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The May Outlook

Market Stance

MARKET VOLATILITY

We doubt the recent equity market rebound is sustainable

Commentary

- The Trump Administration remains a source of market instability across multiple fronts – tariffs, the labour market, Fed independence and more.
- It is likely that the coming months will see weaker global growth, higher inflation and earnings disappointments.
- Equity valuations remain uncompelling.

Upshot

- Multi-asset portfolios remain under-exposed to equities, and over-exposed to fixed income and alternatives - primarily hedge funds, gold and structured products.

THE GLOBAL ECONOMY

The prospect of a global soft landing is fading with macro stresses set to intensify

Commentary

- Global growth shows no signs yet of a sharp slowdown, but the underlying trend is weakening
- Tariffs are central to this pending dislocation, with uncertainty over policy undermining business and consumer planning.
- Markets do not appear to be discounting the potential adverse impact on earnings.
- Tariff-related price rises represent a hit to consumer incomes.

Upshot

- The second quarter is likely to see a more pronounced loss in economic momentum, from a relatively weak starting point.

CENTRAL BANKS

The cavalry is set to arrive: central banks will continue to cut interest rates in the coming months

Commentary

- Markets have already discounted further rate cuts in the major economies into the second half of the year.
- In isolation, these will not contain stresses on equity markets.
- The market reaction to rate cuts, and concerns over fiscal sustainability, have led to more attractive pricing in the 5-10 year range of yield curves in the US and UK in particular.
- We remain sceptical of the investment attraction of yields with longer maturities than ten years.

Upshot

- Duration is being extended in Saranac fixed income portfolios, from a fairly low starting point.

EQUITIES

The improvement in equity valuations has not yet been sufficient to compensate for increasing risks

Commentary

- The reversal of early April's correction reflected a temporary easing over tariff stresses, and short-term drivers as profitable short positions were closed out.
- A sustainable recovery will require improved cyclical conditions (we remain sceptical) or more compelling equity valuations.
- Global equity valuations are less unattractive than at the start of the year, but are still uncompelling: expected returns over cash and fixed income are positive but low.

Upshot

- We await better valuation levels as a catalyst to raise equity exposure

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The Long Read

Has the time come for a 'Minimum Volatility' equity strategy?

SNAPSHOT

A 'minimum volatility' (MV) equity strategy has recently been added to Saranac multi-asset portfolios. In this article we explain the background and rationale behind the decision

What is an MV equity strategy?

1. The strategy avoids high volatility stocks which are highly correlated to market returns
2. Over time, this has delivered slightly higher returns than a conventional global equity strategy – with lower volatility and more limited drawdowns
3. Returns derive primarily from returns within each sector, not large sector bets

What is the case for the strategy now?

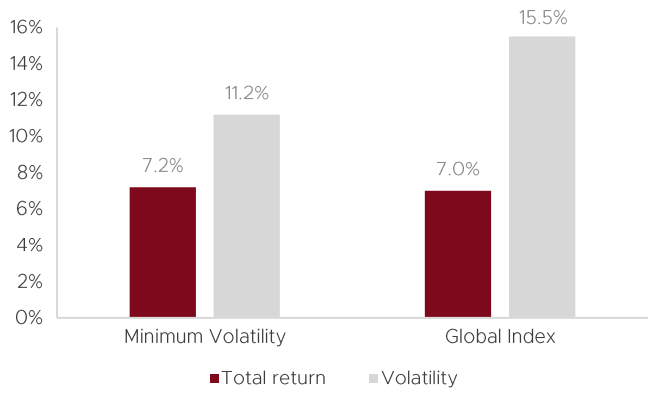
1. Has underperformed significantly in recent years, as higher volatility stocks (e.g. the 'magnificent 7') have been areas of relative strength. In our view, lower volatility stocks are now more attractive.
2. Allows for significant participation when equity markets rise, but provides significant protection in periods of stress
3. So far this year, the minimum volatility strategy has gained 9% in dollar terms, significantly outperforming the global equity index, which has been close to flat.

MV equities: a free lunch?

In the investment management business, it is usually sensible to be sceptical towards strategies which appear to offer a free lunch. An MV global equity strategy does, at first sight, seem to fall into this category. Since 1995, the annualised return to this investment approach has been 7.2%, slightly ahead of the unconstrained MSCI global equity index, which has delivered 7.0% annualised. However, the volatility of the MV approach has been materially lower, at 11.2%, compared to the 15.5% volatility for MSCI world (charts 1 and 2).

CHART 1

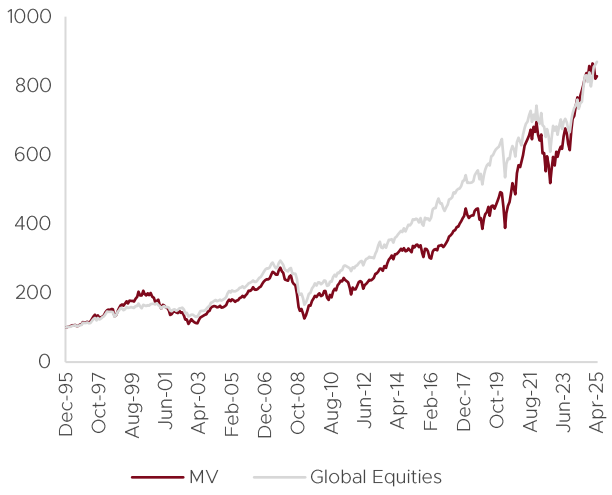
$ Returns and Volatility (since 1995, annualised)



Source: MSCI, Bloomberg

CHART 2

Long-term $ returns to MV and Global Equity Strategies



Source: MSCI, Bloomberg

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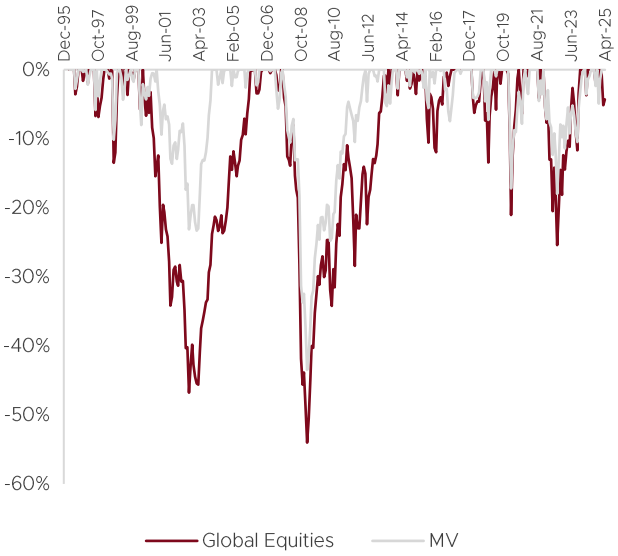
In addition, the drawdowns - or losses in falling markets - associated with the MV approach have been less severe and shorter (chart 3).

CHART 3

Drawdowns in periods of falling markets (% decline from previous peak



Source: MSCI, Bloomberg

Saranac has recently established exposure to MV in multi-asset portfolios. We are sceptical, however, that the free lunch argument really does hold, so this was not the prime motivation. Rather we view the position as an investment strategy which, like all strategies, carries risks, but is appropriate for the current challenging investment environment.

This paper sets out what the characteristics of an MV strategy are, and the rationale for Saranac's recent investment.

The MV rationale: returns from high volatility stocks don't justify the higher risks

A minimum volatility equity strategy is unusual, in that it is defined not so much by over-exposure to securities which are deemed fundamentally attractive – as low multiple stocks would be to a value manager or high expected earnings to a growth manager – but to a greater extent by avoiding stocks which are fundamentally unattractive. The traditional assumption in academic finance has been that the more volatile the share price, the higher the expected return – particularly for stocks which are highly correlated to broad equity market indices.

More technically, the higher the equity 'beta', the more investors require compensation for this risk. However, academic studies have over the years, continued to document a 'low volatility' anomaly across a wide range of equity markets, indicating that portfolios of lower-risk stocks have historically delivered comparable or even superior returns to their higher-risk counterparts. As noted above, a further important differentiating feature is that these returns are typically associated on average with significantly less variation over time, and importantly with less severe and shorter periods of loss in stressed market conditions.

This is not a case of a well-documented market phenomenon seeking an explanation, and there are good reasons why such an anomaly might exist. Behavioural biases are seen as partly responsible. Some investors may chase very high volatility stocks, hoping for lottery-like payoffs, perhaps in response to the greater media attention accorded to such stocks. By contrast, superficially 'boring' lower volatility stocks may be underweighted by speculative investors. Institutional constraints may also play a significant role. Overweighting higher volatility stocks may be seen as an easier way of adding leverage to a portfolio, compared to more conventional routes such as borrowing funds to invest. In a perfectly efficient market, such pricing distortions would be expected to be eliminated, but leverage constraints, short-selling limitations and career risk can prevent this from happening.

What is in an MV investment strategy?

The simple answer is that a global MV strategy has as its objective a diversified portfolio with low volatility. It is constructed through formal optimisation techniques, which consider two aspects of a stock's contribution to a portfolio's variation: the volatility of each stock, and its correlation to the market. An MV strategy will 'dislike' highly variable stock returns which are also highly correlated to the broader market, preferring stocks which have low volatilities and low correlations. To achieve adequate diversification, however, there will also be some holdings in portfolios of higher volatility stocks with low market correlations, and lower volatility stocks with high market correlations.

Importantly, the country and sector positions in an MV strategy are constrained to be fairly close to the broader MSCI World benchmark weights. Charts 4 and 5 show the current sector and regional positions relative to that benchmark. There are underweight positions in consumer durables and IT, offset by overweight positions in consumer staples and healthcare. Other sector positions are smaller. The regional position shows an underweight in the US and an overweight in Asia.

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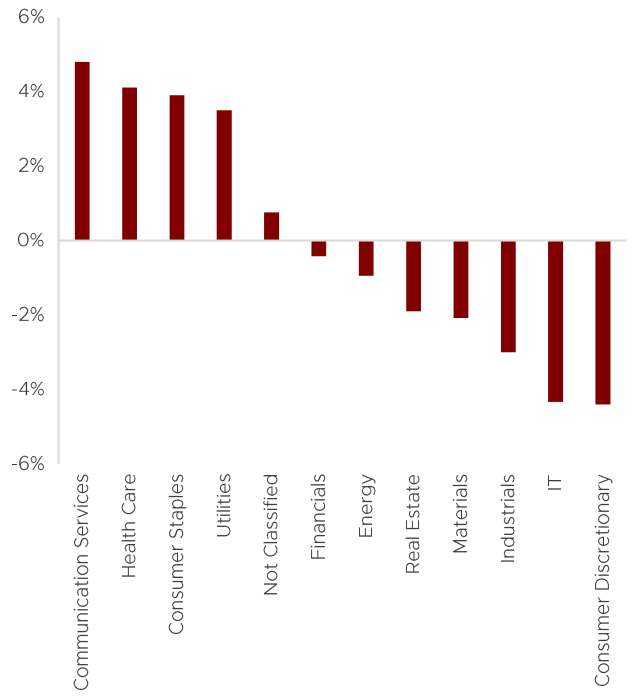
CHART 4

Sector Positions in MV Compared to Global Benchmark



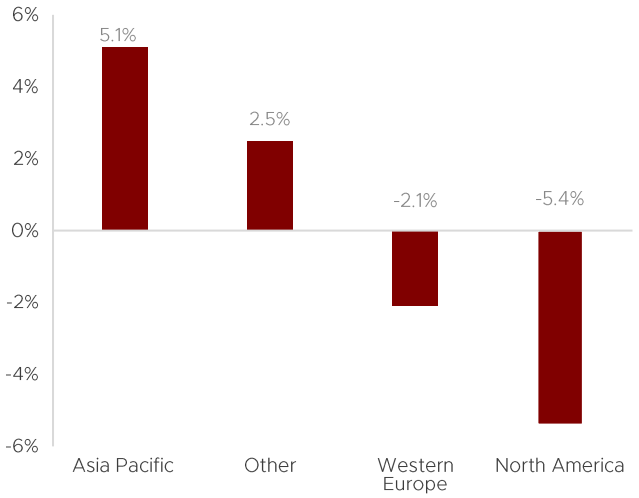
Source: MSCI, Bloomberg

The fact that sector and country positions are taken means that some of the returns from the MV approach reflect high-level strategy. However, these higher-level investment stances are relatively modest, and account for only a minority of the total active risk and return. Much more risk is associated with individual securities. This is demonstrated by the fact that for most time periods, relative returns from the MV strategy have been generated predominantly from security selection within each sector and country, not on large positions between them. For example, the MV strategy has outperformed the global equity index by over 8% this year. Less than 20% of this strong relative outturn has come from sector positioning. Security selection has been the dominant source of return.

A casual glance at the sector positions might suggest that the MV approach is in fact a value or high dividend investment strategy in disguise. However, this is not the case: the very long-term returns to these strategies are slightly lower than the MV approach, but the volatilities are much higher (chart 6), and the drawdowns are also much more severe. In addition, the long-term earnings growth on an MV strategy is similar to that for the broad market, so a characterisation of it as simply 'defensive' (with greater earnings stability traded off for long-term return) is not fully accurate. Indeed, a wide range of high-level characteristics of an MV portfolio are not very divergent from the broader global index. For example, over the past decade and more, the average difference in the dividend yield on the two indexes has been only 0.25% - not a large relative position.

CHART 5

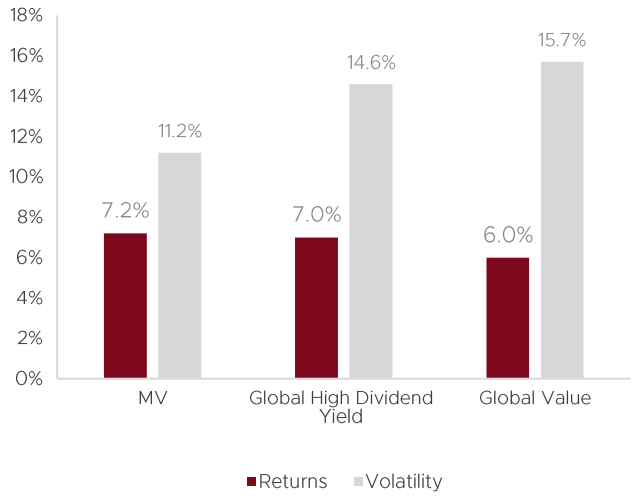
Country Positions in MV compared to Global Benchmark



Source: MSCI, Bloomberg

CHART 6

Long-term Returns and Volatility In Different Global Equity Strategies Since 1995



Source: MSCI, Bloomberg

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More generally, the high-level features of the MV strategy are typically much more similar to the broad global index than to a value strategy (table 1). Neither are these relationships constant. For example, until recently the MV index was on a higher PE ratio than the broad global index, because lower volatility stocks were on premium ratings. The emergence of the 'magnificent 7', which also dragged stocks with similar characteristics higher, has however lead to an MV portfolio being more conservatively valued (chart 7).

TABLE 1

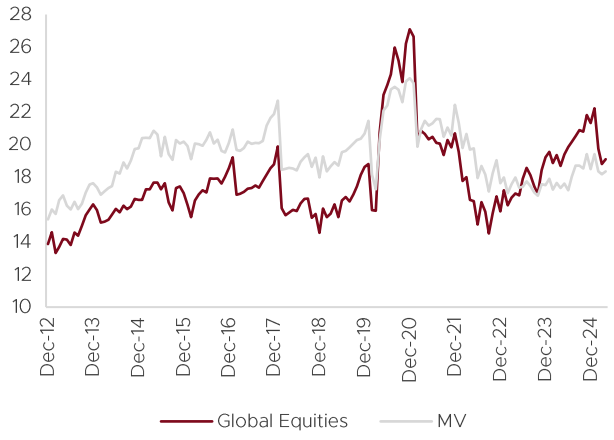
Comparison of Index Properties

	MV	Global Equities
Dividend Yield	2.0%	2.1%
Forward PE Multiple	18.3x	19.1x
Debt/Equity	97.9%	108.8%
Return on Equity	16.8%	15.2%

Source: MSCI, Bloomberg

CHART 7

Forward PE Multiple on MV and Global Equities



Source: MSCI, Bloomberg

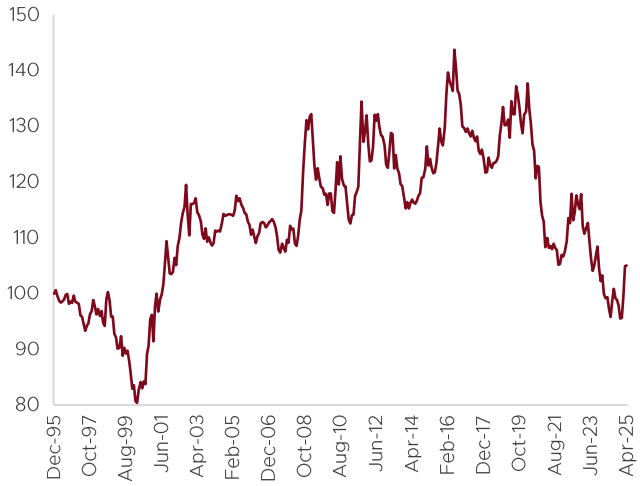
Cycles in MV performance

As noted, the long-term argument for an MV strategy is compelling: marginally higher returns, much lower volatility and materially less severe drawdowns.

However, there have been significant multi-year cycles in its relative performance (chart 8). Unsurprisingly, it underperformed during the 1990s' TMT bubble, before outperforming strongly in relative terms in the subsequent market downturn. Further, if volatile, outperformance emerged during the 2008 crisis and in the subsequent decade. However, the past five years or so – until recently – saw marked underperformance from the MV strategy: the notional free lunch in fact appeared very expensive for an extended period. Indeed, its entire relative outperformance from 1995 was eliminated over this period, although absolute returns remained clearly positive. The strategy is therefore demonstrably not without risk, whatever the attractions of the long-term data.

CHART 8

Relative Performance MV over Global Equities (1995 = 100)



Source: MSCI, Bloomberg

There were two main phases in this recent period of underperformance. First, the more volatile cyclical stocks, which are underweighted in MV portfolios, delivered significant outperformance after the spring 2020 policy stimulus and subsequent covid-recovery. Second, the more volatile large cap growth stocks, particularly in the IT sector, which are also underweighted in MV portfolios, outperformed significantly from late 2022, in part reflecting the outperformance of the very volatile 'magnificent 7' and associated stocks.

MV – why now?

Saranac had not had exposure to the MV strategy until early January this year, reflecting an acceptance of the argument that it was an idea whose time had not yet come.

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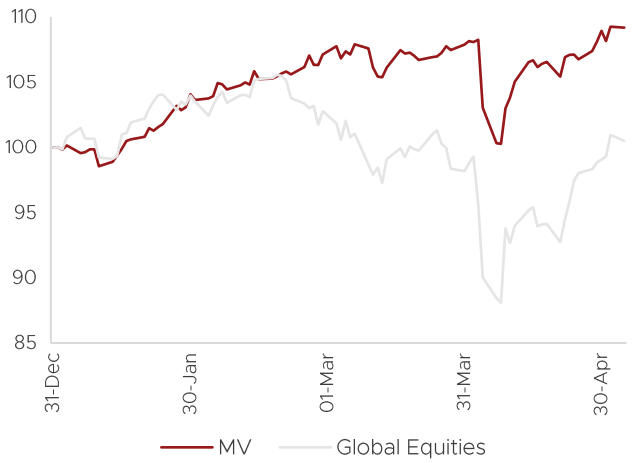
There are two related reasons for adding to the exposure more recently. A key consideration was the combination of a potentially unstable US policy background at a time of increasingly high equity valuations, reached largely because of significant outperformance from high volatility stocks. Given this challenged background, a number of decisions were taken to deliver a more defensive stance (for example through put options and gold), and the exposure to the MV strategy (through an ETF) was a further measure in this context. There was a high conviction that this would constrain exposure to any broad-based equity downturn, while also providing some upside potential should there be a market rally. This approach was seen as superior to simply reducing the equity exposure. In the event, this decision has been positive for performance. The MV strategy has risen by some 9% in dollar terms this year, compared to the broadly flat MSCI world index (chart 9).

CHART 9

Performance of MV and Global Equities, US$, 31 Dec =100



Source: MSCI, Bloomberg

The long-term experience of investing in MV strategies demonstrates that while the lower volatility aspect is a sustained feature of the strategy (usually reducing the variance in an equity position by around 25%), the relative returns are by no means guaranteed. As noted, the demanding environments for the MV strategy tend to be 'junk' rallies in the early phase of a cyclical upturn, or more speculative environments in which investors seek out higher beta and more leveraged exposures. We do not see these as very significant near-term risks. We are therefore maintaining the exposure as a constituent of a diversified global equity exposure, conscious also that the MV strategy limits downside risk, while also maintaining equity exposure should the recent rally persist.

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ABOUT SARANAC PARTNERS

Saranac Partners was founded in 2016 as a private office for investments and more. As an independent firm, we combine the capability of traditional financial institutions with a personalised approach that offers more. We serve a community of individuals and families across the UK, Europe and Middle East with specialisations in strategy, investments and financing.

OUR SERVICES

We start with the question. We listen and seek to understand. We don't make assumptions or force solutions. Rather we co-create a path with our clients.

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