Russell introduces ‘volatility-responsive’ asset allocation

By Editor Test *Wed, Sep 28, 2011*

"Ten years of well-behaved markets can have less impact on the ultimate success or failure of a portfolio than a couple of outlier months of extreme returns," says Russell Investments in a new report on dynamic asset allocation.

Russell Investments’ latest research for institutional investors, entitled “Volatility-Responsive Asset Allocation,” explores the possibility of a dynamic asset allocation policy that varies as market volatility changes.

The underlying principle of volatility-responsive asset allocation is to reduce exposure to risky assets when volatility is high, and to increase that exposure when volatility is low. According to the paper, a volatility-responsive asset allocation policy—which needs to be as systematic and disciplined as any other strategic policy—can lead to a more consistent outcome and a better trade-off between risk and return for institutional investors.

“Market volatility is itself volatile. Markets can be relatively stable at some points in time and explosively volatile at others,” said Michael Thomas, head of consulting and chief investment officer, Americas Institutional and one of the paper’s authors.

“Given this fact, a strategic asset allocation policy is no longer necessarily a set of fixed weights that are held constant until the next review, because the associated risk can be highly variable over time. Rather, a strategic asset allocation policy can be designed to respond to changes in the investor’s experience or to changes in market valuations.”

According to the research authors (Thomas, Bob Collie, chief research strategist, and Mike Sylvanus, senior investment strategist), the foundation of a strategic asset allocation decision is a trade-off between risk and reward. Volatility is an appealing foundation for a dynamic strategy because, unlike the outlook for returns – which are notoriously difficult to forecast – investors can be relatively confident in their assessment of the volatility environment. One reason for this confidence is that changes in volatility are more persistent than changes in returns.

“The most impactful events in a portfolio occur at the extremes – 10 years of well-behaved markets can have less impact on the ultimate success or failure of a portfolio than a couple of outlier months of extreme returns. These extremes tend to be marked by high volatility, in which a 60/40 portfolio can easily behave like an 80/20 portfolio,” explained Thomas.

As part of the analysis, the authors looked at U.S. equity and U.S. fixed income, as represented by the Russell 3000® Index and the Barclays Capital U.S. Aggregate Bond Index. The simulation covered the period January 1979 – June 2011, the timeframe for which data on the Russell 3000 is available. (The strategy starts once 60 days’ return data is available from which to calculate trailing volatility.) The volatility-responsive strategy produced lower volatility than the fixed mix of 50 percent equity and 50 percent fixed income, and its volatility was more stable and predictable. There was also no return penalty over the period analyzed; the volatility-responsive strategy delivered an average 40 basis points higher return after accounting for trading costs.[1]

“The idea of a dynamic adjustment to a strategic asset allocation is not new; there have always been some investors who vary their allocations because of changing return expectations. There’s also been a growing trend for pension plans to vary their allocations in line with funded status, an approach Russell first wrote about in April 2009 called “liability-responsive asset allocation,” said Collie. “These dynamic programs can easily integrate with one another. What’s new here is the idea of adding volatility to the list of factors driving the variation.”