assets are usually hit the worst in any massive sell-off. This time is no different. While not all ARP strategies have these attributes, those that do are likely suffering in the current environment.

Feifei: You have said the time to buy into markets is when we are at peak fear. Which signals do you look at to ascertain this?

Rob: It's impossible to pinpoint peaks and troughs. We don't believe we have any special knowledge or skill to divine peaks or troughs ahead of the pack, particularly in the short term. But we do have the discipline to buy the assets people fear most and sell the assets that are most beloved. Stocks will begin to recover long before the pandemic is on the wane. The strongest bull markets are not built on a foundation of good news, but on diminishing bad news.

Wouldn't it be nice if the world of academic finance had coined the expression "equity fear" premium instead of "equity risk" premium?! The risk premium is at its best when fear is at a peak. It'll be hard to be perfectly right on the turning point, naturally, but don't wait for good news—just wait until the pattern of bad news lets up.

Many of today's leading indicators, such as capital market signals, are available in real time. In contrast, real-economy measures arrive over weeks and months. Today's observation of market signals such as stock prices, real bond yields, commodity prices, credit spreads, yield curve slope, and implied volatilities point to a deep economic contraction. In the coming weeks and months, leading indicators from the real economy will offer estimates of the magnitude of the present contraction.

Feifei: When risk appetite returns, where should investors direct their attention first?

Rob: Consider averaging into newly cheaper and higher-yielding asset classes, such as ex US developed equities and emerging market equities, while paring back expensive assets such as developed market sovereign debt. It can be painful to add to whatever has hurt and sell what is loved and favored. When we rely on model-driven processes, that discipline can institutionalize the courage to make these uncomfortable but ultimately profitable trades. If inflation rears its ugly head, then TIPS and other inflation-fighting assets may offer the most protection in conditions that tend to savage mainstream asset classes.

Those who have explored our Asset Allocation Interactive (AAI) tool on the Research Affiliates website know we have little confidence in anyone's ability to pick market turning points, but we are quite confident that valuation tells us a lot about long-term returns. The arithmetic of long-term returns is simple: the future return of an asset is its yield *plus* growth in income *plus or minus* any changes in valuation levels. It's that simple. This same simple formula can be used with surprising accuracy to better understand past market conditions and to predict long-term future market prospects. Changing valuation levels tend to swamp the impact of growth and income for short-term investors, but yield-plus-growth is the entirely dominant force for long-term investors.

Feifei: Now that volatility has returned to equity markets across the world, do you maintain your view that value investing in stocks is not dead?

Rob: Yes, I do. A serious challenge to our lives, society, and economy, the economic lockdown precipitated by COVID-19 has triggered a global stock market crash. As equity prices dropped, the valuation multiples of growth stocks fell from their previous extravagant heights to less expensive levels, and the valuation multiples of value stocks moved from already cheap levels to far-more attractive levels. As a result, value stocks are now trading globally at historic bargain-basement valuations, although in a wide range from one market to another. A patient and disciplined investor willing to rebalance into what is feared and unloved can position themselves to benefit handsomely from these opportunities.

Feifei: If value investing is not dead, what are some of the best ways to gain exposure to it?

Rob: First, ensure the strategy you wish to invest in relies on a disciplined rebalancing approach. Systematic rebalancing is the engine behind value investing. Ideally, there should also be a *dynamic* value exposure, deep value when value is cheap, and mild value when value is fully priced.

The source of the long-term historical success of the RAFI™ strategy is not the average value tilt of the underlying portfolio, but rather dynamic contra trading against the market's constantly shifting expectations, fads, bubbles, and crashes. That is the key to the RAFI strategies' dynamic style tilts and its competitive advantage relative to cap-weighted value indices. As I, and my colleagues at Research Affiliates, have regularly said, a systematic approach achieves attractive long-term real returns by bearing risk when risk is most feared and moving to a conservative posture when complacency reigns.

Second, when harvesting well-known return premiums, such as value, the details in design and implementation matter. Many quant strategies are built by people who are not experienced investment practitioners and are therefore unaware that implementation costs can destroy even a large theoretical alpha. Various portfolio design and implementation elements—such as signal definition, universe coverage, weighting mechanism, measurement periods, and rebalancing frequency—can materially lower market impact costs, which in turn can preserve a strategy's efficacy in capturing a factor's premium. Let's take signal definition as an example. Value strategies that overly rely on narrow definitions, such as the price-to-book ratio, are more likely to misclassify companies with high intangibles.

Finally, why limit ourselves to equities only? Investors willing to take on maverick risk and move away from mainstream assets can benefit from the diversification offered by a value-oriented rebalancing discipline that spans a wide array of global asset classes.