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FA TALKS

TWO SIDES OF THE SAME COIN: OPTIMIZING RISK & RETURN

Emily Wellikoff recently chatted with Michael McClary, Chief Investment Officer at TOPS®/ ValMark Advisers, to get his perspective on managing volatility.

FA TALKS IS AN INTERVIEW SERIES WHERE INDUSTRY THINKERS SHARE THEIR THOUGHTS AND PERSPECTIVES ON A VARIETY OF MARKET TRENDS AND THEMES IMPACTING INDEXING.

MICHAEL MCCLARY
Chief Investment Officer, TOPS/ValMark Advisers

Michael McClary has been with ValMark, a leading national independent wealth management firm with offices in over 30 states and over USD 7 billion in assets, since 2003. Mr. McClary has direct responsibility for ValMark Investment Alliance™. Michael also oversees all broker-dealer investment products for ValMark Securities, Inc. and leads the Portfolio Management Team for The Optimized Portfolio System (TOPS).

S&P DJI: What are managed volatility strategies?

Michael McClary: I think that it is best to first define the movement of dynamic risk management. Dynamic risk management is multifaceted management of investment portfolios with a focus first on risk management. I have a saying, "don't ever mention return without mentioning risk in the same sentence."

In this area of investing, there have been three key areas of development: low volatility strategies, risk parity strategies and managed volatility strategies.

Low volatility strategies typically take an asset class or index and overweight underlying holdings that have typically exhibited, or are expected to exhibit, lower volatility than other holdings. For example, there are several options for the S&P 500® where lower volatility stocks are overweighted.

A second option that has developed is risk parity funds. Typically, risk parity funds combine stocks, bonds and alternative investments. Sometimes, funds allocate about a third to each area. Whether algorithmically or through a manager selection process, risk parity funds then typically adjust the allocations over time in an attempt to dynamically manage the risk.

We are fortunate to have been pioneers in the managed volatility area. Managed volatility strategies typically manifest as portfolios that adjust allocations based on volatility triggers. For example, our three primary managed volatility portfolios have risk (standard deviation) targets of 8%, 10%, and 12%, and we are able to manage to our targeted risk levels by decreasing or increasing exposure to stocks over time.

S&P DJI: Why are these strategies important in today's investment landscape?

Michael McClary: We have research showing that many of the most significant market pullbacks have historically occurred during periods of high volatility. While many traditional strategies assume that volatility risk is constant over time, managed volatility strategies adjust allocations with the premise that risk is higher in periods of high volatility.

For example, 2008 was a high volatility bear market. As such, investors that reduced exposure to stocks when volatility increased would have generally experienced lower losses. When describing our strategy, I often describe it as a way to adjust the speed in your car to allow for the driving conditions. In our strategy, we simply monitor the weather and we reduce the speed of our car (exposure to stocks) when the weather gets bad. If I said that you were most likely to get into a wreck on days when it snowed more than five inches and I told you exactly when those days would be, wouldn't it make sense for you to slow down on those days? Our strategy aims to do that. And remember, in investing, as in life, the pain of loss is far greater than the joys of gain.

S&P DJI: Who do these strategies appeal to, and why?

Michael McClary: We saw a need for managed volatility strategies to be applied in retirement income products. In 2010, we started telling insurance companies about how managed volatility strategies could improve their overall product offering. The movement that we started caught fire and nearly all insurance companies have now implemented managed volatility strategies. Many major asset managers have also launched their version of managed volatility funds.

As the movement started in the insurance community, it was the insurance-based advisors that first gravitated to the story. Now, we are seeing RIAs understanding the benefits. Properly implemented managed volatility strategies may help to increase an investor's overall chances of success, especially when they are taking withdrawals from an account.

S&P DJI: Can you delve a bit more into the potential benefits to investors?

Michael McClary: Putting managed volatility funds inside insurance products is one of the best alignment of interests I have ever seen. By using managed volatility funds, we seek to reduce the chances that an investor will run out of money. That benefits the insurance companies and enables them to offer more competitive products. And in some cases, it enables them to offer solutions that they wouldn't be able to offer otherwise. Likewise, the client's number one goal is also to not run out of money. By trying to reduce the actuarial odds of running out of money, managed volatility funds may help to align the interests of the investors and the insurance companies.

Fortunately for investors, they now get a highly sophisticated institutional-level investment strategy, which might not be offered if the institutional providers didn't have interests that were aligned. Our ETF portfolios offer a level of investment sophistication that 10 years ago, was reserved for investors with over USD 100 million.

S&P DJI: How are advisors currently implementing these strategies?

Michael McClary: While some individual asset class options exist, we typically see advisors using managers that manage a whole portfolio with a managed volatility overlay.

S&P DJI: What is your firm's approach to managing volatility?

Michael McClary: We put together two main levels of risk management. We start with a specially designed global mix of asset classes. We attempt to optimize the risk-return tradeoff in this mix. I often state our goal as "giving you the most return possible for a given level of risk." We work with our partner Milliman Financial Risk Management to implement the managed risk overlay, called the Milliman Managed Risk Strategy (MMRS). For those who aren't familiar with Milliman, they're one of the leading experts in the world on institutional hedging and risk management.

There are some strategies that use one general volatility measure to adjust their stock exposure. We instead use a proprietary algorithm designed to gauge the risk level of our exact portfolio. Likewise, we use index-based futures contracts to hedge our risk and feel that there are advantages to using index-based futures over using options contracts or simply allocating among stock, bonds and alternative investments. Another differentiator of our strategy is our use of a proprietary capital protection strategy in concert with our managed volatility overlay. The capital protection strategy acts as an emergency brake, providing gains when markets go down.

S&P DJI: What do you look for in a managed volatility benchmark?

Michael McClary: Being one of the first managed volatility managers, we struggled to find appropriate general benchmarks. Since classical active management is geared towards benchmarking, and appropriately so, we felt that we needed to provide advisors and investors the comfort of showing a benchmark. In our early years, the best option we had was the S&P 500 Risk Control Index. While the S&P 500 Risk Control Index has volatility management, the method was much different than what we use and the concentration in the S&P 500 didn't appropriately account for our global mix.

In years of significant divergence between U.S. and international stocks, it is especially important to properly account for global exposure in your benchmarks. We worked with S&P DJI to create some new volatility benchmarks that utilized an underlying global mix—a new group of risk control indices based on the S&P Global BMI. We also collaborated to adjust the risk control methodology, making it more practical for investors.

S&P DJI: How does the current market environment affect your strategy?

Michael McClary: With the S&P 500 near an all-time high and with valuations rising, reducing risk by globally diversifying may be important. A managed risk overlay strategy may help to achieve that. It may also be wise to consider the current precarious interest rate environment. We are proud of the unique fixed income mix in our portfolios, which is strategically designed to optimize risk and return in this climate.