

# SHAKE



# DOWN

It's a difficult environment for pension investors. How can they protect their portfolios from market volatility?

*By Tony Palermo*

**W**ith global economic issues, the ongoing European sovereign debt crisis and pension plan funding levels still a concern, who can blame investors for being worried? At home and abroad, the media is announcing more bad news every day. And the message from investment experts? Get used to it.

"We are at an extreme in terms of volatility," says Robin Lacey, vice-chair and head of institutional distribution with TD Asset Management. "It's really a repeat performance of what we saw in 2008. If you look at measures of volatility—a classic one is the VIX Index—we've basically spiked back up to an extreme point."

Lacey notes that several global economic, political and even social events, such as the recent Occupy movements, are all coming together to cause high levels of market volatility—and with it, heightened levels of anxiety and uncertainty among pension plan sponsors and members.

Mathieu Tanguay, a principal with Mercer, agrees. "Investors, including pension plan sponsors and participants, still have 2008 in mind," he says. "There is uncertainty that world events could lead to something extreme, similar to 2008—like a double-dip recession, or something even worse. While the probability of these extreme events occurring might not be very high, everyone is still keeping it in the back of their minds, because it could still happen."

And there may be other contributing factors, says Mel Mariampillai, a portfolio manager with Sionna Investment Managers. "We believe there are two things exasperating the market volatility right now: exchange traded funds and high frequency trading," he explains. "You have big moves in and out of the market based on macro information; basically, just selling the whole market or buying back the whole market. As a result, correlations have gone up, and you have cases where the energy sector, consumer staples sector and financial sector are all moving

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the same way—which doesn’t make a lot of sense, because the fundamentals for each of those industries are very different. It is likely that high frequency trading and especially index funds are resulting in this increased volatility.”

Despite these concerns, experts agree that this isn’t the time to panic and make rash decisions. Rather, it’s an excellent opportunity to bring your team together to evaluate your plan, ask hard questions and then determine what changes, if any, need to be made to better manage volatility.

### Low-volatility Options

Where the focus used to be on maximizing returns, de-risking is now the latest buzzword. And many investment management firms are responding with low-volatility solutions.

But is it just a marketing gimmick to capitalize on the times, or are providers simply responding to the needs of their clients?

“Ten years ago—and especially prior to the tech bubble—clients were return-driven,” says Tanguay. “Everything seemed easy. Most stocks were going up. It’s easier to talk about return and take risk when you’re at a 130% solvency ratio.”

Lacey agrees, noting that at the turn of the 21st century, everything was moving solidly in one direction: up. He recalls a consultant who asked him why there weren’t more risk-based solutions in place 10 years ago. His reply: “Because no one would’ve listened.”

Today, plan sponsors are looking for solutions and innovative thinking to manage risk—preferably without significantly reducing expected returns. Naturally, not everyone agrees on what type of low-volatility solution should be implemented; different approaches, methodologies and opinions exist. “You’ll hear a lot of people all of a sudden recasting some of the investing they do as ‘low volatility,’ even though it’s not really what it was meant to be,” warns Lacey.

Mariampillai says plan sponsors should be asking themselves two questions: How can you preserve capital in this type of environment? and How can you make money? “As a value investor, we think that focusing on the high-quality cheap stocks continues to make sense,” he explains. “Despite the increased volatility, a conservative approach where you build a portfolio of stocks that are priced cheaper than the index is the way to preserve capital in this environment.”

Mariampillai adds that there should also be a focus on dividend yield. “We’ve seen research that says between 60% and 90% of your total return in a sideways market can come from your dividend yield.”

According to Brendan Bradley, senior vice-president and director of managed volatility strategies with Acadian Asset Management LLC, low-volatility strategies, in their simplest form, are long-only, fully invested equity strategies that do not use or require any sort of derivatives overlay. He adds that these strategies are based on the idea that risk within the cross-section of equities is not rewarded. In other words, riskier investments don’t necessarily translate into higher returns, while lower-risk investments don’t necessarily mean lower returns.

Bradley says there are a number of ways to build a low-volatility portfolio, all of which are designed to capitalize on the lack of relationship between risk and return within equities. For example, some portfolios target low-volatility stocks;

others, low beta stocks.

Another approach targets a low-volatility *portfolio* as opposed to a portfolio of low-volatility stocks. “This approach puts the emphasis on low beta stocks but also penalizes total stock volatility,” says Bradley. “Investors are expected to benefit from compounding the lower-volatility return stream of the low-volatility portfolio.”

And alternatives may offer additional opportunities. “Low-volatility strategies can be used as a complement or alternative to certain hedge fund allocations,” Bradley adds. “The strategies are low risk, low beta and have similar drawdowns to certain long-short equity hedge fund indices. Yet low-volatility strategies are transparent and totally liquid, and have significantly lower fees than equity hedge funds.”

### The Value of Diversification

Diversification remains an important consideration for plan sponsors looking to manage volatility. While it’s definitely not a new concept, experts report that many plans aren’t properly diversified—especially in their equity investments, which tend to reflect a home-country bias.

“Canada is a great market,” says Jeff Storie, an investment consultant with Morningstar Associates Inc. “But we also believe that investors tend to overweight Canada more than what is prudent. If you look at the Canadian equity market from a sector basis, it’s very narrow. Fifty percent of the market is commodities.”

The obvious problem with that, Storie explains, is that when demand drops during an economic slowdown, there are few places to hide in the Canadian market. To put it into perspective, he cites two recent examples: copper, whose price has dropped 20% (as of Nov. 30, 2011), and oil, which is no longer trading at \$130 a barrel. “If your plan assets are concentrated in Canadian equity funds, it’s going to be a problem for your plan members, especially [for those] who are closer to retirement and can’t really afford these types of losses.”

Several low-volatility options exist that exploit the diversity and potential of emerging markets. As Lacey says, they’re still targeting the least-risky stocks. “Think cement manufacturers in Mexico

or hydro companies in Brazil. We want regulated businesses and staple businesses with great defensive qualities that are inherently less risky.”

Increasingly, investors are paying more attention to alternative asset classes such as infrastructure (public systems, services and facilities) and real estate.

“Infrastructure is interesting because, very often, it’s a monopoly-like structure with captive clients,” says Tanguay. “In some situations, like a prison or a hospital, generally, the government is the ‘client’ who is behind it. So you build the hospital (or part of it), you operate it, and you receive cash flows from the government. It’s very interesting in terms of a business model. That being said, it is not to say it’s risk-free.”

Private real estate funds are also becoming more popular, especially with plan sponsors looking to move away from equity markets. “What we’ve seen in Canada is a number of plans increasing their allocation to real estate,” says Katherine Giordano, a portfolio manager with Aberdeen Asset Management. “When we ask them where they’re taking it from, it’s equities.” She points out that a big advantage of private real estate investments is that investors can target a specific strategy—say, an urban office in a particular market—something you can’t typically do with a REIT (real estate investment trust).

Melissa Reagen, Aberdeen’s head of property research for the Americas, agrees. She notes that on a general basis (and keeping regional differences in mind), the industrial sector is the least volatile, and the hotel and office sectors are the most volatile, with apartments and certain niche markets falling somewhere in the middle. “If you’re talking low volatility, you really need to be aware of not only *what* you’re investing in but also *where*,” Reagen says. “Energy and tech tend to be volatile sectors, and some of the most volatile markets are places like Silicon Valley, Calgary, Edmonton and Manhattan.”

Like others, both Giordano and Reagen agree that while investment opportunities exist in Canada, investors should also look beyond its borders. “Canada represents about 4% of the global property market; the U.S., about

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### Go Back to Basics

“Take a solid look at your plan design. Consider your default options. Make sure your plan adheres to the *CAP Guidelines*. Look at the demographics of your workforce and your plan members. If they’re generally an older workforce, are there sufficient options available in the plan to meet those needs? Look at your plan members in terms of education. How investment-savvy are your plan members? Do you need a plan that’s going to provide ongoing education and support to the plan members? Work with your consultant to understand what your options are and to figure out where the consultant can provide assistance.”

— Jeff Storie, investment consultant, Morningstar Associates Inc.

### De-risk With Derivatives

“It’s very interesting that Canadian investors are more likely to embrace derivatives. For the longest time, pension funds were trying to get around the government-imposed foreign property limits before they were dropped in 2005. By that point, a lot of pension funds had found a way around the rule by using derivatives. So that’s been an instrument that Canadian investors, particularly institutional investors, have been very comfortable with for a long time. There are other applications of derivatives to help plan sponsors reduce some of the risk and volatility of their investment programs.”

— Robin Lacey, vice-chair and head of institutional distribution, TD Asset Management

### Ride It Out

“The problem with markets right now is that they’re totally unpredictable. The only thing that seems predictable is a highly volatile environment. But extreme events can happen on both sides. On one hand, you can have failure and defaults in Europe, and a banking crisis. On the other hand, there could be stories where European leaders manage to solve their problems, and, given the amount of cash in the market, that may bring the stock market significantly higher. Volatility means risk, and we just don’t know what’s going to happen. So manage the volatility the best that you can.”

— Mathieu Tanguay, principal, Mercer (Canada) Ltd.

34%,” says Giordano. “So there’s a much stronger argument in Canada for going outside of the home market. You really want to have that diversification.”

But that’s not to say that plan sponsors should move everything away from home. The goal is to get them to think beyond home borders and to recognize that diversification across asset classes and regions is the key to managing a portfolio during these volatile times.

“Really, the best and only long-term solution to volatility is to hold a diversified portfolio,” says Dale Powell, director of investment consulting with Morningstar Associates Inc. “Diversify by manager, geography, region, sector, currency and asset class. That is the classic and the best solution to market volatility over the long term.”

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