

MANAGED VOLATILITY

Shifts in a Growing Market

September 2014

CONTENTS

- I. Executive Summary
- II. Understanding Managed Volatility
- III. Growth of an Investment Trend
- IV. Appendix: Resources
- V. Appendix: International Managed Volatility Funds
- VI. Supplement: Tail Risk Fund Tables
- VII. Supplement: Low Volatility Fund Tables

I. EXECUTIVE SUMMARY

MANAGED VOLATILITY FUND GROWTH CONTINUES APACE

Managed volatility strategies continue to grow in both size and number. Strategic Insight reports a rise in assets from \$35.3 billion at the end of 2006 to \$305.8 billion at the end of 2013, an annualized growth rate of 36.1%. Assets reached \$360.9 billion by Q2' 14.

Variable annuity (VA) funds alone comprised 72% of managed volatility assets, with \$260.8 billion in Q2' 14. Mutual funds totaled \$100.1 billion, or 28%. At the same time, the number of mutual funds continues to rise, with a total of 293, compared with 200 VA funds among a grand total of 493. The widespread use of managed volatility funds in association with VA guarantees accounts for the faster accumulation of assets and generally larger portfolios.

Strategic Insight splits managed volatility into two categories: tail risk managed and low volatility. The former includes a population of 258 funds and \$265.4 billion in assets and the latter has 235 funds and \$95.5 billion in assets. Generally speaking, tail risk managed funds are more strongly represented among VAs—in both assets and number of funds. On the other hand, mutual funds have a great presence with low volatility funds.

We continue to see the rise of “alternative” investment styles into the retail fund space have a strong effect on managed volatility. Since many of these funds also fall within the managed volatility category, they attract managers that are new to the retail arm of the industry. Overall, the diversity of managed volatility players has grown from 16 at the end of 2006 to 117 at the end of Q2' 14.

Smart beta has emerged as an important category and a driving force among low volatility funds. We regard this as a quant-only risk parity strategy but, because of their importance, segregate them in our analysis. With many of these strategies being index funds or index-based ETFs, we see the potential for significant asset growth among these portfolios.

II. UNDERSTANDING MANAGED VOLATILITY

MANAGED VOLATILITY CATEGORY

Though “managed volatility” has become a popular category, the lack of a commonly accepted definition has created confusion both inside and outside of the industry. For the sake of detailed analysis, we have delineated concrete borders around funds that we identify as managed volatility in order to allow us to better understand this important trend.

We define managed volatility funds as those that have an **explicit and primary goal of mitigating equity volatility (or the volatility of a primarily equity-based strategy)**. We also include a small but growing number of funds that mitigate the volatility of certain alternative categories (i.e. managed futures, long/short) but pointedly exclude all funds that reduce volatility of fixed income categories.

The volatility management must be a key objective and not an incidental side effect of the primary strategy. Strategies that employ a specific mechanism that responds to market downturns fall within the tail risk managed sub-category. Those that have a longer-term goal of managing risk are low volatility.

The difference between these two styles is important because they typically employ different core strategies. The aim of responding to tail risk is not the same as maintaining a long-term goal of overall low volatility. In the few instances where a fund implements both types of strategies, the tail risk component trumps the low volatility one.

The selection process filters for all funds that meet one of two basic criteria: the fund is intended to be managed volatility or the fund uses a strategy that

fits our description of managed volatility, excluding certain recognized investing styles (i.e. absolute return).

The evolution of a new investment category is exciting yet raises questions about identity and the establishment of parameters. The creation of new portfolios and strategies means that a novel approach may be lurking around the bend that adds even more color to this growing universe of funds. Indeed, we do see new strategies emerge that potentially fall on the borders of our definitions and may not fall neatly within our previously established categories.

At the same time, we must be careful not to become exuberant and include funds that don't legitimately belong on the list. There are many strategies, particularly within the alternatives category, that are non-correlated to traditional asset classes. For most of these, the reduction of equity volatility is ancillary rather than a primary goal, so they are not included on our lists. However, if equity risk reduction is a primary aim of the fund, we do include it in the appropriate list.

The Concept of Tail Risk Management

The operating theory behind the tail risk managed sub-category of managed volatility is that it describes a strategy designed to responsively cushion the portfolio from the effects of market downturns.

Tail risk management distinguishes itself from low volatility in that it specifically endeavors to alter the investment composition in anticipation of or during either periods of high volatility or during market declines. By contrast, many other approaches may seek to dampen risk in a general sense yet don't employ strategies that address drawdowns per se.

We have also seen the proliferation of new volatility “conscious” strategies that do not fit our definition of managed volatility. For example, certain funds assess the volatility or risk of individual securities in order to compose portfolios that exhibit average volatility with the aim of generating greater alpha.

This working definition of tail risk management does not imply that only these strategies provide protection against drawdowns, nor does it infer that this is the best means to do so. However, it does describe an investment trend that we feel is important and will grow over time.

The Concept of Low Volatility

The other important sub-category of managed volatility is low volatility. Compared with tail risk management, these strategies seek the general goal of lowering volatility versus specifically managing it during times of economic downturns.

Generally speaking, low volatility funds are more likely to be long-only than tail risk managed funds. We also look at factors such as the frequency of rebalancing. We interpret a fund that has the latitude to rebalance and a goal of lowering volatility but cannot respond quickly in a market crisis as low volatility.

As mentioned earlier, though most offerings in the alternative category do not fall under the umbrella of managed volatility, one exception to that is risk parity. These strategies analyze and balance the sectors or securities according to their individual risk profiles. Some even have a volatility target or range, but because they take a long view, these funds end up being low volatility, with the notable exception of the AQR offerings that have a tail risk overlay.

There is one case of a fund that has the term “risk parity” in the name but is not in fact a risk parity

fund, so it is not included in our population.

Diversified Risk Parity Fund does not share the investing characteristics of others in the category. Furthermore, according to [reporting from the Wall Street Journal](#), the company itself does not contend with Morningstar’s classification of the fund as large blend, which is a far cry from risk parity.

Smart Beta

While all risk parity funds have some quantitative element embedded in them, a special sub-set are purely quantitative animals. These fall within “smart beta,” a growing class of investments whose budding popularity warrants separate identification, though they legitimately constitute risk parity as well.

Despite the obvious similarities between risk parity and smart beta, the emergence of smart beta funds is a distinct phenomenon that lives primarily in the world of index funds and ETFs. Adding to the confusion, many funds that have earned the moniker “smart beta” do not fall within our definition of risk parity or managed volatility.

Therefore, our catalog of smart beta funds includes only those that fall within our definition of managed volatility. The broader category of smart beta includes non-asset-weighted funds, and Strategic Insight separately maintains a list of smart beta ETFs. However, for this report, we remain consistent with the managed volatility mandate and exclude funds that select or reweight on criteria that do not specifically pinpoint risk.

Other Risk Mitigating Strategies

In order to better understand our definition of managed volatility, it also helps to look at what falls outside the scope. There are various fairly common or emerging strategies that have risk/volatility mitigating effects but that we consider distinct from managed volatility. Funds

III. GROWTH OF AN INVESTMENT TREND

A MARKET DIVIDED

Strategic Insight defines managed volatility funds as those that have an **explicit and primary goal of mitigating equity volatility (or the volatility of a primarily equity-based strategy)**.

We do not include strategies that incidentally reduce volatility or those that are prone to having unacceptably unpredictable results. We provide more details on selection criteria in the section Understanding Managed Volatility.

This report recognizes two important sub-categories of managed volatility that represent, in very general terms, different trends that share that investment objective. Strategic Insight divides managed volatility into two sub-categories: tail risk managed and low volatility. In short, the tail risk managed funds have a mechanism that responds to severe market drops while the low volatility funds have a longer view on the reduction of volatility.

VA issuers spurred the growth of the tail risk managed category as an adaptation to manage the risk associated with variable annuities.

The low volatility category is more closely associated with the emergence of liquid alternatives as strategies that resided in the institutional make their way into in the retail space. Hedging strategies which have been useful elsewhere in the investing world for years are now finding a home as registered 40 Act funds. Within this population, many fall within our definition of managed volatility, particularly (though not restricted to) low volatility.

The VA trend does not singularly describe the tail risk category, but it does certainly drive the bulk

of assets there. By the same token, liquid alternatives are not the only source of growth among low volatility funds, though they do explain much of the proliferation of managed volatility funds.

However, it is clear from looking at the distribution of funds and assets (see Figure 1) that each category is more prevalent on one platform rather than the other.

Figure 1: Managed Volatility Assets/Fund Counts by Category and Platform (\$B Q2'14)

	Tail Risk Managed	Low Volatility	Total
VA	\$227.47 (165)	\$33.29 (35)	\$260.76 (200)
MF	\$37.94 (93)	\$62.17 (200)	\$100.11 (293)
Total	\$265.41 (258)	\$95.46 (235)	\$360.87 (493)

Source: Strategic Insight, Simfund, Simfund VA

In the case of low volatility funds, among a total of 235 funds, 200 are mutual funds with only 35 VA funds. This gap widened from last year, with mutual funds constituting 85% of low volatility funds at the end of Q2'14, compared with 82% the year before.

As for the tail risk managed funds, 165 of 258 are VA portfolios, accounting for 64% of total funds, which is up a bit from 61% the year before. In terms of assets, the difference is even more dramatic. At the end of Q2'14, 85.7% of tail risk assets were in variable portfolios, compared with 72.9% the year before.

Mutual funds still outnumber VA funds for managed volatility funds as a whole, but VA assets are overwhelmingly greater because insurers continue to actively funneling assets into these portfolios.