MAERKI BAUMANN & CO. AG
PRIVATBANK

MinVol Equities for less quiet markets

Market Comment, April 2019

The sharp decline in volatility since the start of the year once again suggests a certain insouciance on the part of the financial markets, as expected volatility also lies far below historical averages. The above-average rise in equity markets in 2019 to date is another sign of pronounced market optimism – despite the fact that US yield curves are increasingly becoming inverted. While this does not mean that all equity markets are bound to decline imminently, a higher weighting of less volatile stocks (so-called MinVol equities) at the expense of those with higher volatility only makes sense now. A sharp rise in equity market volatility over the next few months would not surprise us, as the economic slowdown does not yet show any signs of being halted. The US yield curve inversion only strengthens us in that view.

Financial markets have performed strongly since the start of the year. Equities in particular have recorded gains that are well above their historical averages. This is being driven by hopes that the economic slowdown apparent all around the world will soon give way to a clear phase of strength. However, the majority of leading economic indicators continue to point to a weakening of global economic growth. Yield curves also flag up ongoing risks to the global economy. Accordingly, the volatility – i.e. market fluctuations – expected by the financial markets should not be at its current low level. In addition, "priced in" or anticipated volatility has fallen far below its historical averages in the currency markets, in the bond markets, and above all in the equity markets.

We would therefore not be surprised if market volatility were to rise again, so we feel it would be prudent to prepare for such a development. One way of doing this is to focus increasingly on stocks with lower volatility (or bandwidth of fluctuation) within the equity weighting. These stocks also exhibit lower market sensitivity, i.e. they have a beta of less than 1.

For example, the MSCI Minimum Volatility World Index, which contains stocks with lower (minimum) volatility, has a beta of around 0.65 compared to the MSCI World Index. This global equity index obviously has a beta of 1 (sensitivity of 100% to the general equity market), whereas – for example – the Nasdaq biotechnology index has a beta of 1.3 compared to the World Index. Given that a rise in volatility in local stock markets (and by extension also the global equity market) would come as no surprise to us, our Investment Committee has recently resolved to incorporate the so-called MinVol World Index into its portfolios by means of an ETF – in other words, to invest in global equities with lower volatility and lower market sensitivity.

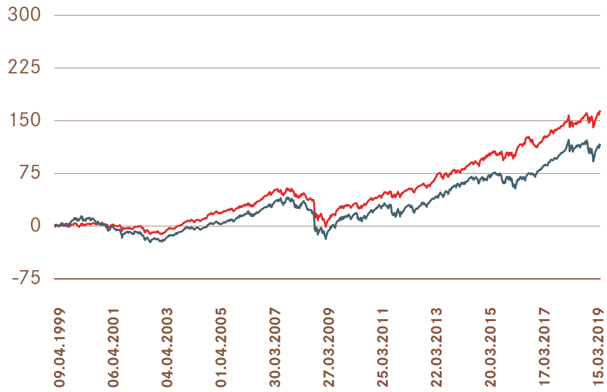
> "Equities with lower volatility can reduce short-term fluctuations without impairing long-term returns."
>
> Gérard Piasko, Chief Investment Officer

This is in keeping with the approach that we have adopted for quite some time now, namely to "defensivize" our portfolios in order to achieve a positioning that is better suited to potentially hazardous phases thanks to a lesser degree of fluctuation, i.e. lower volatility.

Analyses have shown that a MinVol strategy can help investors create a portfolio that has less risk than the overall market. Historically this has often helped to ensure more stable returns as well as lower volatility over the medium to long term. This means fewer short-term fluctuations and still long-term returns.

Indeed, the MinVol World Index outperformed the MSCI World by more than 6% in 2018, by 8% during the 2008/2009 crisis, and by 20% over the period 2000-2003 following the bursting of the Nasdaq stock market bubble – in the latter case, it also outperformed the SMI by 20%. Because the MinVol World Index has a large weighting in companies with relatively more stable earnings and profitability, this index holds better in less quiet markets.

MinVol World stocks have outperformed the MSCI World by 87% since 1999



World Stock Index MSCI World (in USD)
World equities with less volatility (MinVol-World Stock Index , in USD)

Source: Bloomberg, data as of 4 April 2019

The graph shows that over the cycle as a whole, i.e. including both downward and upward phases of the economy and the stock market, the MinVol World Index has outperformed the MSCI World Index by 87% since 1999 – even though it exhibited less risk, i.e. less market fluctuation, than the global equity index. MinVol stocks come from industry sectors and companies that have historically reported more stable revenue streams and margins than the equity market as a whole.

A higher weighting of less volatile equities (so-called MinVol stocks) at the expense of those with greater volatility makes sense right now. A sharp rise in equity market volatility over the next few months would not surprise us, as the economic slowdown does not yet show any signs of being halted. Signs of a US yield curve inversion only strengthen us in that view.

Gérard Piasko

Gérard Piasko is CIO and head of the investment committee of private bank Maerki Baumann & Co. AG. Before he was for many years CIO of Julius Baer, Sal. Oppenheim and Deutsche Bank.

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Editorial deadline: 10 April 2019

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