Northern Trust | Matt Peron: Looking at Ways to Manage Equity Volatility

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The markets reacted to signs of slowing growth and concerns over the health of emerging market economies, China in particular. Last week the US equity markets experienced their first 10% correction in nearly four years, accompanied by the largest weekly percentage increase in stock market volatility. The S&P 500 posted losses of more than 1% on four consecutive days then rebounded on Wednesday and Thursday to erase losses for the week.

This sudden increase in volatility shook the confidence of stock market investors worldwide. On Tuesday alone, US investors redeemed more from equity funds than in any time in the past eight years. Unfortunately, they were out of the market for Wednesdays and Thursdays rebound. Let's revisit the theme of managing volatility and look at strategies design for changeable market conditions.

There has been growing adoption of low volatility a long/short equity strategies, because they are intended to mitigate changeable market conditions. Put simply, they're designed to provide downside protection while pursuing a long term growth objective. These strategies don't eliminate equity risk, but are intended to mitigate them enough to hold the course in periods of heightened volatility, which hopefully deters investors from selling at a bad time.

So let's look at how low volatility and long short equity strategies performed. For objectivity we use Morningstar's mutual fund categories looking at the three month period ending with last week's correction. Over that three month period through August 26, the day after the markets bottomed last week, the MSCI all country world index, a broad global equity benchmark, was off by 9.8%. In contrast the MSCI all country world minimum volatility index, a benchmark for low volatility strategies, was down 7.1%. And the Morningstar long short equity index was down 4.3%. Although, they didn't provide positive returns, and we wouldn't expect them to in a generally weak market environment, these strategies showed much less downside risk than the broad equity market strategies.

Despite last week's sell off, US stocks rebounded and finished up for the week. At Northern Trust, we believe every investment in your portfolio has a function and the purpose of equities is to provide long term growth. To achieve that growth, it is necessary to build a portfolio that can navigate through the short term turbulence. Even though equity strategies are intended for growth more than capital preservation, there are strategies, which may dampen market volatility and make the ride more comfortable, keeping you in the game, when stock markets get volatile.

You can learn more about low volatility, long short equity, and other investment strategies designed to manage portfolio risk on our website, or by contacting your Northern Trust relationship manager.

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