THE INVESTMENT ASSOCIATION

THE INVESTMENT ASSOCIATION VOLATILITY MANAGED SECTOR

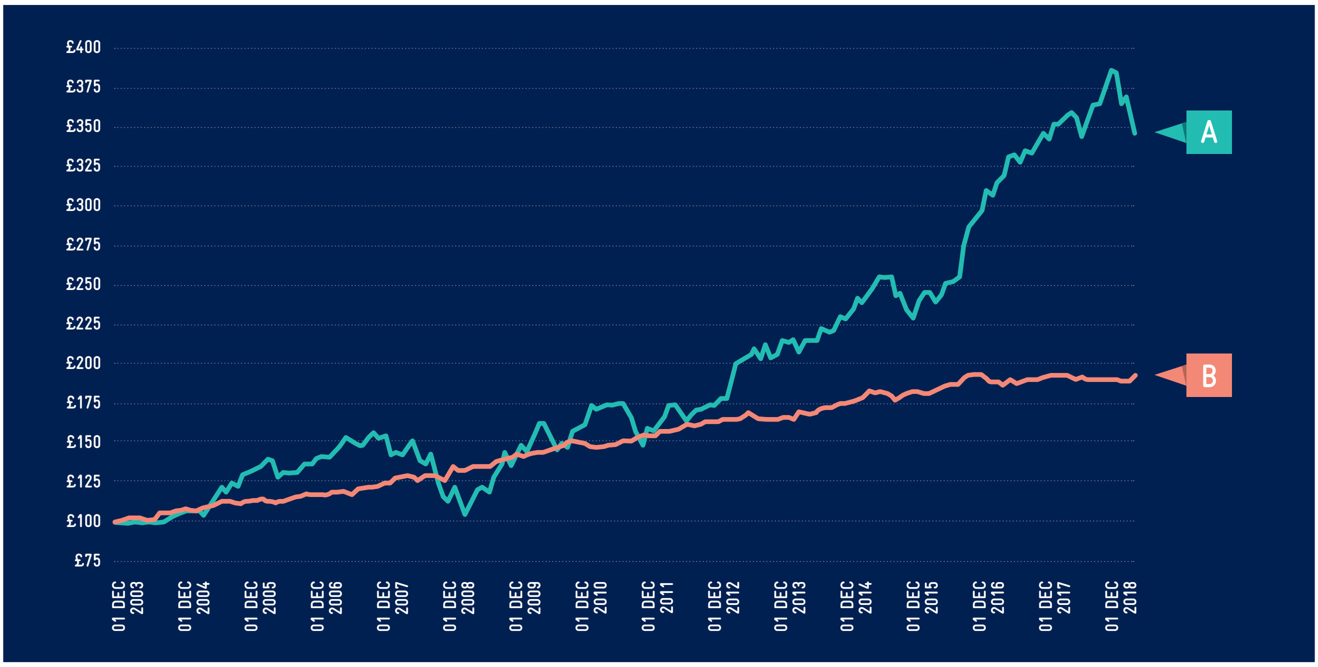
BACKGROUND

The Investment Association launched the Volatility Managed Sector on the 3rd April 2017 as a response to a growing number of funds that were aiming to deliver outcomes based around volatility and risk. Many of these funds were launched post the 2008/9 Financial Crisis when high levels of volatility in the market led to unexpectedly large losses for investors. Asset Managers in recent years have focused on designing products that would give clients outcomes that would suit an individual's particular appetite for taking risk. Many of those firms who addressed this client need did so by setting up suites of funds with a range of risk outcomes to cater for client's individual attitude to risk taking when investing.

SO WHAT IS VOLATILITY?

Simply, volatility is the extent of the ups and downs of price of a fund over time. If the price swings up and down frequently or with large movements, it has high volatility. If the price moves more slowly and to a lesser extent, it has lower volatility. Investors can use volatility as a measure of the riskiness of an investment.

To illustrate this, the below chart shows the return of £100 invested in Global Equities (line A) and Global Bonds (line B) over the past 15 years. Global Equities (A) have exhibited bigger ups and downs than Global Bonds (B). Global Equities for the time period analysed are therefore more volatile than Global Bonds.



The Investment Association (IA) supports UK investment management, supporting British savers, investors and businesses. Our 250 members manage £7.7 trillion, £1.8 trillion of which is on behalf of European clients providing the UK with an important economic contribution in the form of export earnings, tax paid, and jobs created.

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Target volatility is usually expressed as either absolute or relative. Absolute volatility gives an investor the likely deviation of a fund away from its average return expectations. Relative volatility is normally expressed by reference to the volatility of another asset. For example, one might express the target of a fund as a percentage of Global Equity volatility.

HOW IS VOLATILITY MEASURED?

Volatility can be measured or calculated in a number of ways:

Realised (also known as historical volatility) is one measure of volatility which measures the variation of historic returns over a specific time period – it measures what actually happened in the past.

Forecast or implied volatility, uses models and assumptions that forecast the possible variation of returns of investments over varying timeframes in the ***future***. It can be calculated in a number of ways.

HOW DO FUNDS TARGET VOLATILITY?

There are many ways in which funds can be structured to give a specific volatility outcome. Many will blend several asset types (Equities, Bonds, Cash and other investments) to achieve a particular volatility outcome. Even where funds have similar volatility outcomes, they may have different asset allocations, rules around diversification and different assumptions within the risk models used to predict volatility.

For most, but not all, funds in the sector the starting point for allocating between asset types is based around a process that looks to deliver the highest potential return for a given level of volatility. This is often referred to by Asset Managers as risk/return optimisation. These assumptions are usually long term (10 years or longer) and are based on a best estimate of the return and risk expectations for different asset classes. Managers may also choose to adjust the asset allocation of a fund based on short term market views not factored into those long-term expectations.

HOW CAN INVESTORS USE THE IA VOLATILITY MANAGED SECTOR?

The IA Sector contains funds that target various levels of volatility and therefore can give a broad range of risk and return outcomes. Some Asset Managers within the IA Sector have ranges of multiple funds that target low to high levels of volatility. Other Asset Managers have single funds in the sector that target a specific volatility outcome. As a result, investors should not use the sector for comparing fund performance as this would not give a like for like comparison. The main key purpose of the sector is to enable investors to find providers that are offering funds managed to a volatility outcome. Depending on the sophistication of the investor they should then either carry out their own due diligence on the potential investment or seek Financial Advice. This advice will seek to match an individual's risk and return appetite with potential funds for investment.

The Investment Association have committed to review the sector periodically to see if further subdivision would provide investors with the ability to compare fund performance on like for like basis. Previous efforts in this regard have been hampered due to the complex variety of investment processes, time frames and assumptions employed by funds and the wide variety of potential volatility outcomes for clients.

Disclaimer

The purpose of this note is to provide an introductory note to the IA Volatility Managed Sector. We note that this note has been made available to the public and is informational only and should not be treated as legal advice.

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