So how, exactly, do investors mesh these two seemingly diametrically opposed goals of lower volatility and growth-like returns?

It’s a conundrum. Ever since the global financial crisis, investors have been keen to flee the damaging effects of volatility; however, that hasn’t abated their thirst—make that need—for growth. Retirees are short on savings but living longer. Health care and education costs have continued to rise, while the threat of inflation is always looming in the distance. And some investors are moving to very specific goals-oriented approaches to address an array of needs.

So how, exactly, do investors mesh these two seemingly diametrically opposed goals of lower volatility and growth-like returns? For now, many investors have gravitated toward absolute-return strategies that advertise zero tolerance for negative-return periods. But that comes at a price. In contrast, a better approach might center on artfully managing long-term volatility (and tail risk) while positioning for growth-like returns.

A HISTORY REFRESHER

Before weighing in on this growth versus volatility challenge, step back to consider how we arrived here. The bursting of the housing bubble and subsequent fallout from the Great Recession of 2008/09 were very painful experiences. The S&P 500® lost approximately 50% of its value during the two-year bear market, and those losses undoubtedly would have been much deeper without the extraordinary intervention by the U.S. Federal Reserve and other central banks worldwide.

Even seven years into a new bull market for equities, the scars from this experience are evidenced by investor attitudes toward growth-oriented assets. Many have responded by de-risking and reducing exposure to equities and other growth assets.
Consequently, this has also resulted in the rise of multi-asset alternative strategies. These approaches generally offer greater flexibility than traditional approaches, including the ability to short and to employ benchmark-agnostic risk management techniques. Many aim to smooth out the stock market’s bumps in a variety of economic environments. Some of these strategies are absolute return in nature, which means that they typically run at low levels of risk, with standard deviation of roughly 6% or 7%, and they target expected returns in the neighborhood of cash plus 4%.

“The sales pitches of these absolute-return strategies have been powerful and effective,” explains Sinead Colton, head of investment strategy at Mellon Capital, “particularly since investors have clear memories of 2008. It is no surprise why someone would want to reallocate a portion of their growth capital to absolute-return strategies. But is this really the best approach for all investors?”

No one is denying the value of a good night’s sleep courtesy of a lower-risk portfolio. It’s true that few investors can afford another tail event or the severe drawdown of a market crisis. However, responding to the volatility threat by tilting too heavily toward “absolute-return” strategies could create a returns shortfall.

A BETTER WAY?

Investors need to reframe this challenge and consider ways to generate growth-like returns in the context of acceptable levels of risk. So rather than focusing on combating the damages of volatility, perhaps investors facing retirement-funding challenges should be asking: Can I afford to have another decade of growth-oriented assets delivering 4% to 5%?

“You really need to consider if absolute-return strategies can satisfy long-term requirements, particularly in the context of historical returns for equities of 8% on average (see Figure 1), or even compared to more modest future-expected returns,” explains Colton. “That’s why we believe that a larger allocation to growth assets merits consideration.”

FIGURE 1: MSCI WORLD (PRICE) INDEX CALENDAR YEAR RETURNS VS. DRAWDOWNS

Sources: DataStream and Mellon Capital, as of 9/30/16. Returns reflect the MSCI World (Price) Index, which measures the price performance of markets represented by the MSCI World Index without including dividends. On any given day, the price return of the index captures the sum of its constituents’ free float-weighted market capitalization returns. Drawdown refers to the largest market drops from a peak to a trough during the year, and uses daily returns. The MSCI World (Price) Index is used to illustrate the equity market. An investor cannot invest directly in any index.
Consider that over the long term, the average equities drawdown for any calendar year is roughly 14.6% from peak to trough (see Figure 1). That seems much more palatable for most investors given their goals and return requirements. What investors cannot stomach are those periods of severe dislocations—the cathartic experiences with severe drawdowns such as 1989, 1998, 2001 and 2008. The problem is that traditional growth investments do not typically protect significant capital during periods of heightened volatility due to their benchmark-centric approach, and they are particularly exposed to downside tail risk in times of unforeseen events.

Colton, however, believes there is a viable approach that can deliver equity-like returns—slightly less than historical averages—while aiming to restrict drawdowns to within that long term average of below 15%. An investment strategy can seek to accomplish this, in addition to identifying attractive multi-asset investments, targeting a volatility range directly, rather than simply accepting the fluctuations inherent to a traditional benchmark-centric investment approach.

Focusing on shorter-term volatility measures and then dynamically adjusting exposures to growth assets in response can, in theory, create a smoother return profile over the long term. This type of approach can offer investors a dynamic asset allocation based on attractive investment opportunities conditioned on the market risk environment—from strongly growth-oriented in robust economic times to more defensive in nature during more tumultuous markets.

But this type of dynamic approach takes resolve, and the strategy must be willing to re-risk the portfolio and reallocate to growth-like assets at times when volatility is declining. To be effective, this requires timely decision-making and implementation. The volatility management approach should be symmetrical and disciplined to eliminate any potential missteps caused by emotional decision-making in the heat of a market crisis.

Focusing on shorter-term volatility measures and then dynamically adjusting exposures to growth assets in response can, in theory, create a smoother return profile over the long term.

![Figure 2: Managed Volatility: Potentially Better Risk-Adjusted Outcomes](image)

The charts above are for illustrative purposes only and do not represent actual results.

Proactive, forward-looking risk management is essential to any investment approach; however, we believe this should be combined with structural and disciplined de-risking that supports risk mitigation strategies as an unanticipated market crisis is unfolding.
“Some naysayers point out that this type of approach will never correctly pick the absolute bottom when de-risking,” admits Colton. “But that’s not what this dynamic approach is all about. It offers potential for a smoother return profile, dynamically managing exposures, with the aim of providing higher targeted returns than typical absolute-return strategies. Minimizing drawdowns should improve cumulative returns over time relative to traditional assets.”

**OPPORTUNITY COSTS**

Ultimately, the key for investors is to understand that there are many ways to think about de-risking a portfolio. It doesn’t have to be all or nothing when it comes to growth assets. A managed volatility approach offers some potential advantages, and it can be implemented in conjunction with other strategies.

“There may be real opportunity costs associated with strategies that target low absolute returns,” Colton reminds us. “If you believe that cash will remain close to zero over the next few years, an absolute-return strategy that aims to deliver a return of cash plus 4%, assuming they achieve their target, will deliver a return that hovers around 4% before fees. Is this sufficient for the risk-seeking part of your portfolio?”

All investments contain risk and may lose value. There is no guarantee that these investment strategies will work under all market conditions or are suitable for all investors and each investor should evaluate their ability to invest long-term, especially during periods of downturn in the market. Investors should consult their investment professional prior to making an investment decision. Equities are subject to market, market sector, market liquidity, issuer, and investment style risks to varying degrees.

BNY Mellon Investment Management is an investment management organization, encompassing BNY Mellon’s affiliated investment management firms, wealth management organization and global distribution companies including Mellon Capital Management. BNY Mellon is the corporate brand of The Bank of New York Mellon Corporation and may also be used as a generic term to reference the Corporation as a whole or its various subsidiaries generally.

This information is not investment advice, though may be deemed a financial promotion in non-U.S. jurisdictions. Accordingly, where used or distributed in any non-U.S. jurisdiction, the information provided is for Professional Clients only. This information is not for onward distribution to, or to be relied upon by Retail Clients.

For marketing purposes only. Any statements and opinions expressed are as at the date of publication, are subject to change as economic and market conditions dictate, and do not necessarily represent the views of BNY Mellon or any of its affiliates. The information has been provided as a general market commentary only and does not constitute legal, tax, accounting, other professional counsel or investment advice, is not predictive of future performance, and should not be construed as an offer to sell or a solicitation to buy any security or make an offer where otherwise unlawful. The information has been provided without taking into account the investment objective, financial situation or needs of any particular person. BNY Mellon and its affiliates are not responsible for any subsequent investment advice given based on the information supplied. This is not investment research or a research recommendation for regulatory purposes as it does not constitute substantive research or analysis. To the extent that these materials contain statements about future performance, such statements are forward looking and are subject to a number of risks and uncertainties. Information and opinions presented have been obtained or derived from sources which BNY Mellon believed to be reliable, but BNY Mellon makes no representation to its accuracy and completeness. BNY Mellon accepts no liability for any loss arising from use of this material. If nothing is indicated to the contrary, all figures are unaudited.

Any indication of past performance is not a guide to future performance. The value of investments can fall as well as rise, so investors may get back less than originally invested.

Not for distribution to, or use by, any person or entity in any jurisdiction or country in which such distribution or use would be contrary to local law or regulation. This information may not be distributed or used for the purpose of offers or solicitations in any jurisdiction or in any circumstances in which such offers or solicitations are unlawful or not authorized, or where there would be, by virtue of such distribution, new or additional registration requirements. Persons into whose possession this information comes are required to inform themselves about and to observe any restrictions that apply to the distribution of this information in their jurisdiction.

**The investment products and services mentioned here are not insured by the FDIC (or any other state or federal agency), are not deposits of or guaranteed by any bank, and may lose value.**

This information should not be published in hard copy, electronic form, via the web or in any other medium accessible to the public, unless authorized by BNY Mellon Investment Management.

**Issuing entities**

United States: BNY Mellon Investment Management. Securities are offered through MBSC Securities Corporation, distributor, member FINRA and a broker-dealer within BNY Mellon Investment Management. • Canada: Securities are offered through BNY Mellon Asset Management Canada Ltd., registered as a Portfolio Manager and Exempt Market Dealer in all provinces and territories of Canada, and as an Investment Fund Manager and Commodity Trading Manager in Ontario. The issuing entities above are BNY Mellon entities ultimately owned by The Bank of New York Mellon Corporation.