Volatility & the Benefits of Diversification

By Joe Burns

One of the more common topics of discussion for investment advisors and clients these days focuses on market volatility; what it means, why it matters, and where it might be heading. Frustratingly, the conversation is often too broad ("where's the VIX"), or too technical (options pricing) such that the "actionability" of the conversation is generally pretty low.

When I think of volatility, I recall a discussion with the scion of a family office where I worked, regarding the influence of volatility in a balanced portfolio. The year was 2000, and "discussion" might not be the right word considering that the debate was more of an "agreement to disagree" on the value of stable investments during periods of elevated volatility. My view was (and is) relatively straightforward. Assume two $100 investments; one goes up 10%, and then falls 10%; and the other climbs 50%, and drops by 50%. The value of the first investment after this hypothetical "roundtrip" would be $99. The second would be worth only $75. To me, this very simple example illustrates that volatility should be a factor in the portfolio construction process. Since the person I was conversing with believed unequivocally that both investments reverted to $100, it's safe to say that he was mostly unimpressed by the views expressed by his former Director of Investments.

I thought of that story not long ago as several colleagues and I were discussing the changing macroeconomic environment. Specifically, we were reviewing the "price of volatility"—not in terms of realized or implied statistics like Standard Deviation or Black-Scholes, but from a very basic perspective: how should advisors view not a "vol spike" per se, but rather a secular uptick in market volatility when managing client portfolios.

Trying to forecast volatility is a fool's errand, considering all the "unknown unknowns." But planning for an environment that is not supported by trillions of dollars of global stimulus is critical as advisors seek out investments that can either preserve capital, diversify portfolio exposures, and potentially drive returns going forward. When uncertainties rise, the value in tactically adjusting portfolio exposures via a sound investment process increases dramatically. So too does the option to express a negative view on those companies that have been the proverbial low-quality boats during a 10-year rising tide; some of which have recently begun taking on water regarding falling earnings, rising leverage, refinancing challenges, etc. If one assumes that the market environment is in the early stages of shifting from "long and strong" to "long and short" in terms of accessing high quality, risk-adjusted returns across multiple markets and asset classes, then a strong case can be made that hedged strategies are better equipped to navigate, protect, diversify, and enhance performance going forward.

Similarly, another challenge for investors during periods of heightened uncertainty is the ability to "stay the course." When markets are calm, and assets are rising, buying high-performing securities is easy, as we feel emboldened by our investment success. When volatility increases, often losses mount, and investors can look to quickly redeem and reassess. Not a bad strategy necessarily, but the impact of recency and confirmation biases becomes more pronounced during those periods of uncertainty. Simply stated, investors and advisors can be subpar capital allocators during such market conditions. To combat these challenges, maintaining a portion of client capital in longer-duration strategies like private credit and private equity is increasingly beneficial when volatilities are high and the most liquid investments in a portfolio become unhinged.

Having a predetermined allocation to "alternatives" is a challenge on many levels, as strategies with different liquidity structures and risk/return profiles can behave very differently as market volatility changes. One approach is to think of the liquid portion of a portfolio in the context of capital preservation or return generation and consider the relative strengths of a long-only vs. long/short investment approach. Similarly, for those strategies that focus primarily in private markets, the consideration about what allocation is optimal when volatility rises is an increasingly important consideration. While these are hard decisions, the real "alpha" in portfolio management involves thoughtful, multi-layered diversification before an increase in market uncertainty, not after.

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