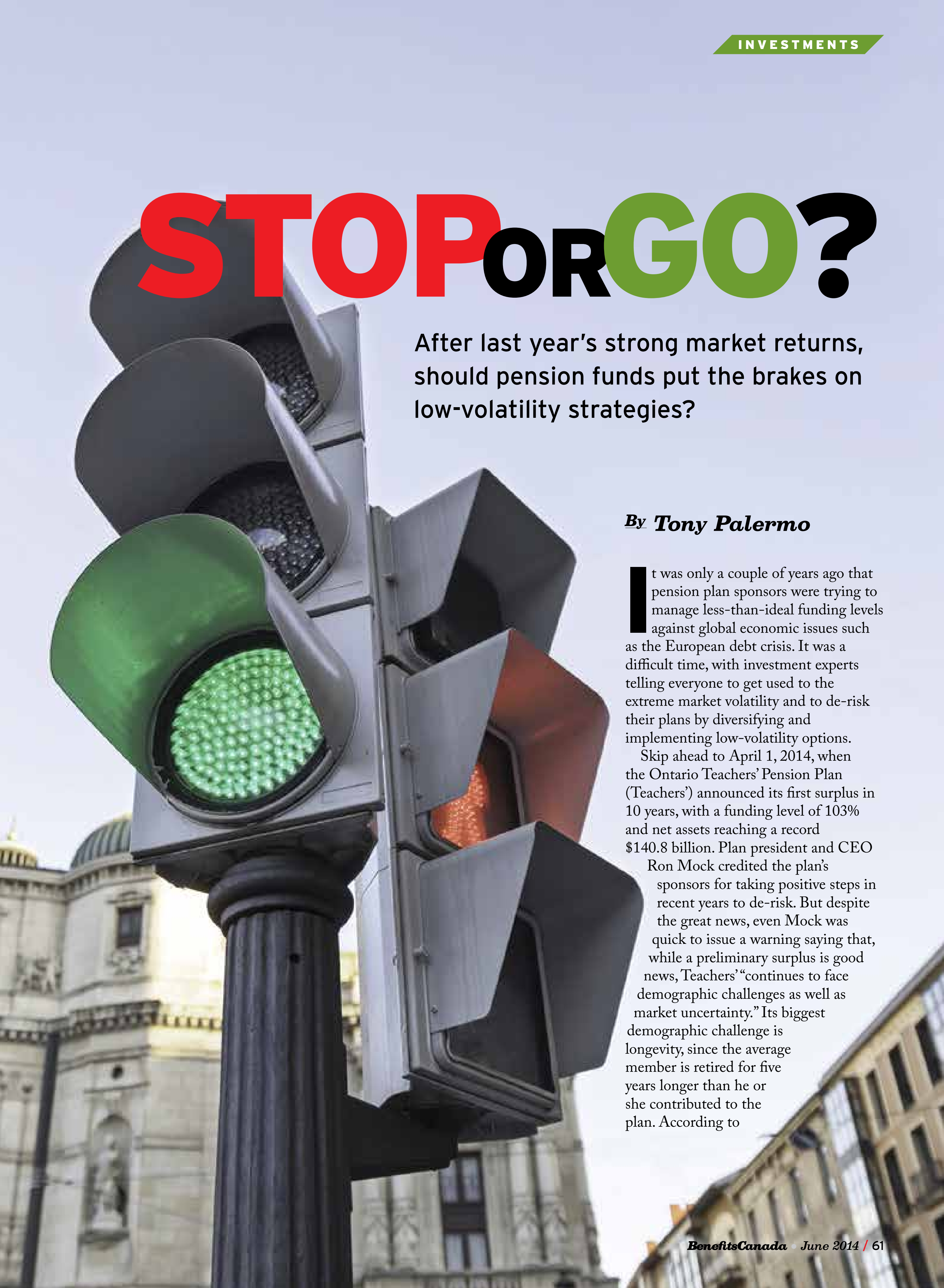
STOP OR GO?

After last year's strong market returns, should pension funds put the brakes on low-volatility strategies?



By ***Tony Palermo***

It was only a couple of years ago that pension plan sponsors were trying to manage less-than-ideal funding levels against global economic issues such as the European debt crisis. It was a difficult time, with investment experts telling everyone to get used to the extreme market volatility and to de-risk their plans by diversifying and implementing low-volatility options.

Skip ahead to April 1, 2014, when the Ontario Teachers' Pension Plan (Teachers') announced its first surplus in 10 years, with a funding level of 103% and net assets reaching a record \$140.8 billion. Plan president and CEO Ron Mock credited the plan's sponsors for taking positive steps in recent years to de-risk. But despite the great news, even Mock was quick to issue a warning saying that, while a preliminary surplus is good news, Teachers' "continues to face demographic challenges as well as market uncertainty." Its biggest demographic challenge is longevity, since the average member is retired for five years longer than he or she contributed to the plan. According to

Teachers', the plan has 2,900 pensioners age 90 or older, of which 126 are 100 years old or older.

Mathieu Tanguay, a partner and investment consulting leader with Mercer, agrees with Mock. He says that risk is still present even though markets have been more stable lately—thanks, in part, to improving international economic data, reduced uncertainty around the eurozone and its banking system, the U.S. fiscal situation and other factors that were perceived as significant threats to the world's financial markets not so long ago.

"I would prefer to say perceived risk is lower than it was a couple of years ago," says Tanguay. "Volatility has gone down, and the rate spreads in places like Europe have gone down, which all means lower risk. But many things can still have an impact on the markets."

As he says, the recent Ukraine crisis hasn't really had much of an impact on world markets up to this point, but the world is a big place, and there will always be the risk of something happening, somewhere. In other words, risk never *entirely* disappears.

Tanguay describes 2013 as a dream year for pension plans, during which many of them saw improvement in their funding status. Still, Tanguay says some of his clients are still looking for ways to de-risk. In certain cases, they're either fully funded or close to being fully funded and want to lock in their recent gains to make sure they don't go back to where they were in 2008. Others, he says, simply want to be smarter about the type of risk they're taking.

"Even some of our clients who are comfortable with their current level of risk are trying to take smarter risks while chasing higher returns," Tanguay explains. "Basically, they're trying to get as much reward as possible for the level of risk they can tolerate—and that could mean, for example, diversifying away from the equity risk premium into alternative asset classes such as real estate, infrastructure and hedge funds."

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— Rob Boston, Morneau Shepell

Mixed Signals

So, if risk never entirely disappears, then it makes sense that low-volatility options still have a place in pension plans, right? "My answer would be yes, but we have to be careful about how we define low volatility," says Rob Boston, a partner with Morneau Shepell. "Some of the low-volatility products out there are really just a lower-volatility version of an index they're looking to beat."

Boston says a low-volatility strategy shouldn't be one of *relative* magnitude (comparing the volatility against a comparable equity index), but rather one of *absolute* magnitude (a stated standard deviation, for example, without regard for an equity benchmark)—and there's a clear difference between the two.

As an example, Boston says if the stock market goes down by 15% and your low-volatility strategy falls by 10%, this is not low volatility because it's not absolute. Absolute low volatility, he explains, is part of the doctrine of outcome-oriented investing. In this case, the outcome is low absolute volatility without regard for benchmarks or asset classes.

"I always say the guy who invented math was evil," says Boston. "With the way math works, you can be down 50% one year, then up 50% the next year, but that doesn't return you to where you were before you went down. You need 100% to get back to where you were. It doesn't seem fair."

As Boston says, the whole idea of absolute low volatility is to protect on the downside as much as possible so you don't have to do all of the heavy lifting that is required with a more volatile investment strategy. It gets you as high a return as possible, with as much certainty as possible, year after year.

"So if we can agree on what low volatility really is, then I would say yes, there is still a place for it," says Boston, before issuing a caution. "Low-volatility strategies will typically underperform when stock markets are on a tear. We had phenomenal returns in most of the world's stock markets last year. The tendency may be to postpone adopting a low-volatility strategy as a complement to an absolute growth strategy, but we wouldn't recommend keeping your foot on the gas right now. People need to remember that markets have bubbles, and they tend to revert back to long-term norms."

Jean Masson, managing director with TD Asset Management, agrees that, after the recent burst of strong market performance, DB pension funds are in better shape than they were before, giving plan sponsors a little more breathing room when deciding whether to take on more or less risk than before. But whatever a DB sponsor decides, Masson says there is *always* a case for low-volatility equities.

"The case for low-volatility investing is based on the whole history of equity markets," says Masson. "Whether we look at a cross-section of markets such as the Canadian, U.S., developed or emerging—or over time, like the last 10 years, 20 years or even 50 years—researchers have shown that the more volatile equities do not deliver higher returns than the less volatile ones. What researchers have found is evidence of a positive risk/return relationship only during short bursts of strong upmarket performance. And this is true for all investors, including pension funds."

Masson says long-term bonds remain the best asset class suited for DB pension funds because they're a good match for their future obligations, although their yields will remain very low. Given the massive liabilities sitting in DB plans, he figures there must be "a lot of pent-up demand" for long-term bonds. But with Canadian government deficits shrinking, there is a reduced supply of fresh long-term bonds. This, concludes Masson, will limit any increase in bond yields for a long time, and DB pension sponsors will be challenged to find suitable assets to match their liabilities.

The Green Light for DC

Low-vol strategies also make sense for DC plans. In his 2014 paper titled "Low Volatility Equity Strategies – The Holy Grail for DC Investors," Neil Lloyd, a partner with Mercer, argues that recent research has shown that the volatility of shares and their return characteristics are not proportionately linked. As he says, if equity-like expected returns can be achieved with less risk, low volatility almost sounds like the Holy Grail of DC investing, doesn't it?

The catch, Lloyd says, is that the performance of low-volatility equity strategies is cyclical. When markets are weak, the expectation is that low-vol strategies will shine; when markets are strong, low-vol strategies are more likely to underperform. And it's this cycle of relative outperformance/underperformance that can be a real concern if DC investors chase the funds that have recently performed better.

"Equally, performance cycles can be quite long, and the potential relative underperformance of low-volatility equity strategies in a strong equity market can be a challenge for fiduciaries," explains Lloyd. "The key is to ensure that investors understand what a low-volatility equity strategy is expected to do, and when and

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>
> **— Harry Marmer, Hillsdale Investment Management**

Did You Know?

39 of the money managers surveyed in the spring 2014 money managers survey offer low-volatility strategies

Source: Canadian Institutional Investment Network

where it is expected to outperform and underperform."

And that, he agrees, is more challenging in a DC plan, where members are the ultimate decision-makers. Lloyd says the unfortunate reality is, if strong equity returns such as the ones seen in 2013 continue, DC plan members may forget about the advantage of low-volatility equity strategies—that is, until the next equity crash comes around.

Harry Marmer, a partner at Hillsdale Investment Management, believes that low-volatility strategies may be unattractive to some investors who care about "deviation from the benchmark," as these strategies have very high tracking error (or deviation) to the index they're being compared against. In other words, the difference between the returns of a low-volatility strategy and the index can be significant at times.

To put it into perspective, Marmer considers the following scenario. Let's say it's 1998, and you've spent years trying to convince your DB pension committee that it's better off with low-volatility strategies: they have less downside risk, a higher risk-to-return ratio and better performance in the long run, and they're a better match for liabilities. So, in 1998, you finally get the go-ahead, and you start investing in these strategies on Jan. 1, 1999.

"Unfortunately for the low-volatility investor, 2000 was the year of the Nortel bubble, and the difference in return between the low-vol investor and the TSX Composite was 32% in favour of the composite," says Marmer. "If your committee did not truly understand the differences between these two investment approaches, you could have faced serious career risk."

But, as Marmer explains, by 2001, the Nortel bubble burst and low vol more than made up for this underperformance relative to the market, going up 32%—19% relative to the TSX (which was up 7.4% and then down 12.6% by 2001). "Low volatility is not for the meek who worry about sticking out from the crowd and do not have a well-thought-through investment plan," says Marmer.

In other words, investors who choose low vol need to clearly map out their route—and understand that it may be a long drive. BC

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