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HOW TO MANAGE VOLATILITY AND DRAWDOWN RISKS WITHOUT FOREGOING UPSIDE POTENTIAL?

2016 wrought seismic changes on the world's political landscape, epitomised by the twin shocks of the US presidential election and the UK referendum on leaving the EU.

Yet these events barely registered as a tremor in financial markets: equities pushed higher through the year and the VIX measure of volatility remained subdued other than immediately after the aforementioned votes.

2017 has seemed even quieter so far, with centrist candidates performing well in the Dutch and French elections and the status quo expected to prevail in September's German election.

This does not mean investors can afford to be complacent, however. Geopolitical tensions around North Korea are elevated, global monetary policy is tightening, and many asset valuations are high by historical standards. Any of these issues could spur a resurgence of market volatility on their own, let alone in combination.

Should a correction occur, it is worth remembering the severe impact of drawdowns on portfolios. A 40% drawdown – milder than that experienced by equities in the financial crisis – mathematically requires a 67% gain to break even again. That recovery will be particularly difficult in a low-return world: the annualised return from a traditional balanced portfolio with 50% in US bonds and 50% in US equities was 8% over the past 10 years, but Pioneer Investments forecasts it dropping to 4.9% for the next decade.

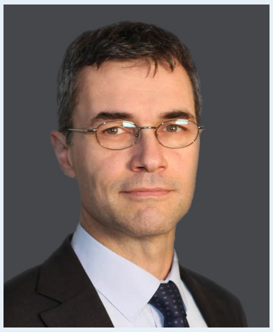
Investors seeking to manage their exposure to volatility and minimise drawdown must therefore consider non-traditional allocations. Davide Cataldo, head of multi-strategy portfolios at Pioneer Investments, seeks positive absolute returns through a process based on four 'pillars': a macro strategy reflecting his team's view of the world; macro hedging that considers risks based on alternative scenario modelling; satellite strategies of diversified ideas with low correlations; and security selection focused on high-quality fixed-income instruments.

'True alpha is not generated from single trades,' Cataldo observed. 'It is the result of a carefully built portfolio of multiple, independent strategies.'

One alternative strategy that can be overlooked by investors is an allocation to currencies. 'It is by far the most liquid and largest capital market in the world, and with the right approach you can extract a reasonable result,' explained Andreas König, head of foreign exchange, Europe, at Pioneer Investments. 'For investors it is very important – especially at the moment, in a zero and low-yield environment where everybody has enough exposure to traditional asset classes already – to look for alternatives. Currencies are one alternative.'

Of course, volatility can also be a source of return rather than a mere risk factor. Fabio Di Giansante, head of long/short European equity at Pioneer Investments, employs a market-neutral approach to produce returns isolated from the macro environment and generate alpha through fundamental stock picking.

'The way we manage volatility is more as an opportunity than as a risk,' said Di Giansante. 'We understand that at the moment there are huge elections going on, which can create some beta drawdown risk in various portfolios. For us, this political risk gives us alpha opportunities.'



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