Funds that are hurting in low-volatility market

seattletimes.com/business/funds-that-are-hurting-in-low-volatility-market/

By Chuck Jaffe

8/19/2017

Your Funds

When the mutual-fund industry started pushing “low-volatility funds” on the public a few years ago, it was cashing in on the fears of the investment public in a frothy market still recovering from the financial crisis.

What everyone overlooked as the category of funds and ETFs grew rapidly was that “low-vol” funds don’t do so great in a low-volatility market.

Like the one we’ve got now.

While everyone is waking up to the fact that these funds don’t look so great sailing in calm seas, there is a legitimate question to be asked about whether investors are giving up on a marketing gimmick or surrendering on a solid investment at exactly the wrong time.

Most Read Stories

Low-volatility funds and ETFs are a prepackaged solution. They are like bluejeans that promise to be reasonably priced and make you look skinny, but they have the potential to be disappointing because they’re not comfortable to wear.

The sales pitch here is that low-vol funds deliver decent returns with below-average volatility. They promise protection against big swings in the market, mostly by investing in stocks with the lowest back-and-forth over a set period.

Investors bought it, literally and figuratively.

The number of low-vol funds and ETFs doubled in the five years leading up to 2017.

Assets in the category, according to Morningstar, grew even faster; low-volatility issues crossed the $100 billion mark early this year, and currently stand at roughly $107 billion.

Meanwhile, the average return among low-volatility issues has lagged the Standard & Poor’s 500 index every year since they were broken out as a fund category at the start of 2012, by as much as 10 percentage points over a calendar year. This year, according to Morningstar, the S&P was up 11.6 percent through July, while the average low-vol fund had gained 10.5 percent.

There may be some structural reasons for lagging results, for example the rush of money into low-vol stocks over the last few years pushed managers to buy stocks with higher valuations; Ben Johnson, director of global ETF research at Morningstar, noted in mid-2016 that “newcomers to the low-volatility party could be setting themselves up for disappointing future returns.”

But another part of the issue is investors and their expectations.

Individual investors routinely say they want “solutions,” but ultimately judge nearly everything based on performance.

Coupled with the sales pitch on these funds — typically market returns without any harsh whipsaws — it’s clear that many investors went with low-volatility issues to juice performance rather than reduce portfolio volatility.

Now bring in current market conditions, where volatility has not been a problem.

In fact, it has been nearly nonexistent as the bull market has continued to climb, almost with lethargy, moving forward like a sloth rather than hopping around like a jumping frog.

The CBOE VIX index — the so-called “fear index” which measures the expected volatility of the market for the next 30 days — has closed under 10 more times this year than it did over the last 25 years combined.

The iPath S&P 500 VIX Short-Term Futures ETN (VXX) is down about 65 percent in the last 12 months, and only looks that good because it has rallied in the last few weeks as the VIX finally climbed up to and past the 15 level.

Meanwhile, in the last 12 months, nearly $10 billion has left low-vol funds.

Managed-volatility experts suggest this represents people bailing out right at the worst possible time, right before volatility returns to the market and the funds can operate in their sweet spot.

While that might be true — it’s tempting to believe that investors enter or exit always at the worst-possible times — it could also be that some investors have decided that the proof is in the performance, and that consistently lagging the benchmark is worse than living with more volatility and getting a market return.

“This is a way to get people to commit to buy a fund or ETF on the basis of something other than performance when, at the end of the day, what investors want is better performance,” said David Trainer, president of New Constructs, a Nashville-based research firm that analyzes stocks, funds and ETFs.

“Individuals need to do what is best to grow and protect their wealth, and avoiding volatility is a component of that, but it shouldn’t be the focus.

“If you avoid volatility and fail to reach your goals because the performance wasn’t great, then your ‘good idea’ turned out to be a gimmick,” Trainer added.

“Individuals need to do what is best to grow their wealth and protect it, but if you ask them which they value more in a stock fund, it’s always going to be growth, and that’s what they are learning watching these funds in this market.”