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Actively managed low beta: Accessing the benefits while managing potential risks

Low-beta equity opportunities can be found across all global markets and sectors.

Investing in these opportunities with traditional low-beta strategies can incur unintended risks from significant country, sector, and duration exposures versus cap-weighted benchmarks.

Such non-security-specific risks can be amplified in a rising-rate environment if not actively managed.

Over the past several years, much has been written about the low-beta anomaly — that, contrary to traditional finance theory, stocks with lower betas have actually had higher returns over time than higher beta stocks — particularly when viewed through a risk-adjusted lens.

Very little, however, has been written about the potential risks embedded in traditionally implemented low-beta strategies. Also missing from the discussion is how sponsors can actively discriminate among manager strategies and mitigate these risks.

For use with institutional investors and investment professionals.

Mitigating unintended risks through active management

Traditional low-beta strategies generally attempt to capitalize on the beta anomaly through portfolios constructed to focus on the lowest beta stocks within the investible universe. This approach to security selection, however, can incur significant overweight exposures to low-beta countries and sectors versus cap-weighted benchmarks.

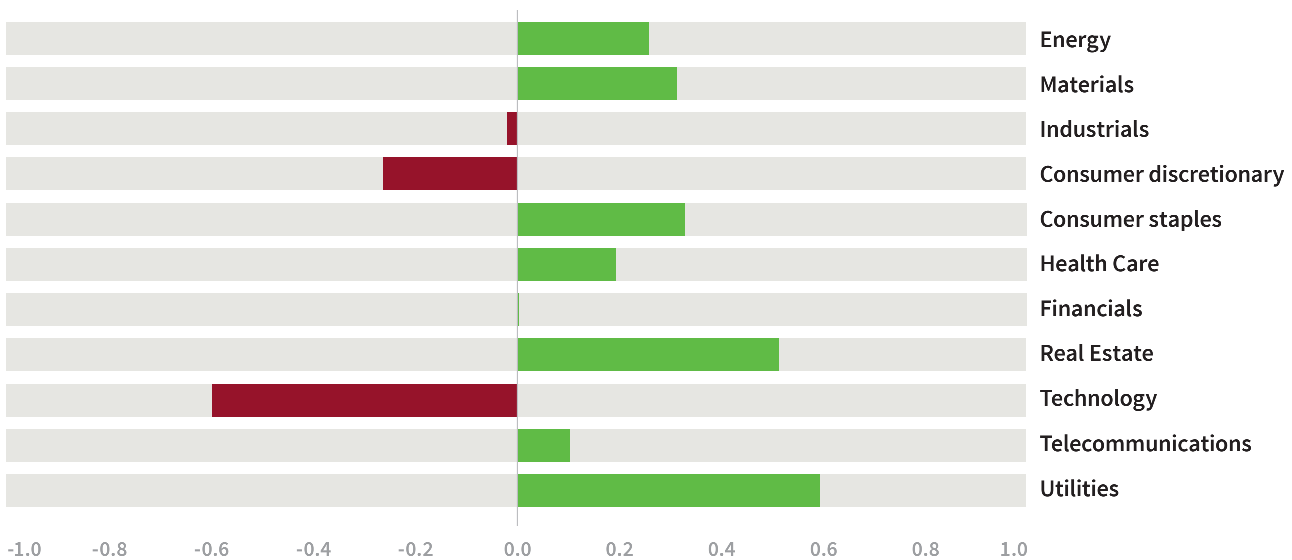
An index comparison provides a useful proxy to highlight the difference in sector exposures that result from a traditional low-beta approach versus a cap-weighted benchmark. The MSCI World Minimum Volatility Index held approximately 50% of its allocation to the traditional low-beta sectors of consumer staples, health care, utilities, and telecommunications as of December 31, 2016. These sectors represented under 30% of the MSCI World Index as of the same date.

Importantly, the sectors with the lowest beta also tend to be the most interest-rate-sensitive sectors, which means that strategies that focus only on the lowest beta stocks without considering sector exposure may also introduce significant interest-rate risk to a portfolio. Figure 1 demonstrates the implied interest-rate sensitivity of traditional low-beta sectors over the past approximately 20 years. This exposure can be particularly harmful in a rising-rate environment.

Taking these unintended risks appears to be unnecessary according to Putnam's research, which demonstrates that there is an inverse relationship between beta and risk-adjusted returns within every sector as well as across countries. In fact, low-beta stocks have provided better long-term Sharpe ratios than high-beta stocks in nine of 10 industry sectors, as measured from February 1997 to June 2016.

FIGURE 1

Traditional low-beta sectors are correlated to movements in interest rates



Sources: Bloomberg, Putnam. Data is as of 12/31/16.

An extreme example of the interest-rate risk embedded in a traditional low-beta strategy occurred when rates spiked during the so-called "Taper Tantrum" in the summer of 2013. During this period, traditional low-beta sectors such as consumer staples, utilities, and telecom underperformed significantly, as did the low-beta MSCI World Minimum Volatility Index (Figure 2).

These examples highlight that traditional strategies targeting the low-beta anomaly require closer analysis of their limitations for pursuing better risk-adjusted performance.

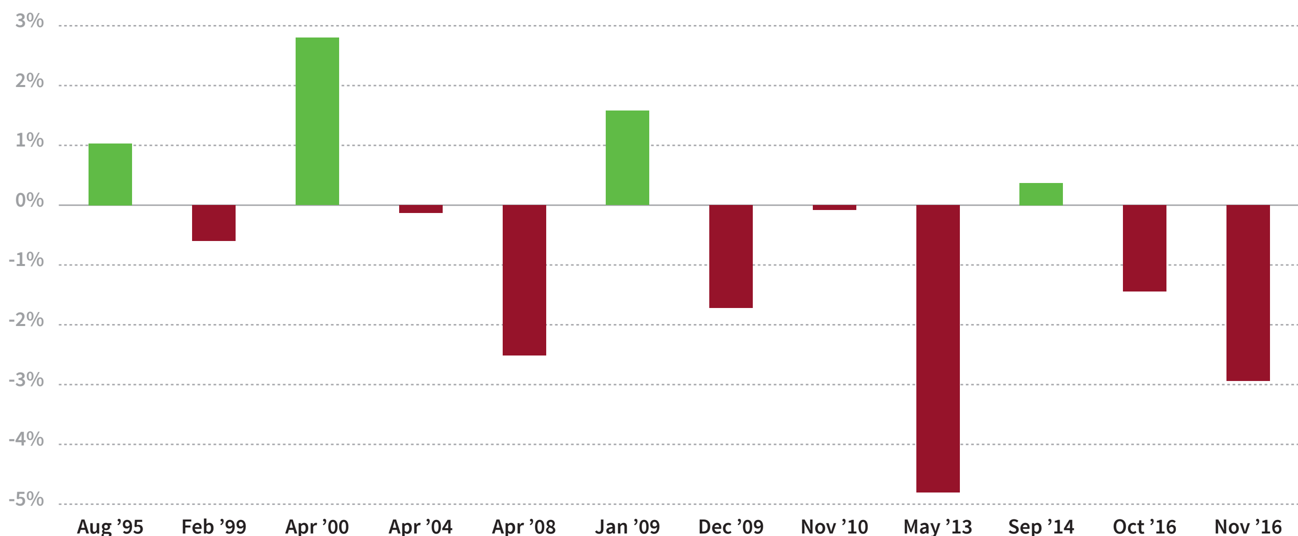
Pursuing the beta anomaly with a more robust approach to risk mitigation

After a long period of policy repression around the globe, odds are increasing that central banks may begin to tighten monetary policy. As interest rates begin to rise, active risk management and flexibility to favor less rate-sensitive sectors within low-beta strategies is likely to be particularly valuable to protect against unwanted risks. If left unchecked, these risks have the potential to undermine the overall objective of these strategies to deliver better risk-adjusted performance. Active management that focuses on constructing a portfolio with high exposure to low-beta stocks within each sector, minimal industry risk, and minimal exposure to most other risk factors is one way to mitigate duration risk over the long term.

FIGURE 2

Rate spikes highlight a risk embedded in traditional low-beta portfolio construction

Relative performance of MSCI World Minimum Volatility vs. MSCI World in months when WGBI was down more than 3%



Sources: Bloomberg, Putnam. Data is as of 12/31/16.

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