# NAVIGATING THROUGH THE VOLATILITY BLOWOUT

**Following last week's stock market plunge, we felt it was an opportune moment to give some insight into how our Multi Asset Navigator strategy was positioned ahead of time and where we see the opportunities in the near future.**

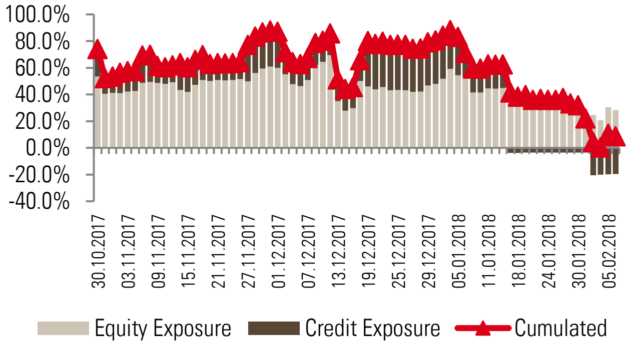
## How was Navigator positioned on the eve of the blowout?

We started this year with a high exposure to equities and real assets, and a negative tilt on duration. Our positioning was based on:

- A positive outlook on growth and inflation as indicated by our real time growth and inflation 'Nowcaster'
- A favourable assessment of the US fiscal plan on corporate profitability
- Our conviction that monetary policy normalisation was generally being underestimated by the market

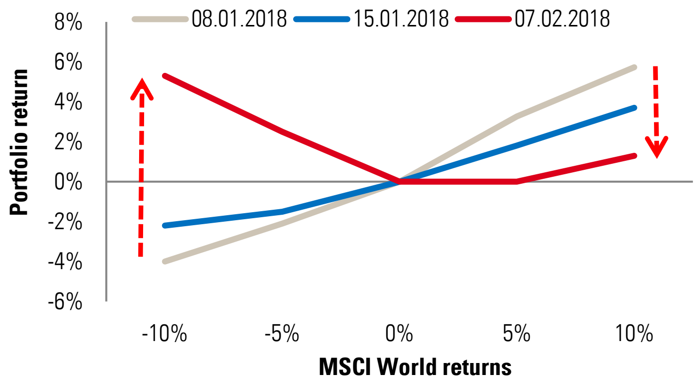
As illustrated by Figure 1, our growth related assets exposure was close to 60% at the beginning of the year. Moreover, the strategy was tilted to the upside (Figure 2) as we had bought some out-of-the-money call spreads on the S&P 500 index in November and December. This was to take advantage of the favourable skew and low expectation on the US fiscal deal in order to increase our convexity. In early January, our growth related assets exposure reached 80% as strong market performance pushed our option strategies in-the-money.

**Figure 1: Growth assets allocation**




Source: Unigestion, February 2018

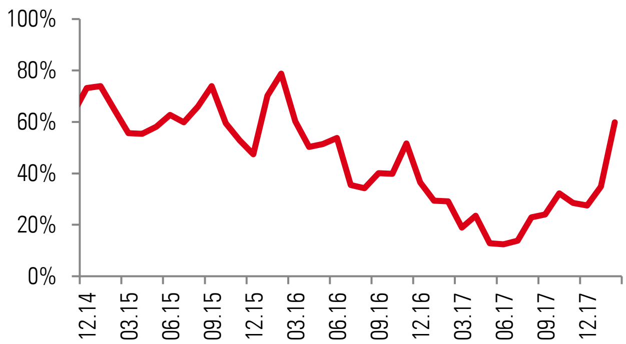
**Figure 2: Predictive stress test**




Reading note: The predictive stress test evaluates how the strategy would perform based on an underlying MSCI World move. Source: Unigestion, Riskmetric, February 2018

Despite the euphoric start to the year for most risky assets, we started to become less optimistic about the sustainability of this trend. We were concerned by the fact the VIX volatility index was rising despite equity markets continuing to hit record highs every day, alongside Central Banks being increasingly vocal about an acceleration of normalisation. Given these two elements, we decided to first take profit on our upside positioning and then to add some downside protection in order to preserve our positive performance. As a result, our positioning shifted from being titled towards growth assets to a more balanced stance as illustrated in Figure 2. Our focus evolved from capturing the upside in equity markets to downside protection.

**Figure 3: Nowcaster Market Stress**




Source: Unigestion, February 2018

At the end of January, we further reinforced our more cautious stance as a result of the following elements:

- Our Market Stress 'Nowcaster' was rising further (Figure 3)
- Crowded positioning on some risky assets
- Our conviction that the market was not prepared to tackle an inflation surprise

This final step in our de-risking was implemented by tapering our overweight equity dynamic allocation back to neutral, by deleveraging the strategy globally and buying volatility (outright and via VIX options). As a result, our risk profile turned very defensive as shown by our predictive stress test monitoring (Figure 2), which highlights how the strategy would perform based on an underlying MSCI World move.

The steps we took reinforce the convictions that are at the heart of our investment philosophy and portfolio construction:

1) Dynamic risk management is essential to mould long-term asset allocation and deliver smooth returns across different market conditions
2) Dynamic risk management is multi-dimensional because risk should be viewed beyond realised volatility. Hence, we monitor macro risk through our "Nowcasters" which assess macroeconomic context in real time and market risks via fundamental and qualitative analysis.

As a result of our positioning and dynamic risk management, we were able to be less exposed to markets which were increasingly disconnecting from their fundamentals.

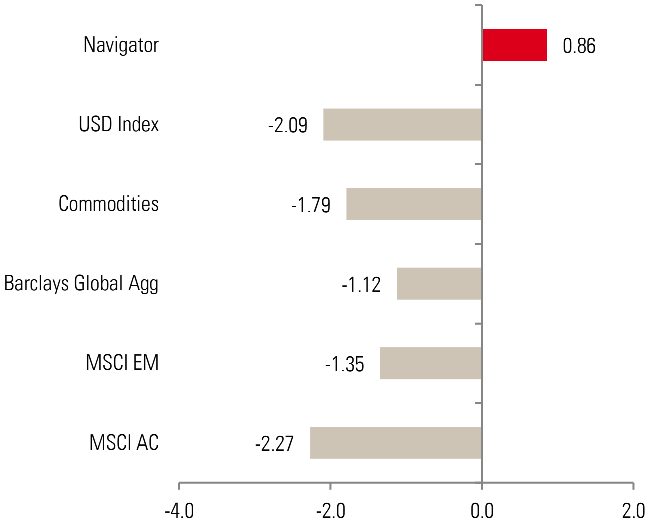
## So what did this mean in terms of performance?

Following the performance achieved in January where Navigator returned 1.8%, equity markets started to decline quickly in early February off the back of rising inflation, as well as growing implied volatility. It resulted in a correlation shock with equities, bonds, credit and commodities all falling at the same time. This negative trend intensified on 5 February as the VIX doubled from 18% to 36%, triggering a massive sell-off in a low liquidity environment.

As a result, the S&P 500 lost 7.8% from its 2018 peak, the NIKKEI declined by 10.5% and the Eurostoxx fell 7.6%.

Despite this heavy market correction, Navigator performed well in absolute and relative terms as shown in Figure 4.

**Figure 4: Navigator performance vs Traditional Risk Premia**




Sources: Unigestion, Bloomberg, February 2018. Year to date performance (from 31.12.2017 to 08.02.18). Past performance is no guide to the future, the value of investments can fall as well as rise, there is no guarantee that your initial investment will be returned.

In short, our returns were driven by:

- Risk reduction: We increased our cash position by deleveraging our portfolio
- Diversification: On Monday 5 and Tuesday 6 February our bond and VIX exposures behaved as hedges against more traditional "risky" assets.
- Equity exposure through our low-risk strategy and our options' book constructed over the last couple of months (out-of-the money put spreads on the S&P500, EuroStoxx and MSCI Emerging and the out-of-the money call on the VIX). This enabled us to reduce our overall beta to equities, while adding returns during the correction.

## Our target: Deliver positive asymmetry whatever the market conditions

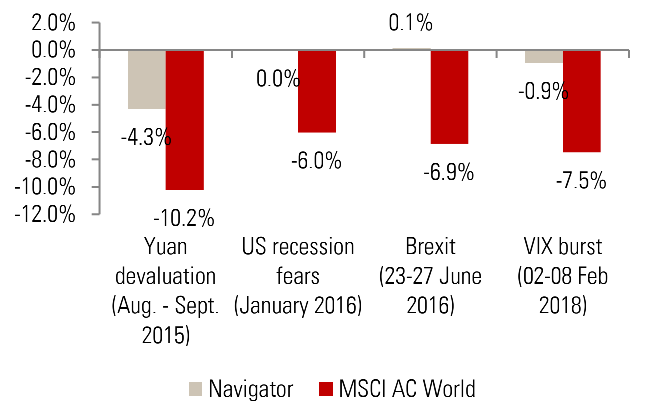
The recent market turmoil highlights the need to be diversified and dynamic to proactively tackle challenging financial markets.

At Unigestion, we believe that investing is about managing risk and providing downside protection during periods of challenging market behaviour in order to deliver smooth returns across different market cycles.

This is why risk analysis is at the heart of our process. We believe that dynamic risk management alongside strategic allocation is the most robust way to manage multi asset portfolios seeking to deliver such an outcome.

In practice and as illustrated by our different tactical allocations recently, Navigator aims to provide a good protection of capital during market drawdowns (Figure 5) as well as a positive asymmetry (Figure 6).

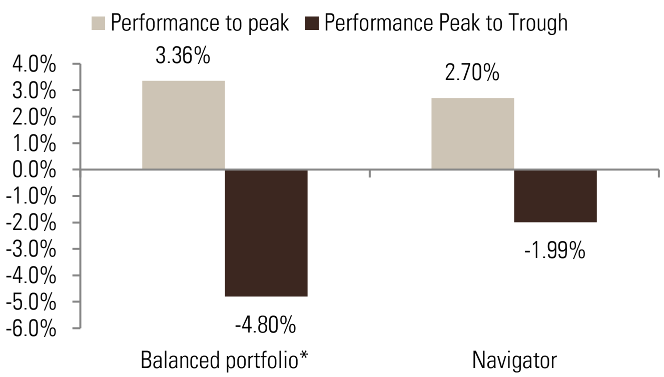
**Figure 5: Navigator performance during Equity drawdowns**




Source: Unigestion, Bloomberg, as at February 2018. Past performance is no guide to the future, the value of investments can fall as well as rise, there is no guarantee that your initial investment will be returned.

Applying this philosophy to the latest stress episode, our strategy has been able to deliver a positive asymmetry during January's equity rally while limiting the downside (Figure 6).

**Figure 6: 2018 performance of the strategy vs balanced portfolio**




Reading note: Performance to the peak is from 31.12.2017 to 26.01.2018. Performance Peak to trough is from 26.01.2018 to 08.02.2018. Balanced portfolio is represented by 50% MSCI AC / 50% Barclays Global Agg portfolio.

Source: Unigestion, Bloomberg, as at February 2018.

This is in line with our target of aiming to deliver smooth returns in all market conditions, alongside producing steadier performance than more passive multi-asset investing strategies (e.g. balanced portfolios) which can only mirror market activity.

## Where do the opportunities now lie?

While such a drop in financial markets provides opportunities, we believe that the high level of market volatility will continue for now and knock investor confidence. Moreover, inflation surprise risks remain high with tight labour markets across the world and rising producer prices. Therefore, we remain relatively cautious in terms of positioning for the coming days.

In this challenging market environment, we expect global monetary policy normalisation to happen sooner than the market expects, and we will remain focused on the volatility trend and the correlation across assets that are historically affected during periods of monetary policy tightening.

We believe that risk management will remain a key source of performance, as we have already seen this year. However, the current level of equity valuation seems attractive given the positive macro outlook in both Emerging and Developed markets. In terms of tactical allocation, the combination of Central Bank activity and low recession risk is supportive for positions with high carry to risk. Therefore, we still have a preference for equities and we also believe that commodities and inflation breakevens will deliver positive performance as inflation will reach Central Bank targets. In addition, we think duration should be reduced significantly in portfolios due to the combination of monetary policy and rising inflation expectations.

All in all, the recent events illustrate the need for a global, proactive and pre-emptive risk managed approach. This should not only be based on mechanical or systematic after the fact reactions, such as simple trend-following strategies, but on a robust and proactive assessment of risk. This has been and will remain the focus of the Unigestion Cross Asset Solutions team.

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