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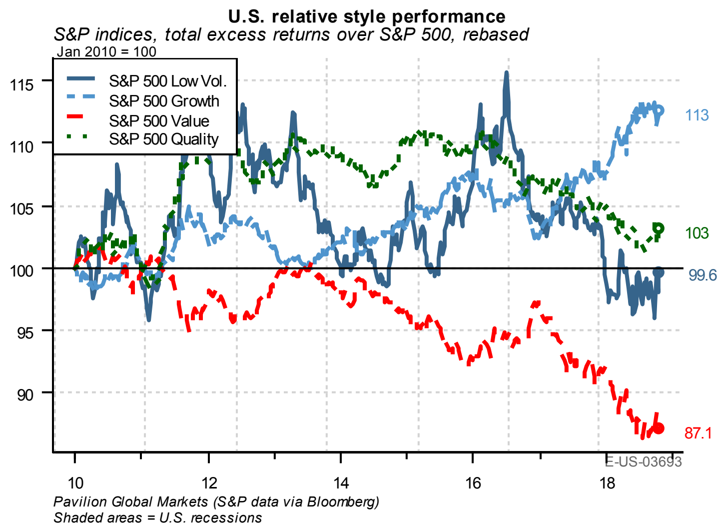
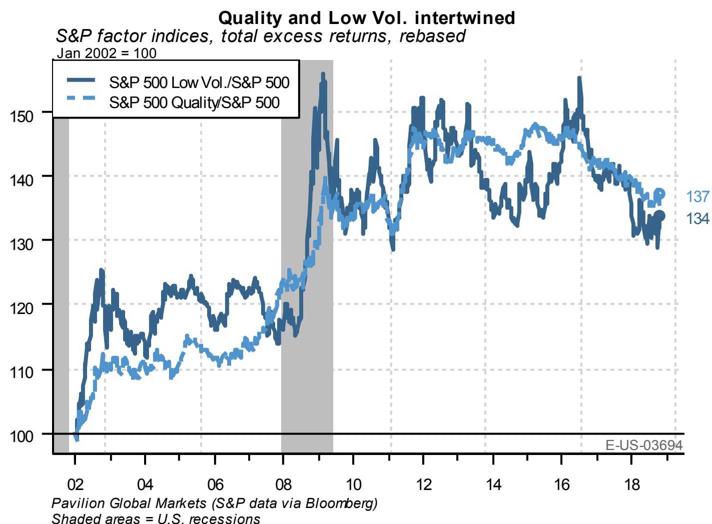
Looking for safety? Today's note looks at the relative merits of Quality vs. Low Volatility strategies for weathering the current economic environment.

Ports in the storm: Low Vol. or Quality?

In uncertain times, investors like to reduce exposure to (downside) volatility. The S&P 500 Low Volatility index includes the 100 S&P 500 stocks with the lowest realized volatility over the past year, with quarterly rebalancing. With few exceptions, Low Vol has broadly outperformed the overall equity index since 2010. Interestingly, the relative performance of Low Vol has been weak this year, despite recurring bouts of market turmoil, and the central role of short-vol strategies during those bouts.



One reason for Low Vol's lackluster performance is simply that Quality stocks have been a better alternative. Quality stocks—traditionally defined as those exhibiting high return on equity, low debt-to-equity, and low volatility of earnings per share or ROE—have more consistently outperformed the S&P 500, while providing a good proxy for Low Vol.



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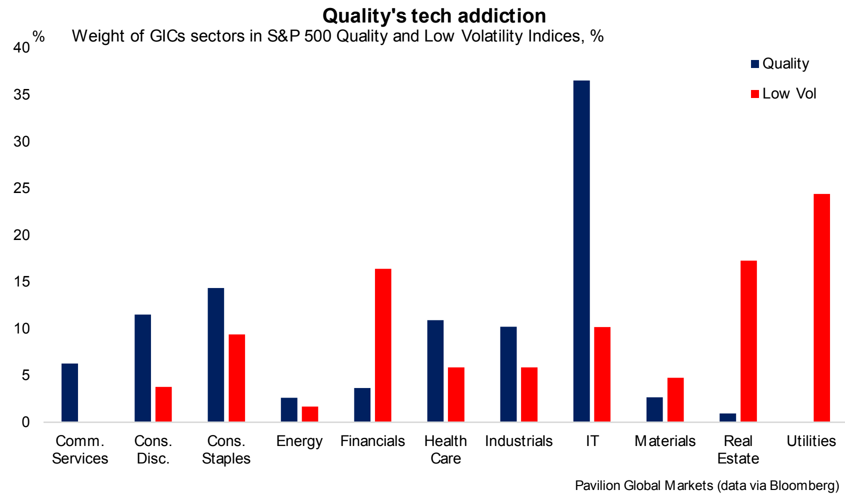
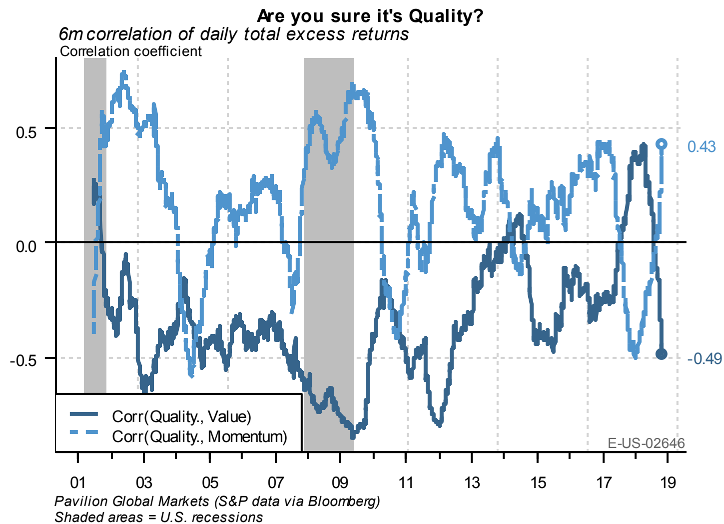
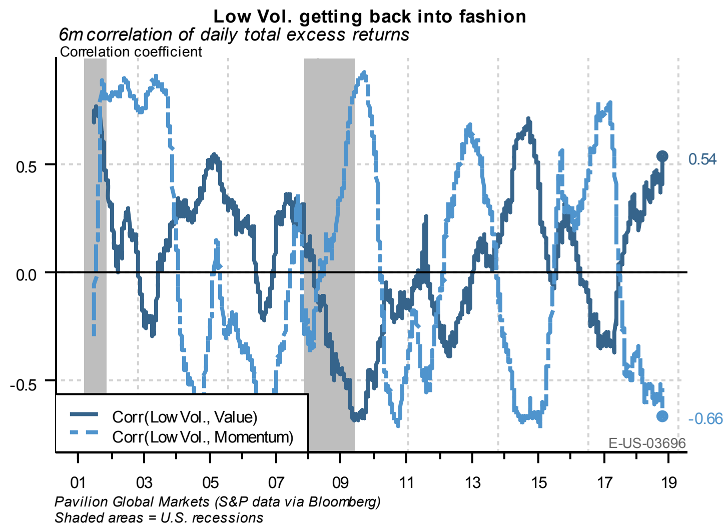
Despite the similar performance profile of Quality and Low Vol, their compositions are very different. Quality has substantially more Tech and no exposure to Utilities. In our view, this isn't ideal, given that we prefer a barbell of 'Quality' Tech and Utilities (see: *"A new market regime?"*, Oct 9). The composition of Low Vol isn't great either. While Utilities represent about a quarter of the index, it has no Tech, and is exposed to regional U.S. banks, which we think will struggle due to slower growth, higher rates and more strained households (see: *"Aligning the R-stars"*, Oct 24).



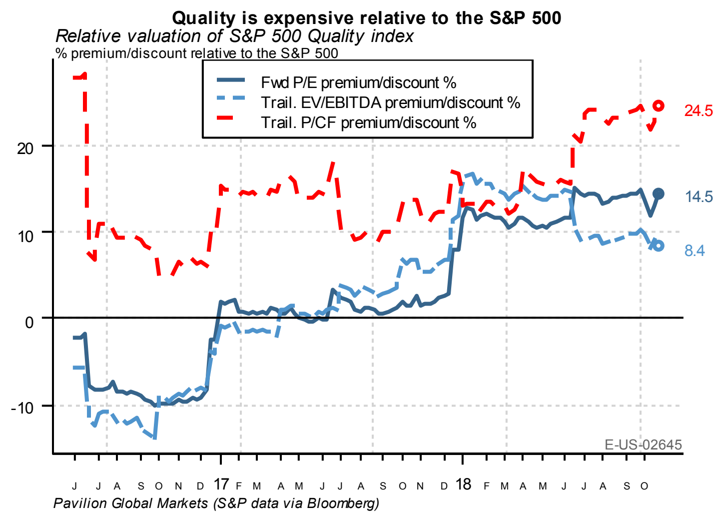
While there are faults to find in the composition of both Quality and Low Vol, there are some distinct disadvantages to the former. Because of the large weighting in Tech, as well as Communication Services, and Consumer Discretionary, Quality has tended to be positively correlated with Momentum, which isn't very appealing when stocks are selling off.



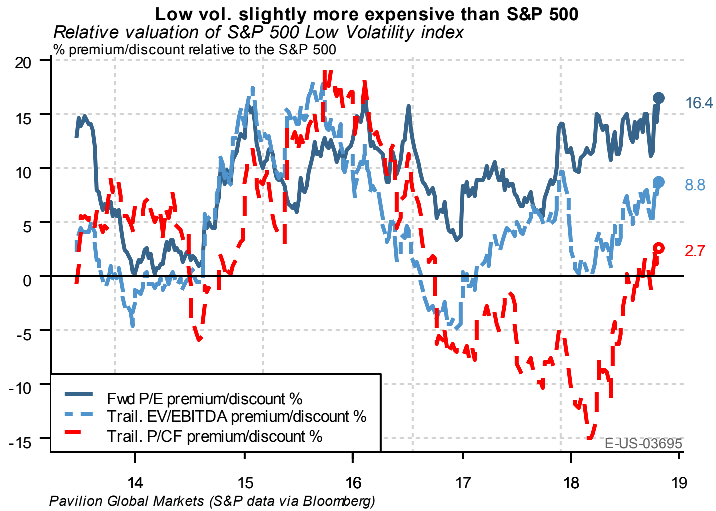
Low Vol, on the other hand, is less correlated with Momentum, and more with Value. This makes sense, since Low Vol has less Tech, and more Defensive Value sectors. As a result, we think it's better constructed than Quality to weather the current market environment.



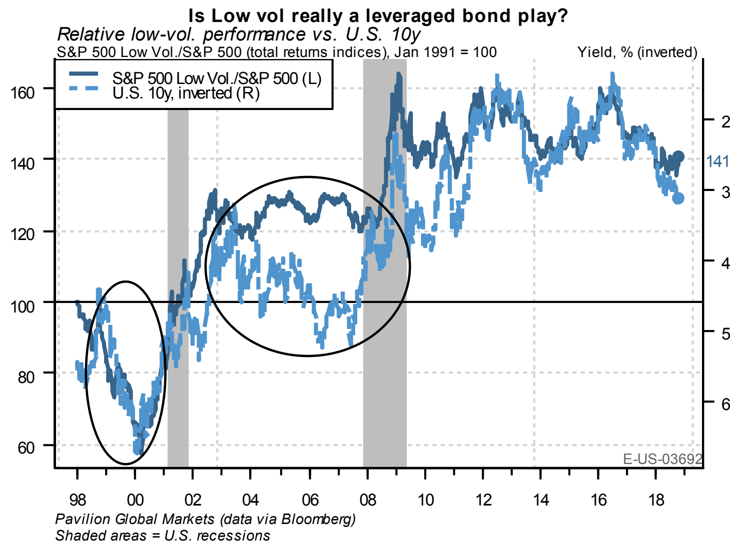
From a valuation perspective, there is little difference between Quality and Low Vol. relative to the S&P 500, except on a price-to-cash-flow basis, where Quality is more expensive.



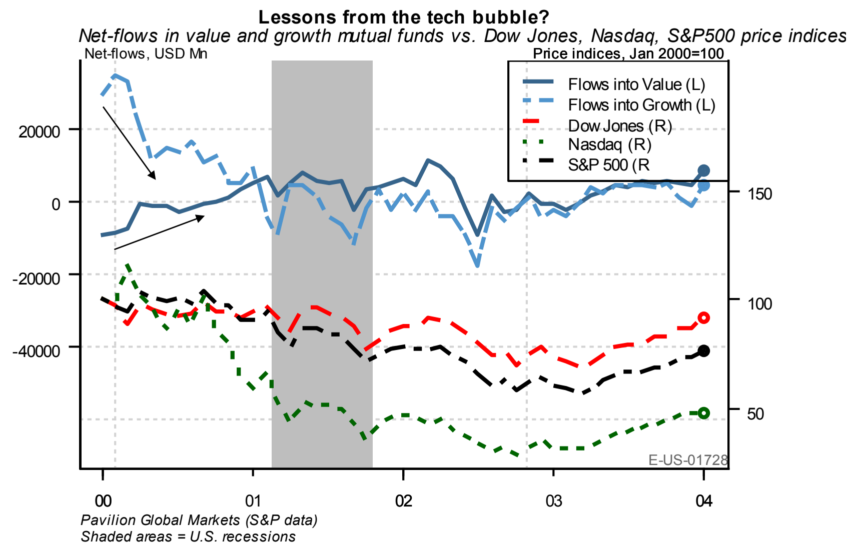
What is more interesting than just the level of valuation is the recent trend. Low Vol. is re-rating relative to the overall market. We think this can continue.



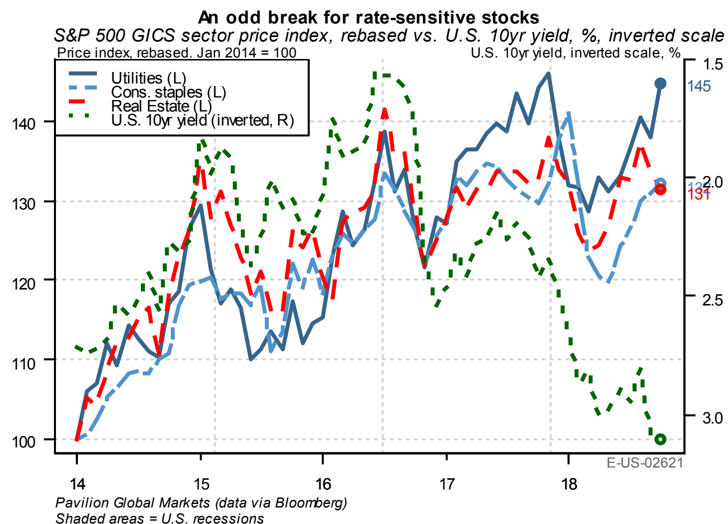
Low Vol. has tended to trade like a levered bond proxy, at least when rates are falling. What about when rates are rising? The last two economic cycles yield some illuminations.



During the latter stages of the tech bubble in the late 1990s and early 2000s, Low Vol underperformed the broader market, as investors moved out of Tech (Nasdaq), into the more broad-based S&P, before finally seeking shelter in the Industrials-heavy Dow Jones. Not surprisingly, cyclical stocks (Industrials) outperformed Low Vol. (Defensives). This occurred because the tech bubble was what has been termed “a rich [wo]man’s recession”. It primarily impacted equity valuations, but wasn’t centered in the real economy.



This hiking cycle is more similar to the one directly preceding the GFC. Rising leverage in the real economy is a feature of both periods. Preceding the GFC, Low Vol. provided returns in line with the overall market, before outperforming the S&P 500 when the crisis intensified. The same thing appears to be playing out now. Low Vol., Defensive sectors, are outperforming the rest of the market, despite rising UST yields. We think this can continue, as expanding operating margins, solid earnings, and relatively high dividend yields shelter the Defensive sectors from the vagaries buffeting the wider market (see: "*The S&P's Defensive perceptions*", Sept 17).



Bottom line: While Low Vol. has underperformed the broader market and Quality for much of the year, we think it could stage a comeback. Not only does Low Vol. have more of the sectors that can do well in the current economic environment, but it can also outperform the broader market when rates are rising.

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