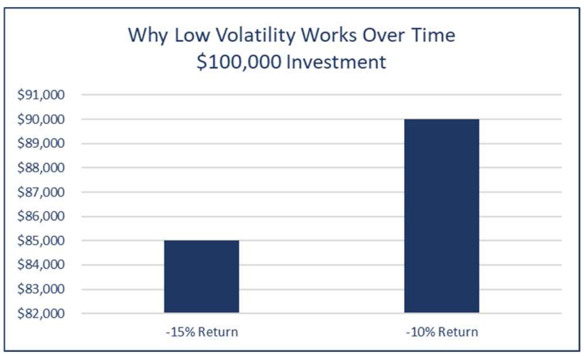
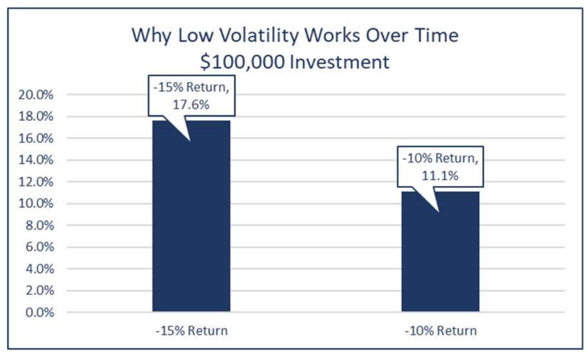
Why Low Volatility Works

While there is some debate about whether low volatility stocks do better than the market over time, there is at least some consensus that they do better on a risk-adjusted basis. Similarly, there is always conjecture about why a factor works. Some argue it is investor behavior that causes it to work; others point to reasons that have more to do with the structure of markets. Regardless of the theoretical reasons, we look here at the math that explains why something that underperforms in up markets can still win in the long-run. We do so by looking at a hypothetical 15% drop in the S&P 500. We assume that, because low volatility stocks tend to hold up better in down markets, they drop by 10%.

What's Left and What's Needed?

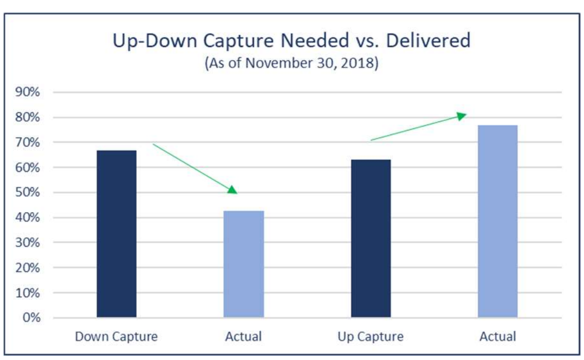
These charts show what is left of the market and low volatility investors' accounts after their declines in value.

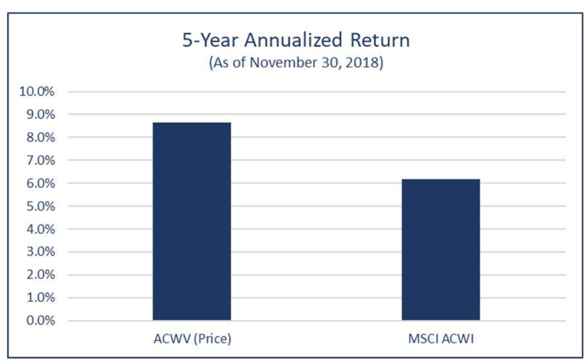




As can be seen from the chart on the right, in order to get back to the original account value, the investor in the market needs a 17.6% return, while the low volatility investor only needs 11.1%.

Hypotheticals are great, but what about real life? To make this math work, low volatility stocks need to deliver 67% of the market's return on the downside and then turn around and deliver 63% of the market's return on the upside. As the chart below shows, low volatility stocks have delivered better up and down capture than that.





Source: Morningstar and Metric Financial; Low Volatility represented by ACWV (iShares Global Minimum Volatility ETF) lower costs. better results.

As the chart on the right points out, by capturing less of the downside and more of the upside, low volatility stocks have outperformed the market over time. Author's note: we would like to go back further than 5 years, but the inception date of the ETF doesn't allow for that. There is longer data for the underlying index (MSCI ACWI Minimum Volatility NR USD), which bears similar results.

Conclusion

There is a term for all of the information presented here. It is called the **asymmetry of investment returns**. That is simply that whatever your investments go down does *not* equate to what they need to go back up. Although low volatility stocks tend to perform worse in up markets, their outperformance (absolute or risk-adjusted) comes from their track record of doing better in down markets.