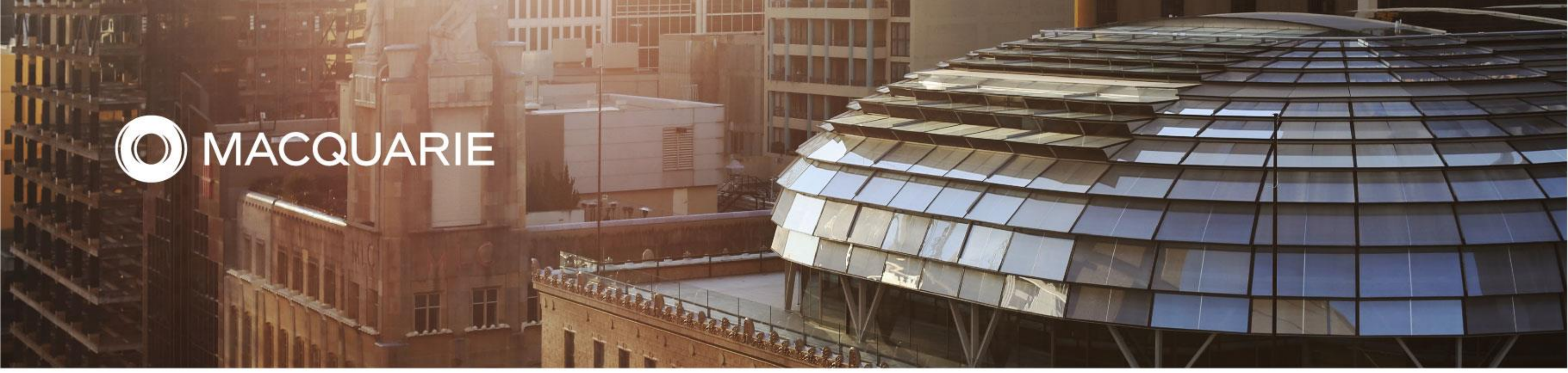


Investment Strategy Update #121

How to manage volatile markets

- Financial market volatility has doubled since the start of the year. We think this is a direct result of rising monetary policy, economic and geopolitical uncertainty.

- The potential for inflation and rates to remain higher and for economic growth to remain lower than seen in the past decade suggest we do not return to an ultra-low volatility environment for some time.

- There are several *"rules of thumb"* that will help investors manage volatile return periods. While a well-diversified portfolio is set up on the basis that market returns will not always be smooth or positive, there are 5 key ways investors can adjust their direct investments to reduce exposure to volatility:

  1. **Avoid "distress" risk:** When growth is slowing and forecast risk is high, greater attention should be put on balance sheet metrics.

  2. **Beware of "fickle" forecasts:** Sell-side analysts tend to be slow in updating earnings during highly volatile macro environments. Strategies based on earnings forecasts will be vulnerable to these lags given estimates are unlikely to keep up with reality.

  3. **Manage "market" risk:** As stock correlations rise, investors need to hold more stocks to reach the same level of diversification. Alternatively, investors may only want to take bets on stocks where conviction levels are high.

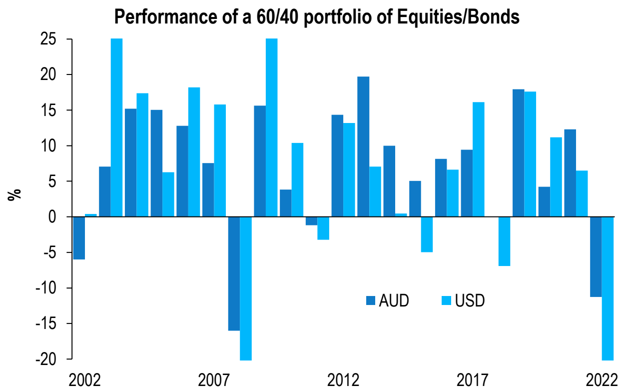
  4. **Understand "Style" risk:** Style investing can also be at the whim of market sentiment. Risk-off markets tend to favour large caps and momentum while value often bears the brunt of economic pain.

- Finally, academic research suggests that active manager returns tend to be strongly counter cyclical (more likely to deliver excess returns during bear markets). This is because active managers tend to hold cash which is a tailwind during bear markets and because active stock selection (avoiding poor quality companies) works better during downturns. This would suggest investors avoid trying to raise net returns by looking for low-cost passive strategies when markets are weak.

Why are markets so weak and volatile?

This year has seen investors suffer the worst start to a calendar year in over 5 decades. If that was not already enough, uncertainty around the outlook has seen a spike in financial market volatility as well as the correlation of assets markets converge. In other words, the chaotic nature of daily/weekly returns has reduced the willingness to be opportunistic (buy on weakness) while the diversification benefits of a traditional portfolio have been falling.

Australian assets have dramatically outperformed global assets with the A$ an important shock absorber

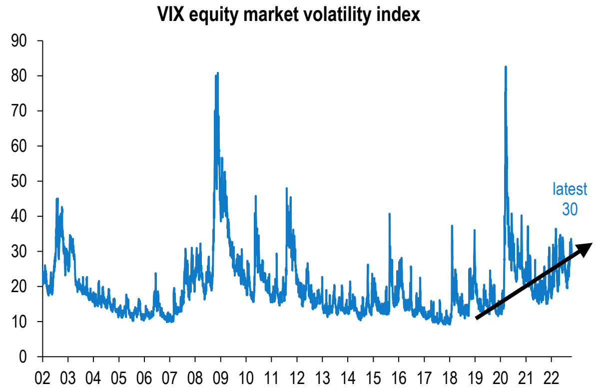


Source: FactSet, MWM Research, October 2022

We believe financial market volatility is a direct result of monetary policy, economic and geopolitical uncertainty. When the direction of monetary policy and its implications on economic growth are clear, financial market volatility is generally low. But when policy uncertainty and its implications for growth are high, volatility picks up. Certainty around monetary policy is important because investors have become used to policy makers backstopping markets when weakness accelerates (the Fed "put"). In addition, the absence of inflation has meant the hurdle to support economic growth has been low as so whenever growth risks picked up, countercyclical policy measures where quickly put in place.

This all changed during the early months of 2022. Stickier than expected inflation has seen central banks raise policy rates at the fastest pace since 1994. They are laser focused on bringing inflation back down to target ranges to ensure it does not become entrenched into expectations. However, in prioritizing inflation over growth, financial markets are suffering collateral damage from not only from a rising discount rate and a weakening growth outlook, but from the uncertainty around where these go from here.

Volatility is likely to remain higher as policy and growth uncertainty pick up



Source: FactSet, MWM Research, October 2022

We have previously set out our markers for a sustained bottom in risk assets / top in bond yields (see *"Investment Strategy Update #106: Why markets remain under pressure"*), but regardless of when markets may turn, we think investors will need to live with much higher financial market volatility than they have experienced in the past due to a period of higher inflation, higher policy rates and weaker economic and/or earnings growth.

How can we manage volatility? Focus on what *"you"* can control

We think there are a few sensible *"rules of thumb"* that will help investors manage volatile return periods. While a well-diversified portfolio is set up on the basis that market returns will not always be smooth or positive, there are 5 key ways investors can adjust their investment exposures to reduce exposure to volatility (see *"Global Dynamics: A practical guide to volatile markets"* – Macquarie Quant Team):

1. **Stick with "active" fund managers:** Academic research suggests that active manager returns tend to be strongly counter cyclical. This means active managers are more likely to deliver excess returns during bear markets. This is because active managers tend to hold cash which is a drag during bull markets but a tailwind during bear markets and because active stock selection (avoiding poor quality companies) works better during downturns. This would suggest investors avoid trying to raise net returns by looking for low-cost passive strategies when markets are weak.

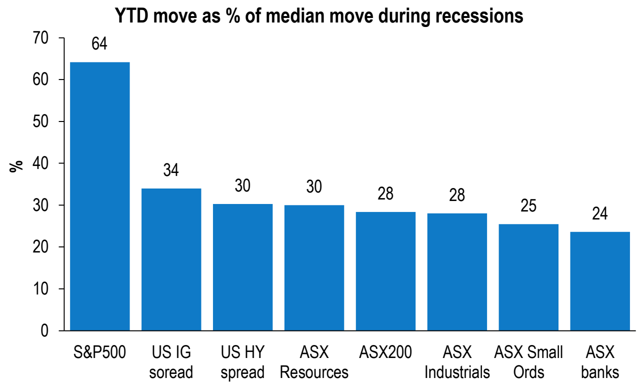
2. **Avoid "distress" risk:** When economies are growing and markets are doing well, owning stocks that have distress (bankruptcy) risk is less of an issue and investors tend to focus on earnings growth and forget about balance sheets. However, when growth is slowing and forecast risk is high, greater attention should be put on balance sheet metrics.

3. **Beware of "fickle" forecasts:** Sell-side analysts tend to be slow in updating earnings numbers during highly volatile macro environments. Any strategy based on earnings forecasts will be vulnerable to these lags given estimates are unlikely to keep up with reality. The simple takeaway is that stocks will bottom before analysts start to upgrade but during bear markets it can be dangerous to be long stocks with weak earnings momentum.

4. **Manage "market" risk:** It is not possible to avoid market risk, but it can be managed when volatility rises. As stock correlations rise, investors need to hold more stocks to reach the same level of diversification. In other words, when uncertainty around single stock outcomes rises, it pays to spread that uncertainty or to reduce bet size. Alternatively, investors may only want to take bets on stocks where conviction levels and/or transparency is relatively high.

5. **Understand "Style" risk:** Style investing can also be at the whim of market sentiment. Risk-off markets tend to favour large caps and momentum (following the trend) while value often bears the brunt of economic pain. Style volatility equals inconsistent returns therefore diversified strategies will win out over short term style timing and this supports a balanced approach towards both "value" and "growth".

Assets are not yet repriced for the *"average"* recession

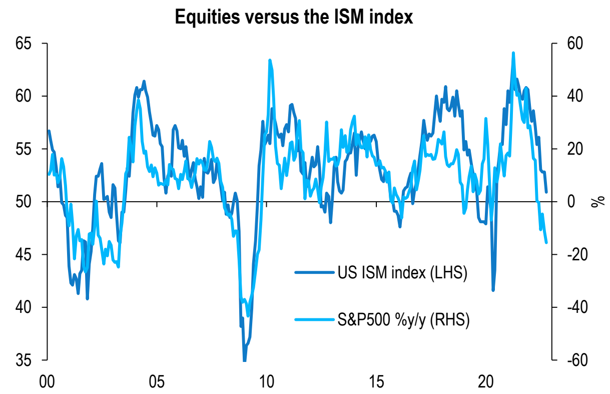


Source: FactSet, MWM Research, October 2022

At this stage we think it remains too early for investors to be trying to time a market bottom. We think trying to protect against downside risk remains the key priority over getting set for the next upswing while the fight against inflation remains the key priority for policy makers.

It is quite possible that central banks lose their nerve and begin to shift their focus towards supporting economic growth, but unless inflation is brought back under control, then investors will simply shift their concerns from "lower inflation and weaker economic growth" to "higher inflation but mildly stronger economic growth". While lower recession risk is positive for markets in the near term, a persistent inflation problem may lead to a period of higher rates and weaker real asset returns, which does not bode well for growth assets.

Equities are closely correlated with the ISM implying macro fundamentals are not signalling an equity turn



Source: FactSet, MWM Research, October 2022

On a positive note, we see no reason why equity markets will not follow their normal course and bottom well before economic indicators such as the labour market and growth.

Historically, there has been a 4-month gap between the last Fed rate hike and the first cut. If expectations of a peak are sometime in late 1Q23, then this would equate to the first-rate cut coming sometime in late 3Q23. Several Fed officials are pushing a more hawkish narrative of rates remaining at peak for an extended time, but this will ultimately depend on the level of peak rates and the damage done to the economy.

Suffice to say, with inflation still close to peak in the US and still rising in Australia, policy rates are going higher and against this backdrop we think investors should continue to look for ways to bring risk exposures down and/or remain defensively positioned. At a portfolio level, this can involve increasing exposure to low correlated assets such as alternatives, increasing exposure to inflation-hedged assets (such as infrastructure) and increasing the 'quality' level of assets that provide greater assurance over dividends and coupons (see *"Investment Strategy Update #105: Why we still like a 60:40 portfolio"*).

Macquarie WM Investment Strategy Team

Mentioned Reports:

1. *Investment Strategy Update #105: Why we still like a 60:40 portfolio*
2. *Investment Strategy Update #106: Why markets remain under pressure*

The report was finalised on 24 October 2022.

Recommendation definitions (Macquarie Australia/New Zealand)
Outperform – return >3% in excess of benchmark return
Neutral – return within 3% of benchmark return
Underperform – return >3% below benchmark return

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