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The Low Volatility Factor

What is Low Volatility?

The Low Volatility factor is a bit of an anomaly. Contrary to intuition or conventional wisdom, it demonstrates the lower volatility investments outperform (absolutely or on a risk-adjusted basis) their higher volatility counterparts overtime. The first work on the phenomenon was conducted by Fischer Black.

How is it captured?

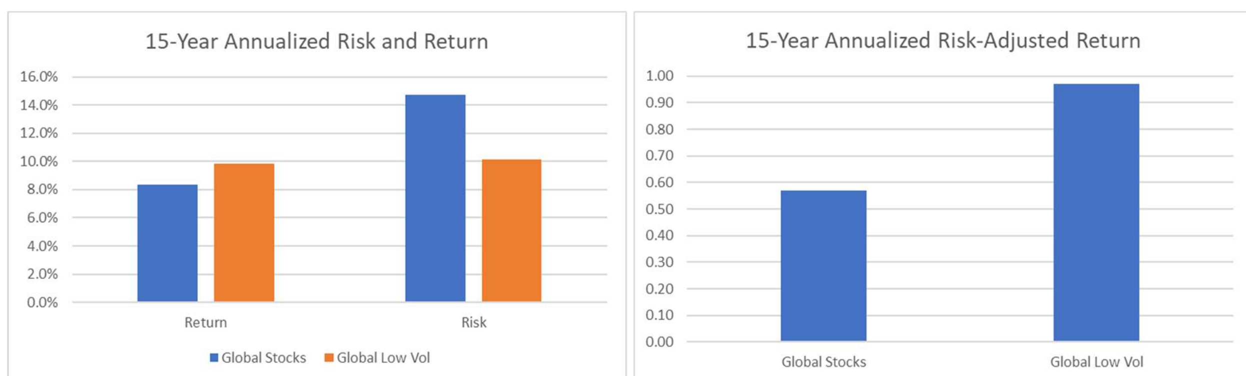
While the Low Volatility factor will obviously reflect some sort of risk metric, it too can be captured in numerous ways. The most popular are low volatility, which looks solely at recent historical risk, and minimum volatility which incorporates recent historical risk AND some measure of how stocks work together (i.e. covariance).

Why does it work?

Several explanations have been put forth by academics on why the factor works. Some can be complex and look at things like leverage and benchmarking. We posit a simpler and more empirical theory that it is the downside protection lower volatility investments offer that leads to their higher-than-expected returns over time.

How has it worked?

Through May 31, 2018, Low Volatility (as measured by the MSCI ACWI Minimum Volatility Index) has outperformed the market (as measured by the MSCI All Country World Index) on both an absolute and risk-adjusted basis.



How do we use it in a portfolio?

Metric portfolios currently gain exposure to the Low Volatility factor in equities by investing in ETFs that track the MSCI USA, EAFE, and Emerging Markets Minimum Volatility indexes. All capture the factor using historical risk and covariance metrics. The primary benefit of the factor is the potential for improved risk-adjusted returns.

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Disclosures

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