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Australian Equities and the Volatility Dilemma

The Australian financial year-end on June 30 marked two consecutive years of strong performance by the local share market, with the S&P/ASX 200 Accumulation Index up nearly 50% since January 2012 and close to 7% higher than its previous peak on November 1, 2007 (**Display 1**). Instead of breaking open the champagne, however, many investors are nervously wondering what might come next.



Among the questions they ask are: Will there be a market correction? If so, how should they respond? Are traditional active, benchmark-following investment strategies the answer, or should they be looking instead at strategies that aim to deliver long-term growth with low volatility?

These concerns have arisen despite the fact that equity valuations don't look particularly stretched by historical standards. As **Display 2** shows, forward price-to-earnings ratios for the index are comfortably below the levels reached before the ratio fell in 2007 as a result of steeply falling share prices (the decline in the ratio in 2009 was caused by earnings rising ahead of share prices). Even so, the market's strong run over the last two-and-a-half years naturally prompts cautious investors to check the possibility of a build-up in downside risks.

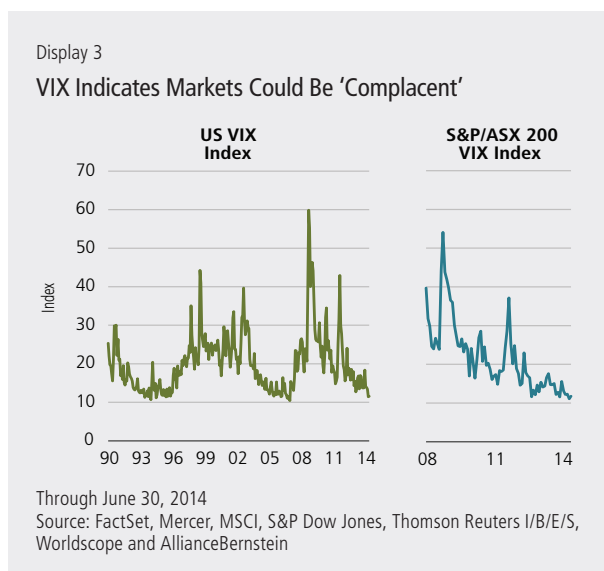


One of the biggest risks in the current environment could be complacency—a reluctance on the part of most investors, when stocks are performing well, to ask the question, 'What could go wrong?' Cautious

investors have been looking at a market index which, under certain circumstances, can be interpreted as a measure of market complacency; many of them don't like what they see.

The index—known as the VIX (short for volatility index)—is designed to give a view of the share market's expectations of volatility over the next 30 days. It's essentially a record, in real time, of stock index option prices, and is inversely correlated to the underlying stock index. Put simply, a rise in the VIX signals an expectation of higher volatility in the underlying share market—historically, a reasonably reliable indicator that share prices are about to fall. Conversely, a fall in the VIX usually points to expectations of lower volatility and is regarded as a positive for underlying equities.

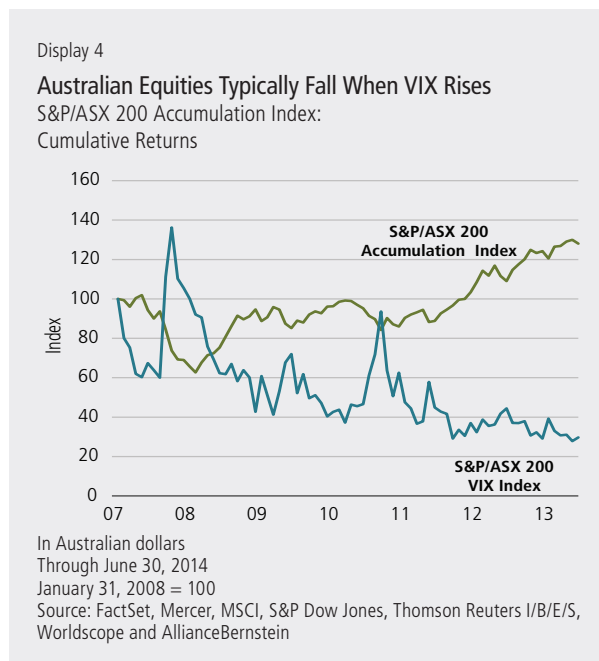
For these reasons, the VIX has become popularly known as the “fear indicator” when it's high and the “complacency indicator” when it's low. As **Display 3** shows, the US market VIX¹ is very low by historical standards, as is its more recently introduced Australian equivalent, the S&P/ASX 200 VIX. Does this mean that investors in Australia's strongly-performing equities market have become complacent and oblivious to potential downside risks?



¹The Chicago Board Options Exchange Volatility Index, which tracks the S&P 500; referred to herein as “US VIX”

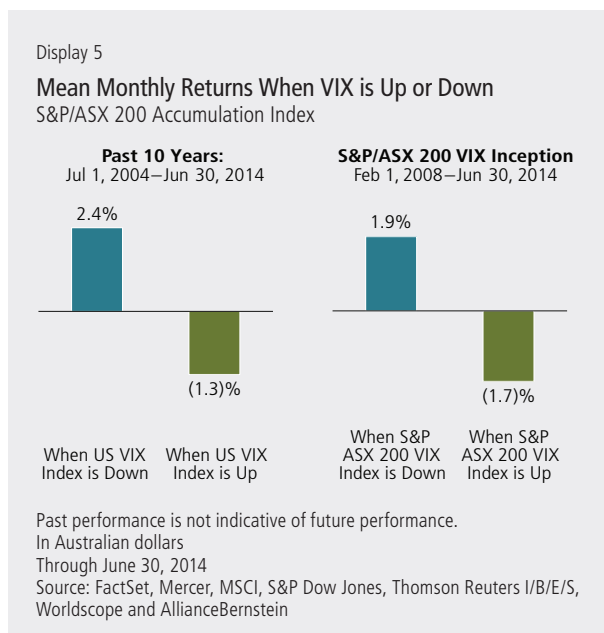
An answer to that question might depend, for example, on how appropriate one feels such a low level of expected volatility to be in light of the number and scale of macroeconomic risks evident in daily headlines, such as the crises in Iraq and Ukraine, uncertainty about growth and economic reforms in China, and weak or uncertain recovery in Europe and the US.

A less subjective response would draw on the historical relationship between the VIX and equity prices. **Display 4**, for example, shows that the inverse correlation between the VIX and equities holds true for the Australian market. **Display 5 (next page)** corroborates this observation by comparing mean monthly returns for the S&P/ASX 200 with monthly changes in both the global VIX and its local counterpart (launched in February 2008). In summary, there appears to be enough prima facie evidence, based on the current differential between the equities and VIX indices in Australia, for investors to take steps to guard against complacency, at the very least. How should they do this?

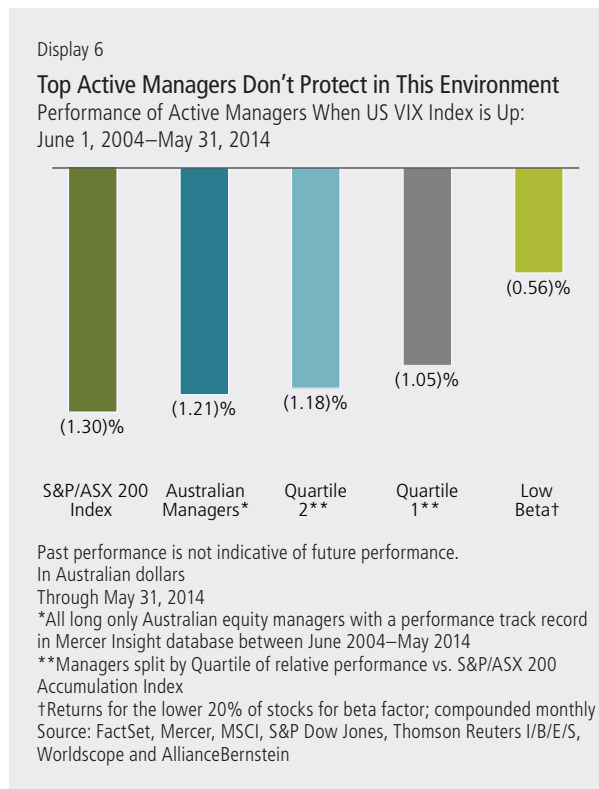


We can begin to answer this question by looking at the track record of active Australian equity managers during periods when the VIX has risen. Active managers are

typically sensitive to the benchmark. As **Display 6** shows, they have modestly outperformed the benchmark when the VIX has risen, but even managers with top quartile performance have provided only limited downside protection in absolute terms. Active managers have notably underperformed low-beta stocks, or stocks with low correlation to market volatility. While it's true that low beta stocks can struggle to keep up in bull markets, they typically provide more downside protection when markets are in retreat.



Indeed, research in several markets has shown that a portfolio of low-volatility stocks will tend to outperform high-volatility portfolios on a risk-adjusted basis over time—a phenomenon known as the “low volatility anomaly”. A suitably refined approach—one, for example, that combines low-beta and high-quality stocks at reasonable valuations with a focus on absolute returns (because it's hard to reduce volatility with a benchmark-hugging strategy)—would be a reasonable option for investors who want to remain exposed to the growth potential of equities but are concerned about the market's apparent complacency. These types of strategies can be particularly appealing for retirees (or those close to retirement), for defined benefit schemes and insurers.



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