Transition Volatility

Q3 2020

Balancing the costs

By James Freeman, CFA

Transitioning between platforms can result in a client's portfolio being out of the market for approximately 2 weeks. Timing such a transition is an unenviable task. It is subject to the opportunity cost of perfect hindsight and the fear of missing out on gains that may occur over those weeks. FOMO indeed. This need not be a paralysing task though. At some point the risks a portfolio remains exposed to exceeds the uncertainty one is trying to manage. What context can history provide?

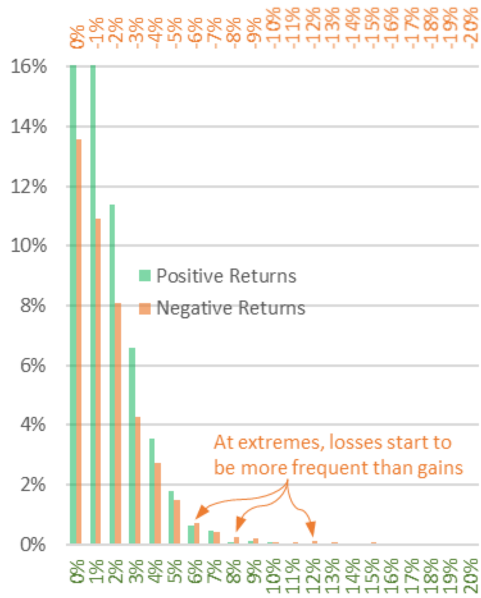
Opportunity cost

Looking at the S&P/ASX200 price index, we calculated the largest 10-day market gains. Of the7056 10-day periods since 1992:

- 227 gained 5% or more; that's 3.2% of the time.
- 11 gained 10% or more; that's 0.2% of the time.

Multi-asset portfolios are more diversified than ASX200; so this represents the worst case scenario in terms of opportunity cost from an asset class perspective. Opportunity costs of 5% or more are rare.

Chart 1. S&P/ASX200 Price Return Frequency



Portfolio risk

When not in transition the portfolio remains exposed to market movements. Once again, looking at the S&P/ASX200 price index, we calculated the largest 10-day market losses. Losses to which one remains exposed while trying to avoid an opportunity cost. Of the 7056 10-day periods since 1992:

- 253 lost -5% or more; that's 3.6% of the time.
- 39 lost -10% or more; that's 0.6% of the time.

While rare, extreme losses have been slightly more common than extreme gains since 1992.

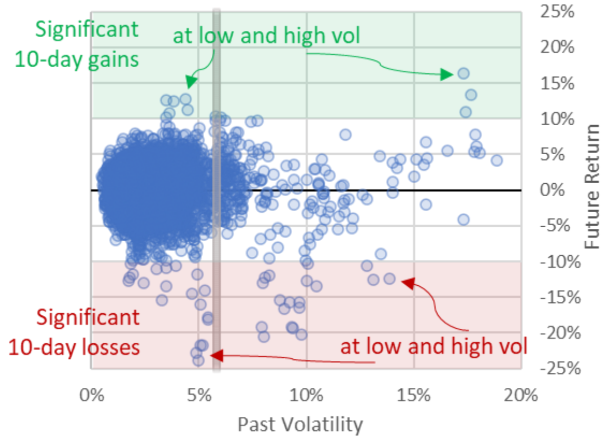
The frequency of extreme losses exceeds that of extreme gains. The risk, however unlikely, of significant market losses is borne every day by a diversified investment portfolio. The risk of missing out on significant market gains, is less frequent, but more annoying.

Market Volatility

Are there obviously worse times to undertake a transition? Looking at the rolling 10-day volatility of the Australian market compared to returns over the next 10 days, we see no obvious relationship.

- Significant 10-day losses can be found at both low and high trailing volatility levels;
- Significant 10-day gains can be similarly found at both low and high trailing volatility levels.
- There have been more extreme losses at times of higher than average volatility. Since 1992 there have been 33 losses of 10% or more when trailing volatility has been greater than average, compared to 11 gains of 10% or more.

Chart 2. Past volatility vs. future returns



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Where do we stand?

At the time of writing (June 2020), we are part way through the COVID-19 pandemic crisis. Volatility levels have spiked and receded. While nowhere near their highs, volatility has oscillated at levels higher than the long-term average level of 3.11%. The current level of 3.98% (as at 30/06/2020) is higher than average, but it is not uncommon, having been exceeded in all but 5 of the past 28 years.

Chart 3. Long term rolling 10 trading day volatility

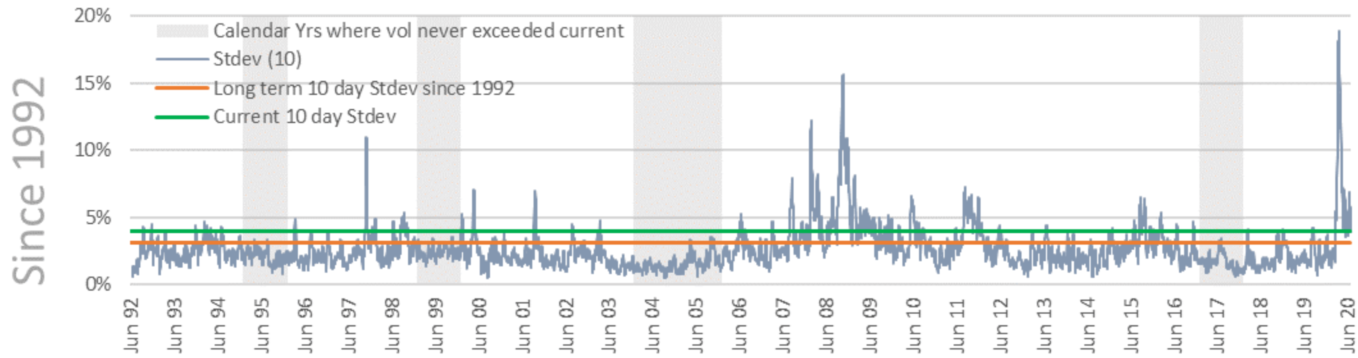
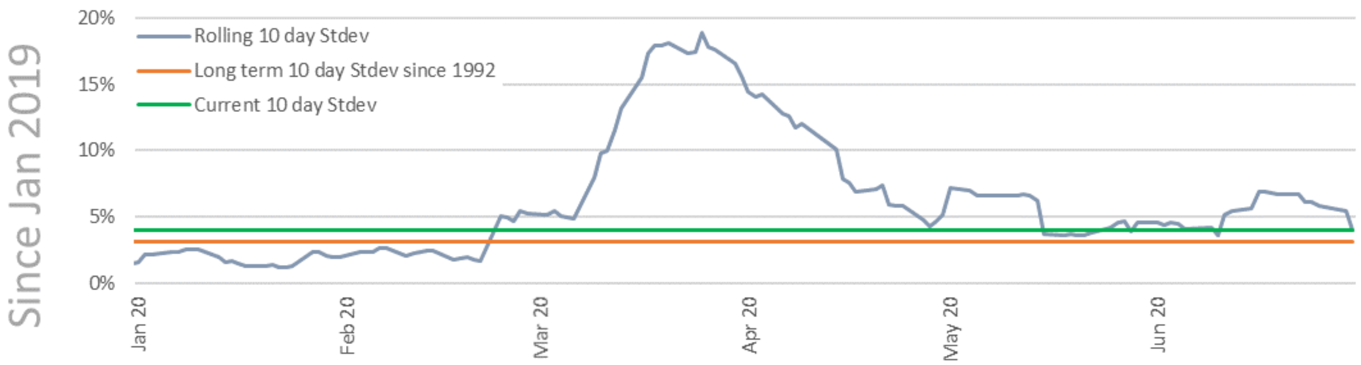


Chart 4. Recent rolling 10 trading day volatility



This analysis has reviewed equity market volatility and extreme return risk. A well-designed multi-asset portfolio will have significantly less extreme performance characteristics than the equity market shown here, muting the impact of opportunity cost markedly.

This analysis also ignores the reason for a transition. The potential for enhanced service, transparency, investment opportunity set and dynamic management that comes with a move to a new portfolio management regime has a positive value. Delay creates an uncertain opportunity cost of its own.

We have seen that the frequency of extreme opportunity cost in transition is lower than extreme losses while waiting, and that trailing 10-day volatility provides no clear guide to timing transitions. This historic analysis provides no evidence to support delaying transition on recent volatility levels alone.