COLUMBIA THREADNEEDLE INVESTMENTS

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# Strategies that benefit from volatility

## While 2019 proved a buoyant year for all financial markets, the first weeks of 2020 have proved volatile. Asian investors who remember previous corrections are looking for sophisticated strategies fit for all market conditions.

Financial markets proved unpredictably buoyant in 2019. Although the fog of US-China trade frictions hung over them, and economic growth faltered, both equities and bonds ended the year far higher than they started it.

The MSCI AC Asia ex Japan Index climbed almost a fifth (18.17%).[1] Unusually, bonds also rallied, with US 10-year Treasury bond yields falling from 3.2% in October 2018 – when the US Federal Reserve was still raising interest rates – to 1.84% in early January 2020.[2]

Synchronised weakening in economic activity across the globe led the US Fed and other central banks to perform a policy U-turn in the first half of the year after the Fed cut rates twice in 2019. And, the European Central Bank controversially restarted quantitative easing.

Looser monetary conditions have proved a balm for financial markets, although volatility has returned in early 2020 as the rapid spread of the coronavirus in China has has sparked fears over what was already expected to be a muted recovery in economic growth. Indeed, the World Bank's most recent forecasts see global GDP growth picking up from 2.4% last year to 2.5%.[3] Even so, valuations in equity and bond markets remain relatively high, with the economic cycle ageing and trade friction undermining business confidence. This raises the possibility that still more market volatility could be around the corner.

An uptick in volatility could present rich pickings for long-short equity strategies, also known as "extended alpha". With their focus on fundamental stock picking, they benefit as companies' fortunes diverge. Unsettled markets trigger price dislocations, creating investment opportunities for the stock pickers who run these funds. They can navigate market volatility, through short selling and altering gross exposure to equities.

At the same time, the principle behind extended alpha funds is that your gains will be more closely linked to the difference between the best and worst performing stocks than the market's performance – and so less susceptible to volatility.

### Matching long and short exposures

Over the last decade when low-cost beta strategies in the form of exchange-traded funds have become popular, long-short

strategies have continued to offer investors a highly effective way to source alpha. The managers behind these funds have ratcheted beta and alpha exposure up or down, depending on the market outlook and clients' risk appetites.

At Columbia Threadneedle Investments, we have a range of extended alpha strategies. We meet companies and conduct fundamental research, using our trusted stock picking approach that relies on Porter's Five Forces as a key tool to assess the pricing power of companies for our long positions. High-quality companies with strong pricing power can compound their earnings yields powerfully over time, generating outsized gains.

Most of the strategies' short books are made up of relative pair trades, which are expected to underperform the corresponding long holdings in the same sector. The portfolios also have short positions where events such as disappointing earnings, competitive product launches etc. are expected to trigger price falls.

## Fine tuning market exposure

But not all extended alpha strategies are the same. Investors can choose between strategies that share the same investment approach, yet offer different levels of risk. The typical extended alpha strategy offers equity-like levels of market risk, while market-neutral funds are designed to offer absolute, or cash-plus, returns. This results from varying net market exposures: an extended alpha strategy might range from 90% to 110% and market neutral from -10% to +50%.

Taken together, the two strategies offer a unique combination that enriches the wealth manager's opportunity set, particularly in current market conditions.

The scarcity and appeal of high-alpha equity portfolios has increased with the rise of passive funds, making a strong case for long-short equity with high-alpha potential. These strategies allow for a full range of market exposures, and they can be used separately or combined to fine tune client portfolios.

## Demand for sophisticated strategies

While the mood in Asian markets has lifted in 2019 and 2020, the equity market rout of 2018 is not long ago. That was the worst year in a decade for China's equity market – the Shanghai composite index fell by almost a quarter, or 24.6%,[4] unsettled by the trade war and a slowdown in growth.

That has resulted in many Asian investors looking for sophisticated strategies able to benefit, rather than suffer, from volatility.


**Sources:**

1. Source: MSCI.
2. Source: FT.com, 7 November, 2019.
3. Slow growth, policy challenges; World Bank Group; January 2020.
4. Chinese markets' 2018 performance was their worst in a decade, CNBC, 31 December 2018.

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