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Taming volatility through equity minimum risk strategies

Caroline Cakebread | September 26, 2011

Is the equity risk premium dead? Not according to Chris Guthrie, president of Hillsdale Investment Management who says stock market volatility can be tamed through equity minimum risk strategies. According to him, one Quebec-based pension fund is already using them — and equity minimum risk strategies are also being used in the ETF space. What are they? And how how do they work with ETFs? Guthrie answers my questions below.

What is an equity minimum risk strategy?

It's a systematic and disciplined investment approach where the objective is to construct a portfolio of stocks with the lowest volatility available at that time in the market. Equity minimum risk strategies are also known as low volatility or minimum variance strategies. The unique property of this approach is that stocks are optimally weighted in the portfolio based solely on individual stock volatility instead of expected return. The resulting portfolio aims to achieve a higher return-to-risk ratio than the market portfolio.

Are they just another new investment fad or does this strategy actually have legs?

Equity minimum risk strategies are not a new concept or gimmick. They are well grounded in applied academic research and have been discussed for over 20 years in the investment management community. But they've become more relevant today because of investor interest in strategies that address concerns over spikes in equity market volatility.

In fact many would argue that the equity risk premium does not actually apply to cap weighted benchmarks as investors are not supposed to be rewarded for risk that is diversifiable.

Over the 12.5 years ending June 2011, an equity minimum risk strategy averaged more than 35% lower volatility than the market while outperforming it by 5.1%. The beta of the low risk strategy over this period was 0.40 or 60% lower than the market.

Are pension funds looking seriously at equity minimum risk strategies?

Equity minimum risk strategies are extremely compelling for pension funds today for the simple fact that they allow you to capture the equity risk premium with lower volatility then the market. This is exactly why one pension fund in Quebec has invested in them. These strategies offer a better equity match for liabilities than most other equity strategies. In the asset/liability space, less equity volatility leads to lower asset/liability volatility.

By way of example, over 12.5 years ending June 2011, our Canadian equity minimum risk strategy averaged nearly 40% lower volatility than the market (i.e. 9.7% volatility vs. 15.8% volatility). This translated into 34 % lower tracking error relative to long bonds for the equity minimum risk strategy in comparison to the S&P/TSX Composite Index (i.e.10.9% vs. 16.5%).

How do you use ETFs?

The Horizons AlphaPro Balanced ETF (HAA) balanced fund was purposely designed to have a lower volatility than the median manager. We have an allocation to a low volatility strategy within this ETF.

Are plan sponsors ready for this kind of approach?

Demand for equity minimum risk strategies is just starting to show up on the institutional radar screen and we have had a number of inquiries on these strategies by both plan sponsors and consultants.

Interestingly enough, a number of consultants have come forward with the recommendation that equity minimum risk strategies are a neat strategy to include as an equity anchor for higher beta strategies. They are looking at them as a means of totally redesigning equity strategies beyond simply considering them as excellent risk reducers in asset/liability space.

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