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WHITE PAPER

Managing Volatility—A Little Planning Goes a Long Way

Recent market volatility has prompted many advisors to mount an aggressive stance against portfolio risk. But a better time to address risk and volatility is during portfolio construction. Being proactive, rather than reacting to market conditions, can position client portfolios to limit downside losses and participate in the prospective upside.

A Toolbox to Manage Risk

Many investors don't give serious consideration to managing risk and volatility until deep in the throes of a market correction. But waiting to address it then often makes them adopt a too-conservative investment stance that limits their ability to achieve the positive long-term returns required to meet their goals. Properly managing "tail risk"—the level of volatility that corresponds to large portfolio losses—should begin when the portfolio is being structured. Advisors have several arrows in their quiver, among which are diversification, alternative assets, low-beta equities, and crisis planning. Combining these strategies can both limit the portfolio's downside loss potential and position it for long-term returns.

In the wake of the financial crisis of 2008, many investors saw their portfolios shattered as typical diversification across equities, fixed income, and real estate failed to protect them. It was particularly painful for investors with an outsized concentration in equities that comprised the bulk of their portfolios. Even portfolios with a reasonable allocation to alternative assets weren't spared, as nearly every asset class fell during that tumultuous time.

Portfolios having allocations to so-called "diversifying asset classes" tend to fare better during periods of market turmoil. These historically have included asset classes such as commodities, REITs, and fixed-income investments in corporate, mortgage, and emerging markets. Since no one knows for sure when or why the next market dislocation will appear, having some degree of exposure to these asset classes from the get-go can mitigate tail risk when markets are roiling.

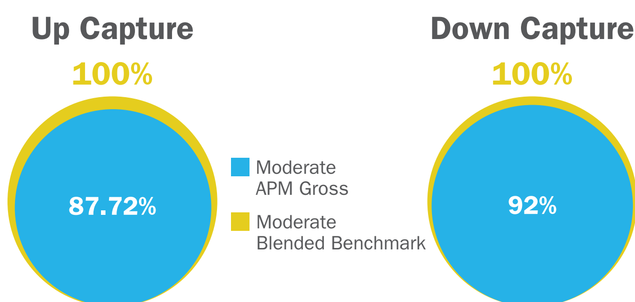
Alternative assets are another technique to help manage portfolio risk. Because many of these strategies seek to capitalize on market inefficiencies, and have more flexible mandates, they often zig when the rest of the market zags, presenting opportunities for positive returns and a smoother ride when other asset classes may be underperforming.

Taking advantage of low-beta equities is another option in managing volatility. Examples of these are quality companies with a history of paying increasing dividends. Although these equities may not appreciate as rapidly as those in faster-growing sectors, they also tend not to drop as deeply during a market selloff.

One of the most important risk-management strategies is crisis planning—essentially removing "emotional" reactions to market deterioration. Deploying stop losses or sticking to a drawdown control system are examples of these techniques. Knowing that a 20% drop may cause an investor to panic, a more prudent plan may be for an advisor to have the investment policy statement stipulate that losses be cut after a 10% drop, and stay on the sidelines until a clear path forward emerges. Although the portfolio runs the risk of not being invested when the market initially turns up, by the same token, investors aren't forced

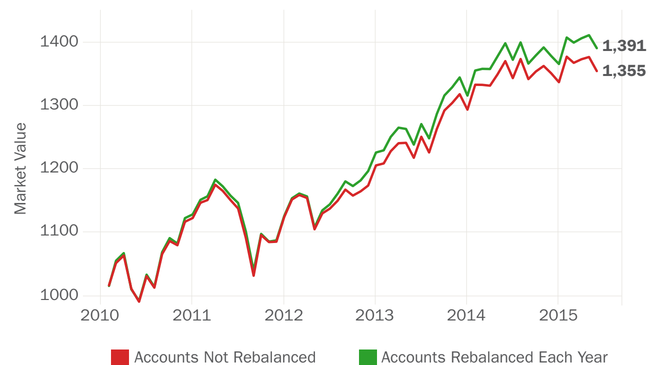
to assume more risk than they can tolerate should markets plummet further (see Figure 1). Constructing and adhering to a pre-determined plan will keep investors from unwisely clinging to positions as asset values drop, only to panic and liquidate when prices hit rock-bottom levels.

Figure 1: Up/Down Capture Ratios of Moderate APM Strategies vs. Benchmark[1, 3]
January 2008–December 2015



Finally, another practical means of mitigating risk is to employ a systematic rebalancing process. Since asset classes don't all move in one direction at the same rate for any length of time, a diversified portfolio can become overweight in particular segments. Rebalancing the portfolio at periodic intervals can reduce unintended risks associated with asset class and factor overexposures. A simple policy of systematically rebalancing the portfolio annually can be an effective strategy for keeping exposures at intended levels. Based on Envestnet's research, irrespective of product, accounts that were rebalanced outperformed those that were not by 53 basis points annually on a risk-adjusted basis (see Figure 2).

Figure 2: Growth of $1000 Over time[2, 3]



In summary, markets rarely exhibit a normal bell curve distribution, and investors are justified in focusing on tail risk: large short-term portfolio losses can indeed dampen long-term investment returns. A strategy that encompasses diversification both across and within asset classes (including exposure to alternatives), coupled with a disciplined plan to manage drawdown, can go a long way toward improving a portfolio's risk-return characteristics.

[1] Statistics displayed are based on monthly composite results for Moderate risk tier APM accounts from January 2008 to December 2015 on the Envestnet platform. Blended Benchmark: 18% Russell 100 Growth, 18% Russell 1000 Value; 2.5% Russell 2000 Growth; 2.5% Russell 2000 Value; 15% MSCI EAFE; 4% MSCI Emerging Markets; 26% Barclays US Govt/Credit; 6% Barclays 1-3 Year US Govt/Credit; 8% Barclays Global Aggregate.

[2] The analysis universe was comprised of accounts which were active during January 2010 through June 2015 on the Envestnet platform.

[3] About ENVESTAT—Envestat, Envestnet's industry analytics engine, delivers regular digests of business intelligence designed to provide context to the decisions that financial advisors and enterprise business owners face every day. While the regular digests provide insights that revolve around a quarterly theme, our quarter-end INTERSECTION connects these insights to highlight the significance of the quarterly theme and its impact on advisory practices.

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