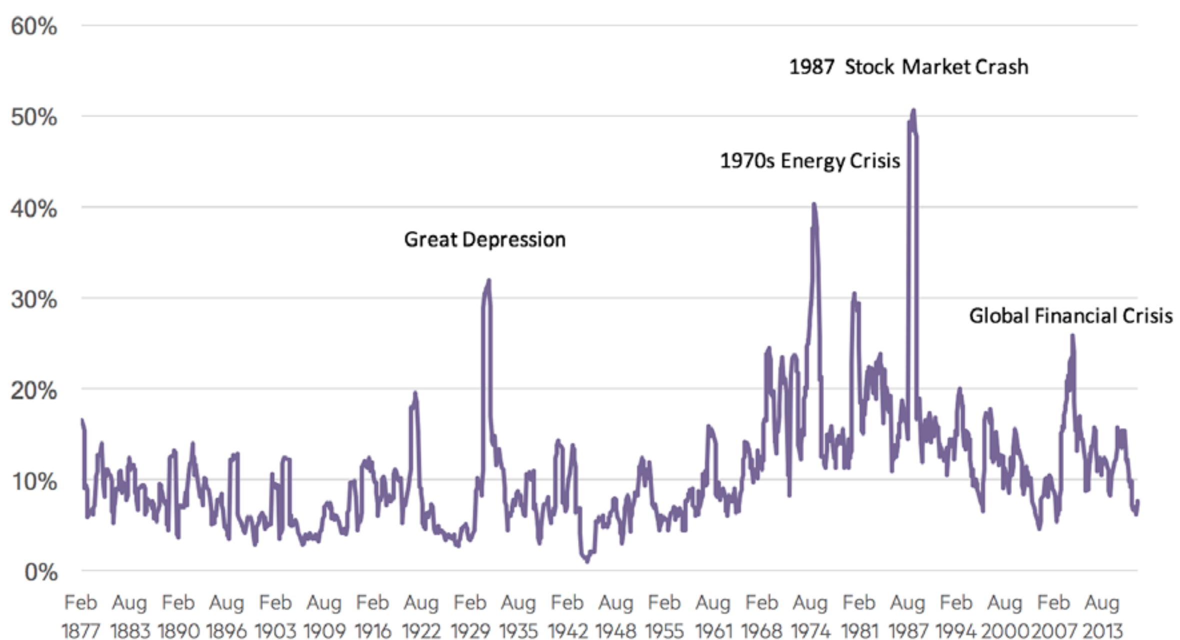
News and Insights

Volatility

In February of this year, global equity markets experienced a sudden increase in volatility. The accompanying drawdown was sharp and fast, and came after a couple of years of strong performance. Prior to February,some experienced investors were beginning to question the extent to which equity markets could continue to rally, but they were in the minority. The Chicago Board of Exchange Volatility Index (the VIX) that measures investor expectations of volatility over the next 30 days, had reached multi-decade lows. The volatility was not expected in the short term, and was a reminder that markets can suddenly reverse course when it is least expected.

As well as forward expectations for low volatility, realised volatility, directly calculated from historical prices, was also low. With investing, it is always useful to take a long term view and put the present market environment in context. At Platypus, we have a history of monthly returns of the Australian stock market, beginning in 1877. We calculate the standard deviation of the last 12 months returns, and annualise the number.

Annualised volatility of Australian equities



Source: Platypus

Using this measure, equity market volatility can remain at present levels for many years. In fact, from the late1800s to the early 1960s (except from the Great Depression), volatility averaged at these levels. Despite this volatility, Australian equities were one of the best performing markets around the world, returning an annualized real rate of return of 6.8% from 1900 to 2017[1]. Volatility is simply part of investing in the asset class, and overlong time periods, investors are generally compensated for this extra volatility.

So, if investors can take a long term view, the index provides reasonable returns. However, as an active Australian equity manager we think you can do better. There is evidence that skill exists generally amongst active Australian equity managers, and that this skill is especially prevalent in small boutique firms[2]. Against this backdrop, at the very least, investors should think carefully before settling for index returns. Platypus is one example of an asset manager that has demonstrated some level of skill since we began managing

equity portfolios in December 1998. Over this time an investment in the index returned 8.4% per annum, while an investment in the Platypus portfolios returned 11.6% per annum (after fees). The compounding effect of this extra return means that, over this time period, a retirement account using Platypus would be much healthier than one using the index.

Volatility and Active Management

Platypus is a growth style investment manager. We would rather pay a fair price for an excellent business, than a cheap price for a challenged business. We have maintained this style through the numerous market cycles over the past two decades. With this long history, we are in a position to see how the Platypus portfolios perform through environments with different levels of volatility.

Active managers have discretion over when they buy and sell, giving them an advantage over index managers whose portfolios are pre-defined by the index providers. Historically, however, after fees and taxes this extra opportunity surrounding decision making has been more of a curse than a blessing, with index portfolios often producing better results for the investor (see our recent note

https://www.platypusassetmanagement.com.au/news/indexing-and-factor-investing

highlighting the US centric nature of this research). Anecdotally, given the success of active management in Australia, we would expect an active manager to be able to take advantage of heightened volatility, buying low and selling high.

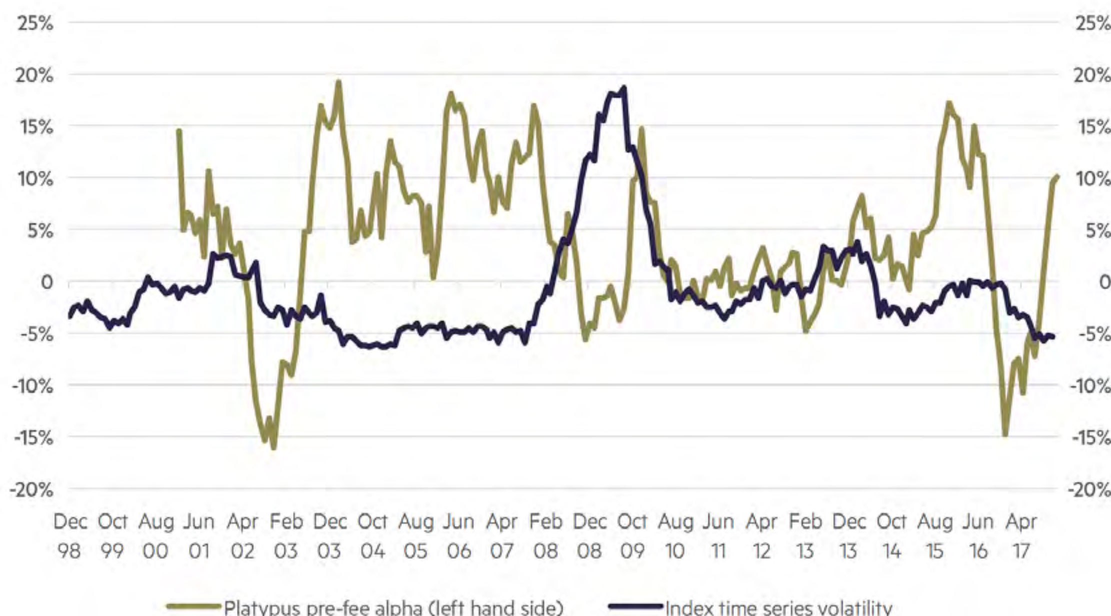
We calculate the standard deviation of each stock in the S&P ASX 300 over the past 12 months, then we annualise, and then we take the average of all these values to calculate the volatility for the index as a whole. We then look at how the Platypus portfolios performed in five different volatility regimes.

Table 1: Comparison of pre-fee alpha and volatility for the Platypus portfolios

	Volatility > 12%	Volatility <=12% and > 11%	Volatility <=11% and > 10%	Volatility <=10% and > 9%	Volatility <= 9%
Average pre-fee alpha over the 12months	2.3%	0.8%	3.3%	0.5%	8.8%
Number of observations	40	20	45	43	56

The Platypus portfolios make most of their pre-fee alpha when volatility is low, and in very volatile markets thepre-fee alpha offers some protection to investors. As with most things, the details reveal a more nuancedpicture. To help us, we look at the pre-fee alpha and index volatility through time.

Platypus pre-fee alpha compared to index volatility



Source: Platypus, IRESS, FactSet

Two outperformance periods stand out: 2003-2007 and 2014-2016. During the first, volatility remained low, but during the second volatility was rising. The recent recovery from the value to growth rotation that occurred at the end of 2016 see **https://www.platypusassetmanagement.com.au/news/comparing-value-and-growth** happened during a period when volatility was declining. However, in 2001-2003, when volatility was also declining, the portfolios underperformed. Through the two decade history of the portfolios, there are examples of good and bad performance in declining, stable, and rising volatility environments.

Invest for the long term

The history of the Platypus portfolios encompasses the Technology bubble from the late 1990s, the resources bull market during the early to mid-2000s, the Global Financial Crisis, the European debt crisis, and of course the recent benign, but low-growth economic environment. Each of these periods brought different volatility characteristics to equities, and Platypus navigated each of them according to the specific conditions at the time. Although in any 12 month period, the alpha can be negative, over the long term investors have benefited from the portfolios alpha. If nothing else, this highlights the importance of taking a long term view, and not letting the events of February dictate your portfolio exposure to Australian equities.

1. Credit Suisse Global Investment Returns Yearbook

2. Alpha Generation in Portfolio Management: Long-Run Australian Equity Fund Evidence, Bennett et.al., **https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2138149**

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