Northern Trust | Don't Fear Volatility, Fear Negative Skew

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Trade tensions and inverted yield curve and shifting commodity prices sunk global markets almost 6% in May. However, not all investors experienced the same degree of pain, as the heightened volatility was accompanied by something we haven't seen since October of 2018-- strong negative return skew. In other words, we saw periods of large losses, which hurt the most aggressive portfolios. Investors should come to expect the negative skew and prepare accordingly.

Let's take a closer look. While we're sanguine about the future of both the economy and equity markets, investors are confronted with issues that increase the threat of more bad days. Last month provided some insight on those threats with a rapid escalation of Chinese and Mexican trade conflicts, free falling oil prices, and a growing concern over global recession, Fed error, and a future course of monetary policy. Investors positioned aggressively in their equity portfolios face a potentially unintended and dangerous risk.

At the core of the problem is simple compounding. To maintain a consistent value, a portfolio must rebound by an amount greater than any decline. For example, a portfolio down by 10% must rebound almost 12% to remain whole. But this can only occur in a market characterized by larger positive days, which is not the market we see now.

Aggressive, or high-beta portfolios, amplify drawdowns and face an increasingly daunting task as return skews become progressively more negative. Simply put, high-beta portfolios require significant, positive return skew to succeed, and we don't see much of that in the future. In contrast, low-beta portfolios thrive on negative skew.

Going forward, investors should be very concerned about the aggressiveness of their equity portfolios. Given heightened risk to the downside, we advocate a lower volatility equity stance. Not only should this partially insulate the portfolio from the worst drawdowns, through compounding, the right positioning may serve as a potent source of outperformance.

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