For much of 2014 markets were somewhat tamed by central banks. The potent combination of forward guidance and centralising monetary policies has largely met their goal of market stability via ultra-loose and accommodative monetary policy, and we find ourselves amidst a low-volatility, low-volume, low-conviction bull market.

The S&P® 500 Index has almost tripled since the depths of the financial crisis and sovereign bond spreads have collapsed well beyond pre-crisis levels. The Chicago Board Options Exchange Market Volatility Index® (VIX) — a measure of equity volatility — has been low since the start of 2012, at or below pre-GFC levels.

**The Dangers of Complacency**

A blip in late October 2014 may well have given some investors pause for thought but for some time now we have asked: Are investors conditioned to a low volatility environment and possibly too complacent?

Low volatility combined with the need for higher yield has driven investors further up the risk spectrum and complacency could ultimately spell trouble for many and precipitate the next market correction.

And, it is not just US equity volatility that has been low — European equity, interest rate and foreign exchange volatility levels are also at near-decade lows.

**What Could Go Wrong?**

Volatility is driven by uncertainty and — through coordinated monetary policy, together with bond purchases and more recently forward guidance — uncertainty has indeed been extraordinarily low. However, we expect volatility to rise as the advanced economies follow increasingly divergent paths with their monetary policy.

The US and the UK are already deliberating on their tightening paths, while the ECB is only just in preparatory stages. This could well be enough to force volatility from its subdued state, but there are other risks on the horizon that could cause a more sudden rise.

**KNOW WHERE YOUR RISK LIES:**

Equity Risk Dominates the Traditional 60/40 Balanced Portfolio

This means that the true portfolio risk is highly concentrated and highly correlated. It also means that investors may not be realising the true level of protection they require.

*Based on a rolling 5-year risk allocation of a 60% Equity / 40% Bond portfolio average spanning 1981-2012. Source: SSgA. As at 28 November 2014. For illustrative purposes only.
Reflecting on 2014 market performance and considering traditional valuation metrics, there is indeed cause to pause and take stock. And it is not just recent market performance that suggests caution. As well as the VIX other risk metrics, such as the Merrill Option Volatility Estimate Indices, have fallen to very low levels not seen since 2007, prior to the Great Financial Crisis.

SSGA’s MRI† spent most of 2014 indicating very low risk, even spending a fairly unprecedented three months in the Euphoria regime (indicating extreme complacency towards risk) before moving sharply into High Risk in October, a portent, perhaps, of things to come.

Fundamentals may also present potential pitfalls. From eurozone deflation concerns to geopolitical issues in Ukraine or the Middle East, spats between China, Vietnam and Japan are causing concern, and China’s shadow banking sector also casts a pall.

US valuations are at the higher range of what we would consider to be fair value. European valuations look better but we believe that, in the short term and on a risk-adjusted basis, it may well be worth adopting a more prudent stance.

Equity Indices at All-Time Highs

Source: Bloomberg Finance LP. As at 31 October 2014. Past performance is not a guarantee of future results. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income.

Risk Aversion Has Spiked Sharply Upwards

Source: SSGA. MRI. As at 31 October 2014

†SSGA’s Market Regime Indicator (MRI) uses a mix of inputs, such as equity and currency volatility and bond spreads to monitor market conditions.
Investors are well aware of the deleterious effects of drawdowns and typically adopt protective strategies to avoid them. Geopolitical risk is undoubtedly a factor in some drawdown events, but just how important is it over meaningful time periods? We looked back at the major (greater than 20%) drawdowns over the last 50 years and found that only one was geopolitical and multi-year in nature: the 1970s oil crisis.

A major event like 9/11 might be expected to have severe long-term effects. In fact, investment wise it barely even maps since we were already in a bear market from the highs of early 2000. Even the Asian Crisis and Russian Default didn’t get to -20%. A host of other geopolitical events — such as the recent Ukraine crisis, the Arab Spring and the first Gulf War — all have impact but what seems clear is that the markets typically shrugged them off in short order.

**Rapid Recovery**

Not only do geopolitical events tend to show lesser impact than market-based events, the market also tends to recover more quickly from geopolitical events. Consider again 9/11: on 10 September the S&P 500 closed at 1,092, it reached an intraday low of 965.80 on 21 September (down 12%) but had fully recovered by the end of October. Of course, the Fed had taken decisive action but the point is that the impact was, indeed, short term.

**The Takeaway**

Be realistic about the effect of geopolitical risks — they may not have the lasting long-term effects that many ascribe to them. However, many investors cannot bear even short-term drawdowns and avoiding or severely limiting drawdowns makes sense in terms of time to recovery. In any case, market-based events can and typically do affect portfolios deeply and broadly over the long term. The right protection strategy should help defend against both types of risk.
When to Start, What to Do?

Although we note the risks that stem from high valuations and the propensity for geopolitical instability to change the investment landscape, we also recognise in our conversations with clients that there is a concern that adopting a ‘defensive’ stance risks missing continued upside potential. This is particularly the case against a backdrop of ultra-low interest rates and Quantitative Easing (QE).

Getting the Balance Right

However, we believe that there are ways to optimise the balance of needs through a variety of overlay and direct investment strategies. In particular, investors could consider a Target Volatility Trigger (TVT) framework, which seeks to provide downside protection and yet leaves potential for upside participation; or asset allocation strategies which dynamically allocate according to the prevailing market conditions, and can be good way to help provide downside protection and potential alpha generation. Overlay programs using listed futures and options to create put-spread or put-spread collar strategies have also historically provided downside protection.

Timing is Critical

Aggressive de-risking can prove costly should the markets continue to rise, and yet a ‘defensive’ stance risks missing continued upside potential, particularly against the backdrop of ultra-low interest rates and QE.

In light of this, we believe that implementing downside risk protection while costs are low may make sense. Our experience has been that it is always better to start implementing portfolio protection decisions when others are greedy, when there is time to consider alternatives and also when the cost of implementing these decisions is low.

When markets are in crisis mode — as they were in September 2008 and August 2011 — it is often, quite simply, too late.

INVESTMENT IDEAS

- **Target Volatility Triggers** can provide a stable volatility level in the portfolio.
- **Market Regime Aware Investing** via Dynamic Asset Allocation Funds.
- **Derivatives Overlays** Option-based overlays and volatility futures.
- **Alternative strategies** Liquid alternatives, such as Managed Futures and Global Macro and advanced beta equities, such as Managed Volatility.
US Treasury bills are insured and guaranteed by the US government.

Government bonds and corporate bonds generally have more moderate short-term price fluctuations than stocks, but provide lower potential long-term returns.

There are risks associated with investing in Real Assets and the Real Assets sector, including real estate, precious metals and natural resources. Investments can be significantly affected by events relating to these industries. Investing in high yield fixed income securities, otherwise known as junk bonds, is considered speculative and involves greater risk of loss of principal and interest than investing in investment grade fixed income securities. These lower-quality debt securities involve greater risk of default or price changes due to potential changes in the credit quality of the issuer.

Investing in futures is highly risky. Futures positions are considered highly leveraged because the initial margins are significantly smaller than the cash value of the contracts. The smaller the value of the margin in comparison to the cash value of the futures contract, the higher the leverage. There are a number of risks associated with futures investing including but not limited to counterparty credit risk, currency risk, derivatives risk, foreign issuer exposure risk, sector concentration risk, leveraging and liquidity risks.

Options investing entail a high degree of risk and may not be appropriate for all investors.

Investing involves risk including the risk of loss of principal.

Diversification does not ensure a profit or guarantee against loss.

The information provided does not constitute investment advice and it should not be relied on as such. It should not be considered a solicitation to buy or an offer to sell a security. It does not take into account information and State Street shall have no liability for decisions based on such information.

Risk associated with equity investing include stock values which may fluctuate in response to the activities of individual companies and general market and economic conditions.

Investments in small-sized companies may involve greater risks than in those of larger, better known companies.

Investing in foreign-domiciled securities may involve risk of capital loss from unfavourable fluctuation in currency values, withholding taxes, from differences in generally accepted accounting principles or from economic or political instability in other nations.

Currency Risk is a form of risk that arises from the change in price of one currency against another. Whenever investors or companies have assets or business operations across national borders, they face currency risk if their positions are not hedged.

Investing in commodities entail significant risk and is not appropriate for all investors. Commodities investing entail significant risk as commodity prices can be extremely volatile due to wide range of factors. A few such factors include overall market movements, real or perceived inflationary trends, commodity index volatility, international, economic and political changes, change in interest and currency exchange rates.

Companies with large market capitalizations go in and out of favor based on market and economic conditions. Larger companies tend to be less volatile than companies with smaller market capitalizations. In exchange for this potentially lower risk, the value of the security may not rise as much as companies with smaller market capitalizations.

Investments in emerging or developing markets may be more volatile and less liquid than investing in developed markets and may involve exposure to economic structures that are generally less diverse and mature and to political systems which have less stability than those of more developed countries.

Although subject to the risks of common stocks, low volatility stocks are seen as having a lower risk profile than the overall markets. However, a portfolio comprised of low volatility stocks may not produce investment exposure that has lower variability to changes in such stocks’ price levels.

Although bonds generally present less short-term risk and volatility risk than stocks, bonds contain interest rate risks; the risk of issuer default; issuer credit risk; liquidity risk; and inflation risk. This effect is usually pronounced for longer-term securities. Any fixed income security sold or redeemed prior to maturity may be subject to a substantial gain or loss.

US Treasury bills are insured and guaranteed by the US government.

The views expressed in this material are the views of SSGA Investment Management through the period ended 1 December 2014 and are subject to change based on market and other conditions. This document contains certain statements that may be deemed forward-looking statements. Please note that any such statements are not guarantees of any future performance and actual results or developments may differ materially from those projected.

All information is from Bloomberg and FactSet unless otherwise noted and has been obtained from sources believed to be reliable, but its accuracy is not guaranteed. There is no representation or warranty as to the current accuracy, reliability or completeness of, nor liability for, decisions based on such information and it should not be relied on as such.

Risk associated with equity investing include stock values which may fluctuate in response to the activities of individual companies and general market and economic conditions.

Investments in small-sized companies may involve greater risks than in those of larger, better known companies.

Investing in foreign-domiciled securities may involve risk of capital loss from unfavourable fluctuation in currency values, withholding taxes, from differences in generally accepted accounting principles or from economic or political instability in other nations.

Currency Risk is a form of risk that arises from the change in price of one currency against another. Whenever investors or companies have assets or business operations across national borders, they face currency risk if their positions are not hedged.

Investing in commodities entail significant risk and is not appropriate for all investors. Commodities investing entail significant risk as commodity prices can be extremely volatile due to wide range of factors. A few such factors include overall market movements, real or perceived inflationary trends, commodity index volatility, international, economic and political changes, change in interest and currency exchange rates.

Companies with large market capitalizations go in and out of favor based on market and economic conditions. Larger companies tend to be less volatile than companies with smaller market capitalizations. In exchange for this potentially lower risk, the value of the security may not rise as much as companies with smaller market capitalizations.

Investments in emerging or developing markets may be more volatile and less liquid than investing in developed markets and may involve exposure to economic structures that are generally less diverse and mature and to political systems which have less stability than those of more developed countries.

Although subject to the risks of common stocks, low volatility stocks are seen as having a lower risk profile than the overall markets. However, a portfolio comprised of low volatility stocks may not produce investment exposure that has lower variability to changes in such stocks’ price levels.

Although bonds generally present less short-term risk and volatility risk than stocks, bonds contain interest rate risks; the risk of issuer default; issuer credit risk; liquidity risk; and inflation risk. This effect is usually pronounced for longer-term securities. Any fixed income security sold or redeemed prior to maturity may be subject to a substantial gain or loss.

US Treasury bills are insured and guaranteed by the US government.

Past performance is not a guarantee of future results.