
VOLATILITY IS COMING. ARE YOU PREPARED?

Pierre Debru – Head of Quantitative Research and Multi Asset Solutions, WisdomTree Europe.
23 Sep 2020

Upon entering the fourth quarter of a literally unbelievable year, it feels like the world is waiting for the next “thing” to happen. Investors already had to contend with the fastest bear market in history, the fastest recovery, a tech boom...what now?

Listening to market participants and looking at the CBOE Volatility Index (VIX) market, in particular, it appears that more volatility could be next. With a new increase in COVID-19 infections and the US election on the horizon, this would not be very surprising.

Volatility is usually the poster child for unpredictability. Changes in VIX regime are notoriously hard to anticipate. However, for once, volatility may have sent us advance notice. So, to prepare for Q4, investors could look back at what worked historically and what did not.

From our own analysis, it is clear that some strategies are more suited to a period of increased volatility and risk:

- among equities strategies, Quality stands out with a balanced performance profile, protecting portfolios when risk is rising and benefitting from the normalizing period after
- diversifying assets like Gold and Long Duration government bonds typically provide a very nice buffer both before, during and after the increase in volatility.

The market expects the months of October and November to be very volatile

2020 has proved to be a high volatility year, but looking forward, volatility traders are pricing and have been pricing for a while an even more volatile autumn. From a VIX at 25 currently (as of 14th September), traders are seeing levels upward of 30 a few weeks down the line. Whether this increased volatility is the results of a jump in coronavirus infections, uncertainties around a potential vaccine, a disputed US elections or signs of weaknesses in the current tech led rally, does not dramatically change the stark message to investors: “Prepare!”

Figure 1: The VIX Future Curve is pricing an increase in Volatility for October



Source: WisdomTree, Bloomberg. As of 14th September 2020.

Historical performance is not an indication of future performance and any investments may go down in value.

Which assets resisted the best to the most recent volatility spike: Gold, Long Duration Government Bonds and Quality

Assuming that volatility is coming then what is the smart choice for a portfolio? How to protect and benefit from such a period? As always, history is an excellent teacher.

In this blog, we aim to study the behaviour of different assets around changes in volatility regimes i.e. before, during and after the volatility spike itself. To do so we consider 3 different periods:

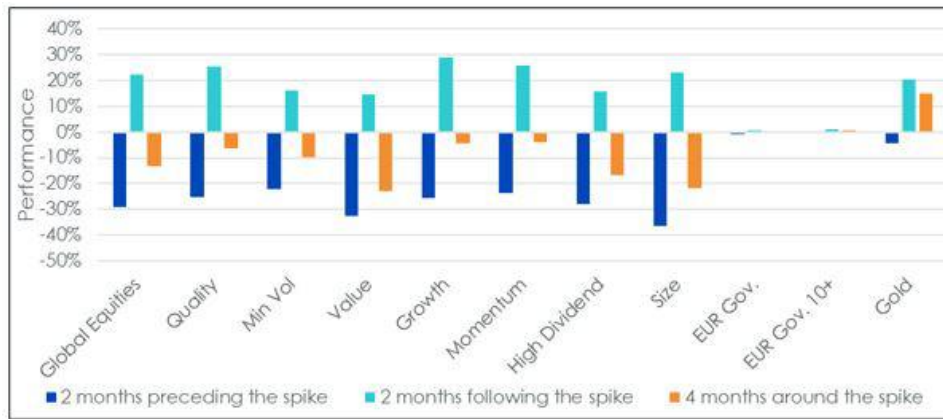
- the 2 months that precede a daily spike in VIX
- the 2 months that follow a daily spike in VIX
- the 4 months around a daily spike in VIX (2 months before and 2 months after)

As a first step, let's look at what happened this year around the biggest volatility spike (+24.86 on the 16th March 2020).

In Figure 2, we observe that the strongest performers before the spike were Government Bonds, Gold and Min Volatility. After the spike, though the best performers were Gold, Growth and then Momentum and Quality tied for third. These are two very different lists; one is more defensive and the other one is more cyclical in nature. So which asset did the best over the whole period?

In the multi asset realm, Gold benefitted the most, of course, being in both top 3 and benefitting from its all-weather behaviour. Long duration government bonds followed just after. In the equity world, Momentum, Growth and Quality did the best. Momentum and Growth got pushed by the Tech rally in Q2 and Q3 and Quality benefitted from its balanced profile, doing well before and after the spike.

Figure 2: Assets performance around the 16th March 2020 volatility spike



Source: WisdomTree, Bloomberg. 16 January 2020 and 16 May 2020. All returns are in euros. More details about the indices used at the end of this blog.

Historical performance is not an indication of future performance and any investments may go down in value.

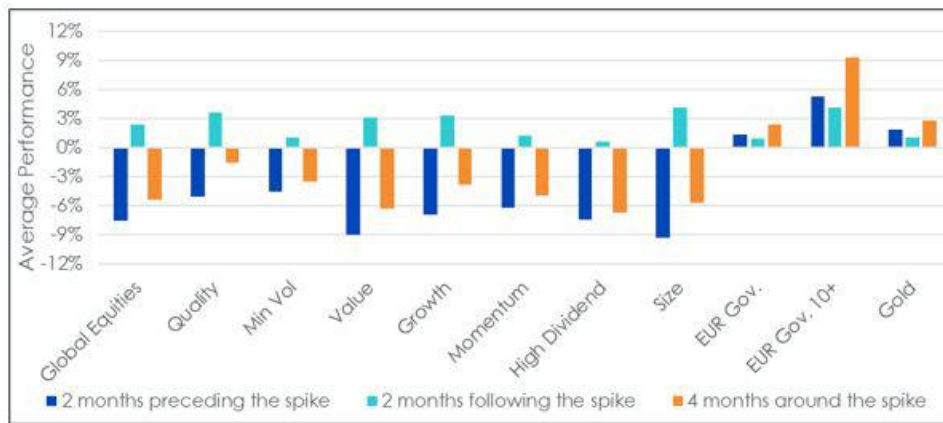
All-weather assets, like Gold and Quality, are particularly suited to navigate the lead-up and the aftermath of a volatility spike

Trying to generalize our findings further, we look at the lead up and aftermath periods to all volatility spikes since 2002. A volatility spike is defined as an increase in VIX of 5 points or more.

In Figure 3, we can clearly see that:

- Defensive assets tend to do very well in the period preceding the volatility spikes. The Top 4 performers in those lead-up periods historically have been Gold, EUR Government Bonds, Min volatility Equities and Quality Equities. Over those two months, Gold has outperformed Global Equities on average by 13.1%, government Bonds have outperformed by 9%. In the equities, Min volatility has outperformed by 3.8% and Quality by 1.8%. Those results are very consistent with our observation in March 2020.
- In the aftermath, i.e. in the period immediately following the volatility spike, the Top 4 is quite different. First comes Gold with 2.8% average performance over the period (vs +0.5% for Global Equities) then Quality just behind with +2.6%. Government bonds are third and Growth and Momentum are tied for fourth with a positive performance of 1.17% over the 2 months. Again, those results are quite similar to our observations in Q1 this year. It is worth noting though, that Growth and Momentum have “outperformed” their historical average this year thanks to the current Tech rally which may or may not continue in the last quarter of the year.

Figure 3: Average performance around volatility spikes



Source: WisdomTree, Bloomberg. July 2002 to September 2020. All returns are in euros. More details about the indices used at the end of this blog.

Historical performance is not an indication of future performance and any investments may go down in value.

What these two analysis show is that historically the assets the best suited to deal with periods of heightened volatility are all-weather type assets i.e. asset with strong defensiveness in the downside and with the capabilities to capture a large part of the upside. In our analysis such assets have proven to be:

- Quality Equities
- Long Duration Government Bonds
- Gold

Looking ahead, many investors are formulating their views and resulting asset allocation on potential election results. If a democratic administration plus a democratic congress took control, there could be more spending which could eventually lead to higher inflation. If Republicans were to maintain control, that could possibly mean lower tax rates for a longer time and less fiscal restraint. Massive time and research are spent on analyzing individual companies with these possibilities in mind. However, we do not find as many people framing their considerations of equities, fixed income or gold purely from the standpoint of wanting to be reading for higher volatility.

Dialling up gold, long duration government bond and Quality exposure, as one example, could be a good step towards 'volatility readiness' in light of historical patterns and the upcoming uncertainty in the markets.

Global equities are proxied by the MSCI World net TR Index. **Min Vol** is proxied by MSCI World Min Volatility net total return index. **Quality** is proxied by MSCI world Quality net total return index. **High Dividend** is proxied by MSCI world High Dividend net total return index. **Value** is proxied by MSCI World Enhanced Value net total return index. **Momentum** is proxied by MSCI world Momentum net total return index.. **EUR Gov.** is proxied by Bloomberg Barclays Euro-Aggregate: Treasury Index net Total Return. **EUR Gov. 10+** is proxied by Bloomberg Barclays Euro-Aggregate: Treasury 10+ Index net Total Return. **Gold**

is proxied by LBMA Gold Price PM USD.

Related blogs

- + [A moment in markets – Don't be surprised by a bit of volatility](#)
- + [Dollar depreciation and ultra-low Treasury yields provide gold and silver a base to continue with strong gains](#)
- + [Quality Investing, an All-Weather Approach](#)
- + [Defensive Assets: Gold, a precious ally in the fight against equity drawdown](#)

Related products

- + [WisdomTree Eurozone Quality Dividend Growth UCITS ETF – EUR Acc](#)
- + [WisdomTree Global Quality Dividend Growth UCITS ETF – USD Acc](#)
- + [WisdomTree US Quality Dividend Growth UCITS ETF – USD Acc](#)
- + [WisdomTree Physical Swiss Gold](#)
- + [WisdomTree EUR Government Bond Enhanced Yield UCITS ETF – EUR](#)

View the online version of this article [here](#).

Important Information

Marketing communications issued in the European Economic Area (“EEA”): This document has been issued and approved by WisdomTree Ireland Limited, which is authorised and regulated by the Central Bank of Ireland.

Marketing communications issued in jurisdictions outside of the EEA: This document has been issued and approved by WisdomTree UK Limited, which is authorised and regulated by the United Kingdom Financial Conduct Authority.

WisdomTree Ireland Limited and WisdomTree UK Limited are each referred to as “WisdomTree” (as applicable). Our Conflicts of Interest Policy and Inventory are available on request.

For professional clients only. The information contained in this document is for your general information only and is neither an offer for sale nor a solicitation of an offer to buy securities or shares. This document should not be used as the basis for any investment decision. Investments may go up or down in value and you may lose some or all of the amount invested. Past performance is not necessarily a guide to future performance. Any decision to invest should be based on the information contained in the appropriate prospectus and after seeking independent investment, tax and legal advice.

The application of regulations and tax laws can often lead to a number of different interpretations. Any views or opinions expressed in this communication represent the views of WisdomTree and should not be construed as regulatory, tax or legal advice. WisdomTree makes no warranty or representation as to the accuracy of any of the views or opinions expressed in this communication. Any decision to invest should be based on the information contained in the appropriate prospectus and after seeking independent investment, tax and legal advice.

This document is not, and under no circumstances is to be construed as, an advertisement or any other step in furtherance of a public offering of shares or securities in the United States or any province or territory thereof. Neither this document nor any copy hereof should be taken, transmitted or distributed (directly or indirectly) into the United States.

Although WisdomTree endeavours to ensure the accuracy of the content in this document, WisdomTree does not warrant or guarantee its accuracy or correctness. Where WisdomTree has expressed its own opinions related to product or market activity, these views may change. Neither WisdomTree, nor any affiliate, nor any of their respective officers, directors, partners, or employees accepts any liability whatsoever for any direct or consequential loss arising from any use of this document or its contents.