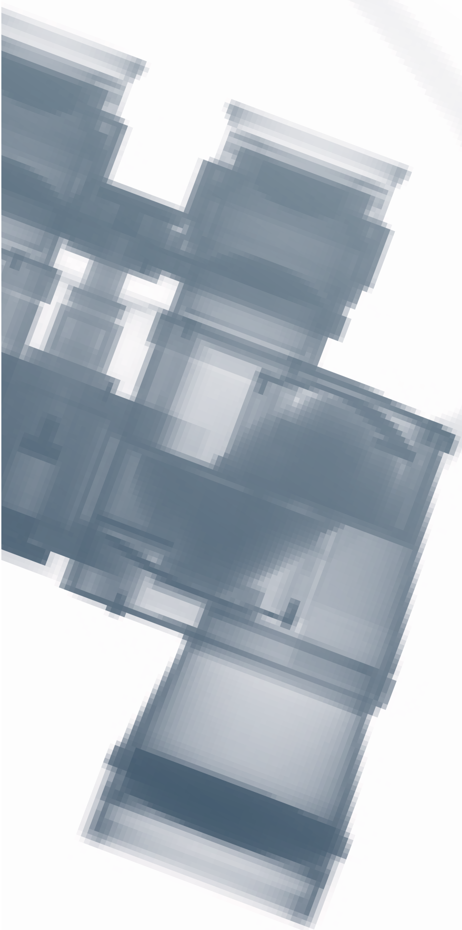
Heartwood Investment Management

11 August 2017

Investment Insight

Weekly Insight



Have investors been too complacent?

Volatility in equity markets picked up at the end of the week, having been exceptionally low this year. The VIX Index - also known as the 'fear' gauge and which measures the implied volatility levels of the S&P 500 - has increased to levels last seen in early November 2016, having spent much of the year falling to historic lows. It is important to consider what has been driving down volatility.

The VIX Index: Implied volatility levels of the S&P 500 (last three years)

Source: Bloomberg

Past performance is not a reliable indicator of future performance.

Low growth, low interest rates and low inflation have fuelled investors thirst for yield and return, driving asset prices higher especially in those sectors that are cash generative, such as 'bond-proxies'. The hunt for yield has been further reinforced by central bank buying – estimated to be worth $2 trillion of assets this year – which has lowered yields in government and corporate bond markets, forcing investors into riskier assets. However, the impact of central bank asset-purchase programmes is not the whole story.

Over the past decade, we have also witnessed the rise of the 'non-fundamental' investor. A shift in the composition of buyers and sellers through product innovations is changing the structure of the market. J.P. Morgan estimates that only 10% of trading volumes now originate from discretionary fundamental investors. In fact, more than half of equity assets are owned by passive or quantitative investors compared with less than one-third a decade ago.

As a result, investors are now buying and selling the market in its entirety rather than trading on stock-specific fundamentals. This investment behaviour not only increases the market's efficiency but tends to lead to large rotations across style and sector, such as we saw in the weeks following Donald Trump's election. At that time, there were significant asset flows from growth into value and from defensive sectors into more cyclical areas of the market. Moreover, large asset shifts actually lower correlations among sectors and stocks, further depressing volatility.

Some investors are now viewing volatility as an asset class in its own right. The strategy of selling volatility, via writing options, has been increasingly adopted by both hedge funds and institutional investors, including pension funds and life insurers, as a way to extract additional income in a low yield environment. Such strategies also distort measures of volatility, creating an impression of calm.

Clear Thinking

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Are we entering a new phase?

There will come a time when market liquidity and risk appetite must be tested – perhaps these trends are starting to emerge now. Beyond the headlines about US and North Korean tensions, there is an increasing sense that we are shifting into a new phase for the global economy, as central banks look towards exiting emergency stimulus levels. The US Federal Reserve plans to begin reducing its balance sheet later this year and with less liquidity being injected into financial markets, this may be enough to undermine market sentiment. Such potential action also comes at a time when economic momentum appears to be moderating, albeit at the margin.

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