Assante® WEALTH MANAGEMENT

PORTFOLIO CONSTRUCTION

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Befriending volatility: The evolution of risk management

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Financial markets have been boisterous in recent weeks, but the frenzy has been building for several months as investors scrambled to participate in the stock market excitement. We view the recent pullback in broad equity markets as a reflection of a correction in valuations more than a meaningful change in fundamentals. Companies are still generating profits and are expected to continue doing so in a macroeconomic environment that remains healthy. However, we have been observing signals that are characteristic of the late stage of a typical business cycle and believe that equity markets have been getting ahead of economic fundamentals. While the investing public in general, flushed with optimism and perhaps some greed, has been chasing higher returns from the financial markets in recent quarters, the Multi-Asset Management team has been working to fine-tune our risk management process.

Over the past decade, we have been adding to our suite of risk management tools, including a currency overlay strategy, concentrated equity mandates, and an increased flexibility to manage fixed income. We are confident these tools will continue to be effective contributors to risk-adjusted performance. However, we note that many traditional risk management tools face distinct challenges today, especially when viewed in isolation:

- Hawkish central banks are making it more difficult for bonds to play their usual safe haven role during stock market drawdowns;
- The U.S. dollar faces headwinds from worsening trade imbalances and budget deficits;
- Stock selection can improve relative performance over a full investment cycle but provides limited offset in market panics, particularly due to the proliferation of indexing strategies that have permanently increased correlations between stocks; and
- Real assets such as commercial real estate and infrastructure are trading at elevated valuations while gold – whose fundamental value is always difficult to pinpoint – has been rising with the general tide in recent quarters.

There are still plenty of opportunities to create positive synergies by combining the above tools with active decisions. However, the job has become progressively more difficult for the traditional asset allocator.

Over the few days in February when most of the major equity, fixed-income and commodities markets were flashing red across our computer screens, one unusual asset class stood out as a consistent outperformer. Enter “volatility.” This unlikely asset class resides in the pricing of options contracts and, like all other investments, is influenced by supply and demand. When demand rises (and/or supply decreases) for protection against large market moves, an option contract linked to the market increases in value, reflecting investors' expectations for higher volatility ahead. The opposite is true when demand decreases and/or supply increases.

In recent years, implied volatility had declined to historical lows as investors became hungrier for growth rather than seeking protection against volatile markets. In fact, a growing number of investors, both institutional and retail, have been systematically selling protection, in other words "shorting volatility," possibly encouraged by the prevailing calm environment. Volatility had become attractively priced compared to historical averages. Prior to the recent correction, the Multi-Asset Management team deployed a put spread overlay to hedge a portion of the U.S. equity exposure across all of our managed portfolios. A put spread is a low-cost insurance strategy that comprises a purchased put option that is partially funded by selling a put option that has a lower exercise price. The strategy is intended to significantly dampen large drawdowns without materially sacrificing upside potential given its low cost. It is positively correlated to rising volatility and has been useful in helping to minimize the impact of recent market sell-offs for our investors.

The substantial increase in money supply following the financial crisis in 2008-09 has led to overvaluations across most major asset classes. We are in a time when the need for risk management is at a cyclical high. Yet financial market indicators suggest that risk management is out of style among investors. We believe that risk management should be imbedded within an investment process as one cannot predict with precision and consistency when the next significant market selloff will occur. With a diverse toolkit, our team manages risk throughout the entire investment cycle by selecting the appropriate combination of tools based on fluctuating valuations. The ability to manage volatility directly through options strategies is just one more tool to assist with actively managing risk on behalf of investors.

Combined top 15 equity holdings as of January 31, 2018 of the Evolution 40i60e Standard portfolio with Alpha-style exposure:

1. Canadian Natural Resources	6. Apple	11. Gilead Sciences
2. Microsoft	7. UnitedHealth	12. SNC-Lavalin
3. Atco	8. Toronto-Dominion Bank	13. AltaGas
4. Athene Holding	9. Alphabet Class A	14. Chubb
5. Walgreens Boots Alliance	10. Suncor Energy	15. ICICI Bank