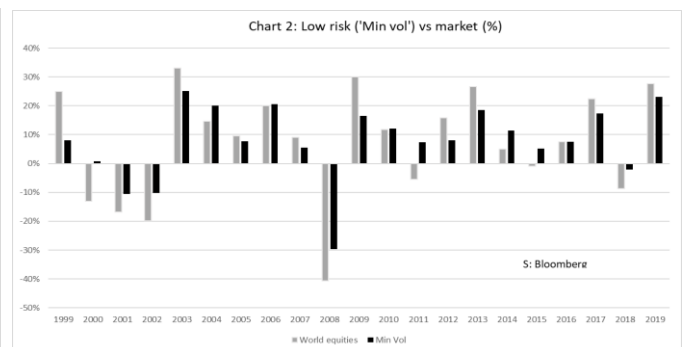


## Minimum risk has done well in recent years; even better times lie ahead.

It is generally accepted that the more you risk, the greater the return you should enjoy. Whatever the broader truth of this – and it is a widely accepted investment principle - it is a striking fact that in practice, portfolios of lower-risk stocks have produced higher risk-adjusted returns than both the market and portfolios of high-risk stocks (Chart 1). Putting numbers on this, and based on the universe of stocks in the MSCI World Index since the end of 1999, lower risk (Minimum Volatility or ‘Min Vol’) stock portfolios have delivered a compound gross return of 7.5% per annum while the market has returned 5.0% (MSCI World Index) to 31 December 2019.<sup>1</sup>

### The holy grail of defensive investing

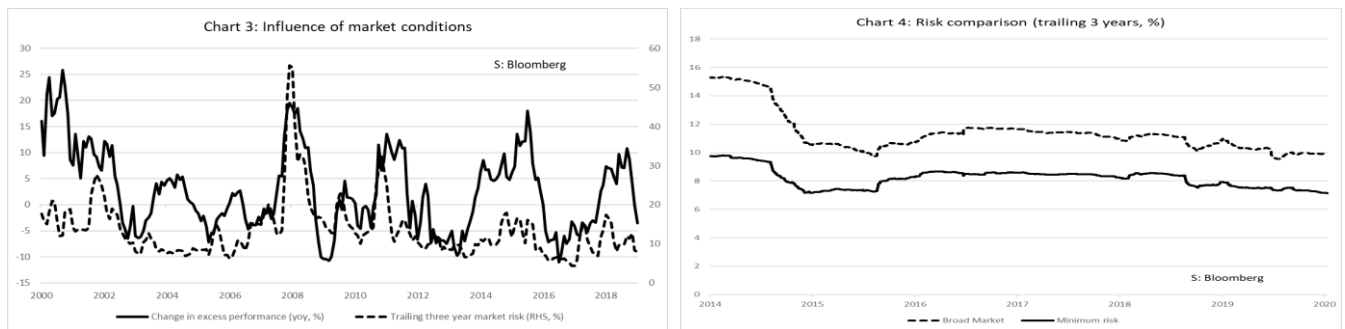
As might be expected, the excess returns obtained from investing defensively have tended to come when the broad market has been under stress i.e. post ‘dotcom’, during the Credit Crunch and in 2018 (Chart 2). This highlights the holy grail of defensive investing: participate in less of the market downside than is forsaken when stocks rise. Again, from 1999 and based on monthly returns, ‘Min Vol’ has suffered an average 49% of falls in the broad market while it has enjoyed 70% of the gains.



Source: Bloomberg

The chart of the compound excess return (Chart 1) demonstrates clearly that there has been an element of cyclicality to performance while suggesting that the pace of outperformance is tapering off. Historical data highlights a strong link between the pace of excess return (from ‘Min Vol’ relative to the market) and the underlying volatility of the broader market; the gain is greatest when markets are most lively (Chart 3). Put differently, outperformance from minimum risk is weakest when markets are quiet – as they have been recently. Thankfully (or maybe not), quiet markets don’t remain subdued for long.

Even in current conditions, a minimum risk approach still delivers significantly lower risk than the broader market which can be seen using the annualised daily standard deviation (Chart 4 below).



Source: Bloomberg

It is reasonable to ask why low risk strategies work, defying theory. Firstly, most active managers are measured against a market index but have limited, if any, ability to take on the leverage needed to sustain broad market risk. Low beta stocks might be solid investments in the long-term but short-term performance pressures can see low risk stocks as generating too much benchmark risk. Perversely, long-only managers find stocks which lag in bull markets unattractive, even if they save more when markets fall. Bull markets generate new business sales; bear markets don't!

Another reason for outperformance comes from the likelihood that the more diversified the portfolio, the lower its level of risk. Smaller stocks tend to be more varied across countries and business lines, possessing weak or non-existent correlation that is attractive for a low risk strategy. Historically, small companies have also generated an attractive, additional risk premium that helps support overall returns. The average market weighted capitalisation of the Osmosis Low Volatility Strategy (\$72bn) is less than half that of the broader global market (\$186bn).<sup>ii</sup>

There are two approaches to building a minimum risk portfolio: by focusing only on companies with the lowest individual level of share price volatility or by using statistical tools to combine a wide range of stocks which, collectively, exhibit low levels of portfolio volatility. While there are advocates of both approaches, our preference is for the latter. For us, too many individually low volatility companies can simply be dull (lacking performance in all market conditions). We understand that some may worry about using statistics to construct a portfolio, but this can be an invaluable approach to combine large numbers of stocks each exhibiting their own idiosyncratic behaviour. Importantly we recognise and are alert to the 'rubbish in, rubbish out' limitations of numeric techniques used to minimise (optimise) the risk profile of a portfolio of stocks. The benefit of this approach is that it allows us to invest in vibrant stocks, which on their own could be too 'risky' but, when combined, can deliver an attractive balance in a portfolio because they may possess contrasting performance drivers.

## Finally, when is best to invest?

Standard cycle analysis suggests that low risk portfolios perform best in the late expansion and early contraction stages of the market cycle. This conclusion has intuitive appeal; this is when markets are most vulnerable to sharp sell-offs (and a spike in volatility).

We are currently still in the longest economic and market expansion in living memory; the end may not be nigh, but it is undeniably late stage. In the years ahead we are therefore likely to pass through the parts of the market cycle when minimum risk strategies are likely to perform best relative to broad market programmes. We are set to endure periods of heightened market volatility favourable to a minimum risk approach and when defensive characteristics are prized most. Minimum risk has done well in recent years; even better times lie ahead.

### **IMPORTANT INFORMATION**

*This document was prepared and issued by Osmosis Investment Research Solutions Limited (“OIRS”). OIRS is an affiliate of Osmosis Investment Management US LLC (regulated in the US by the SEC) and Osmosis Investment Management UK Limited (regulated in the UK by the FCA). OIRS and these affiliated companies are wholly owned by Osmosis (Holdings) Limited (“Osmosis”), a UK based financial services group. Osmosis has been operating its Model of Resource Efficiency since 2011.*

*The MSCI World Index captures large and midcap representation across 23 Developed Markets countries. With 1,645 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.*

*The MSCI World Minimum Volatility (USD) Index aims to reflect the performance characteristics of a minimum variance strategy applied to the MSCI large and mid-cap equity universe across 23 Developed Markets countries. The index is calculated by optimizing the MSCI World Index, its parent index, for the lowest absolute risk (within a given set of constraints). Historically, the index has shown lower beta and volatility characteristics relative to the MSCI World Index.*

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<sup>i</sup> MSCI World Minimum Volatility in USD Gross Total Return USD Index (31.12.19)

<sup>ii</sup> The MSCI World Developed Index (31.12.19)