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INSIGHT

VIEWPOINT

Investor Complacency vs. The Search for Black Swans

WILL LLOYD | JANUARY 2018

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Mr. Lloyd joined TCW in September 2014 as Managing Director, Alternative Products Group. Prior to joining TCW, Mr. Lloyd was a Managing Director at VelocityShares, where he spent the previous five years building the innovative exchange-traded products company. Mr. Lloyd joined Bridgewater Associates in 2003 as a Portfolio Strategist in the research department where he worked with institutional investors globally on the structuring of portfolios and hedge fund investments. Prior to joining Bridgewater, Mr. Lloyd was Managing Director, research at Barclays Capital in London. He had global responsibility for Portfolio Strategies, Index Products, and Securitization research. He was instrumental in the growth of Barclays' inflation-linked bond business, and was a founding board member of iBoxx plc. Mr. Lloyd joined Barclays in 1997 from Credit Suisse First Boston. He serves on the board of The Susan Fund, a charitable organization granting scholarships to cancer survivors and on the President's Council at Union College. Mr. Lloyd received a BA in Political Science from Union College and an MBA from Columbia University.

Everyone seems to be searching for black swans. Investors typically invest in alternatives seeking diversification and enhanced returns, but these days every investment is compared to the stock market. Last year's impressive equity market performance took most people by surprise. Below are some market observations from 2017 and thoughts for 2018.

Market Observations of 2017:

- Shorting Volatility: Investors' Complacency
- Growth Outperformed Value
- The Push to Passive Continues
- Private Equity Dry Powder
- The FOMO Dilemma

Shorting Volatility: Investors' Complacency

It seems that everyone wants to know what will spark the next equity sell-off, and one potential risk we see is investors' complacency with the low level of volatility. A good indicator of this complacency is investors' comfort taking direct exposure to short volatility trades. Expectations of future equity market volatility is typically measured by the CBOE's Volatility Index (VIX). The VIX has been at historically low levels for an extended period of time, but that hasn't stopped investors from shorting volatility.

Volatility-based exchange traded products (ETPs) represent a relatively small portion of the total volatility market, but ETPs provide us with an easy way to measure investors' willingness to take direct volatility exposure. As shown on the following page, the AUM in short volatility ETPs exceeded that of long volatility ETPs for most of the second half of the year, and it's usually the other way around. The growth in short volatility AUM was fueled by a combination of rising prices and the creation of new shares. By mid-September the number of shares outstanding had increased 35% since the beginning of the year.

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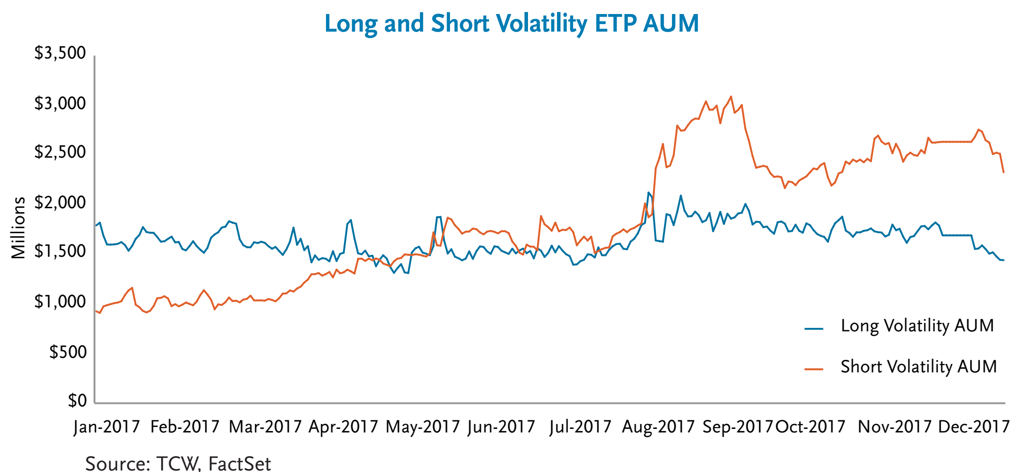
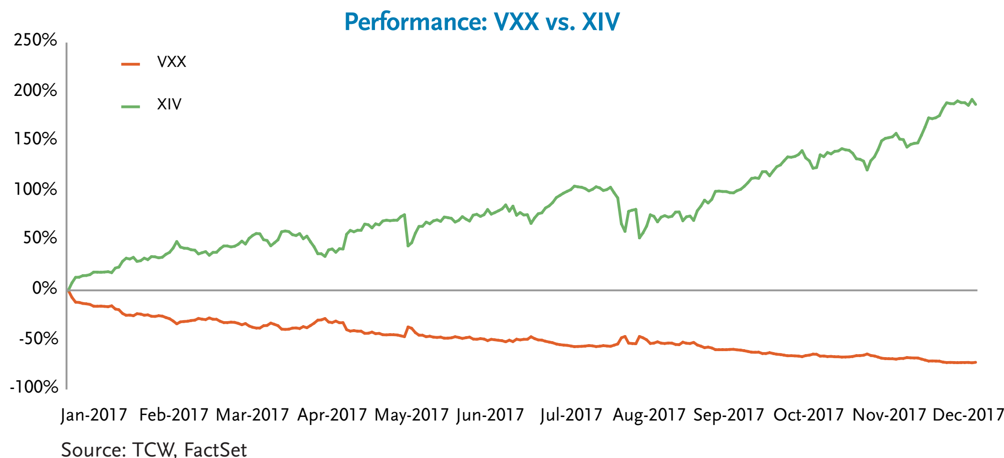
Additionally, we saw a jump in short volatility ETP creations shortly after the August VIX spike. Perhaps investors saw this as a buying opportunity, and it turns out they were right.



Source: TCW, FactSet

Investors have long known that significant returns can be earned by shorting equity volatility, while also recognizing there was significant downside if the VIX were to spike. Investors who were willing to take this risk were well rewarded in 2017. XIV (VelocityShares Inverse VIX ETN) returned more than 185% in 2017 while the long volatility ETN, VXX (iPath VIX ETN) lost more than 70% of its value. The relative stability of the VIX (which ranged from 16 to 9 in 2017), and the benefit of the contango in the futures curve apparently persuaded investors that the potential return was worth the risk.



Source: TCW, FactSet

To be clear, the performance of the XIV (short volatility) and VXX (long volatility) is based on the S&P 500 VIX Short-Term Futures Index, not on the VIX itself. The index is composed of exposures to the first and second month VIX futures contract. The shape of the VIX futures curve is usually in contango (upward sloping) and therefore an investor who is short the futures contract will earn a positive return even if the market doesn't change. In 2017, the VIX fell from 14 to 11, but it was the shape of the futures curve that generated most of the return. To put the value of the contango in perspective, at the end of 2017 the one month roll was worth 8.7% (not annualized) and as a result investors were getting paid more than just pennies for standing in front of this steamroller.

Even in this benign volatility environment there can be significant volatility. On August 10, 2017, the VIX Short-Term Futures Index fell almost 20%, opening at 11.5 and closing at 16.0. Imagine what would happen if there were to be a 2008-type spike in the VIX? There is good reason that the front page of the XIV prospectus warns in bold letters "...you are likely to lose part or all of your initial investment."

We see potential risk with respect to the rapid unwinding of this short volatility trade. A significant spike in volatility would lead to large losses in the short volatility positions. If these losses were met with redemptions of these ETPs then in theory this could push VIX futures prices higher and therefore short volatility ETP prices would drop, resulting in further selling. It is important to reiterate that volatility ETPs are a small part of the volatility market. Since the early days of VIX ETPs, much has been written about the concept that the buying of VIX ETPs could drive a sell-off in the equity market, but to-date we have not seen that event materialize.

Growth Outperformed Value

The S&P 500 Index returned 21.8% in 2017. The top 10 contributors represented almost a third of that return and most of that came from growth companies. It is no surprise that last year's strong stock market performance was driven largely by growth stocks, and more specifically by certain tech stocks. FAAMG – Facebook, Apple, Amazon, Microsoft, and Google (Alphabet) – represented 23.7% of the S&P 500's performance. Growth significantly outperformed value in both the large and small cap markets in 2017, as outlined in the table below.

2017 Index Returns

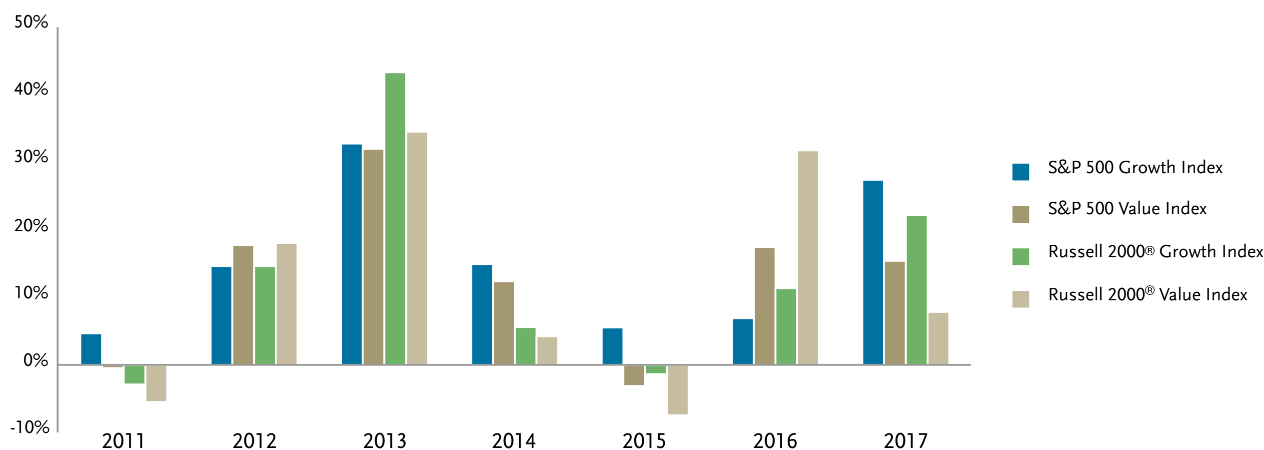
	Growth Stock Returns (%)	Value Stock Returns (%)	Difference (%)
S&P 500	27.4	15.4	12.0
Russell 2000	22.2	7.8	14.4

Source: TCW, FactSet

While it can be helpful to look at last year's returns, the more important question is, will this relative outperformance continue in 2018?

Obviously, growth and value stocks do not move in lock-step, and in some instances, such as in 2015, they move in different directions. In answering the question posed above, it is important to think about the drivers of performance, and what might cause growth to continue to outperform so significantly.

Growth vs. Value Index Returns



Source: Standard & Poor's, FTSE Russell Indices

A similar picture appears when we compare growth versus value in the small cap market. The Russell 2000 index is not as concentrated as the S&P 500, but the top 10 contributing stocks still represented 15% of the performance of the overall index, and the top 10 is dominated by growth companies.

Unlike the late 1990s, the outperformance in tech was not driven simply by an expansion of price-earnings ratios (P/E). While P/E did grow, earnings did as well. The table below presents the change in P/E over the past 12 months.*

Price/Earnings Ratios

	12/30/2016	12/29/2017	% Change
S&P Value Index	19.1	20.2	6
S&P Growth Index	22.7	25.7	13
Russell 2000® Value Index	34.5	32.7	-5
Russell 2000® Growth Index	59.0	60.8	3
Apple	13.6	18.4	35
Amazon	153.0	296.8	94
Alphabet (Google)	28.1	35.1	25
Microsoft	24.4	29.1	19
Facebook	33.0	34.2	4

Source: TCW, FactSet

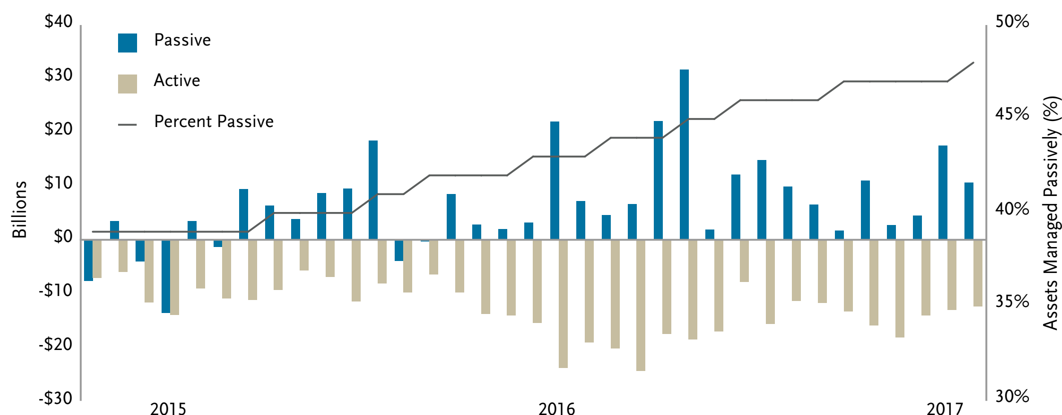
One reason that this relationship might persist in 2018 is that investors like to buy winners. Another reason that growth stocks may drive performance in the coming year is the continuation of the trend toward passive management. The weighting of FAAMG in the S&P 500 Index is now 13.3%, so for every $100 being invested in the S&P 500 Index more than $13 is being invested in these tech companies.

The Push to Passive Continues

The further shift from active to passive investment management could result in a continuation of last year's trends. By our calculation approximately 48% of '40 Act U.S. large cap equity assets are now managed passively, and we know anecdotally than many large institutional investors are following a passive approach to managing their developed market equity exposures. This means that a company's weight in the index is becoming more important than the market's view of its future prospects – increasingly capital allocation is being based on index weighting not the market's assessment of intrinsic value. Said another way, the big expensive companies attract the capital.

Last year's top 10 contributors to return accounted for 15.9% of the market cap of the S&P 500 Index at the end of 2016, and by the end of 2017 their combined weight had climbed to 18.6%. If we focus on tech, FAAMG's weight in the S&P 500 increased by 20% during the course of the year. If investors continue to chase returns, then this weight is likely to continue to increase.

Large Cap Flows



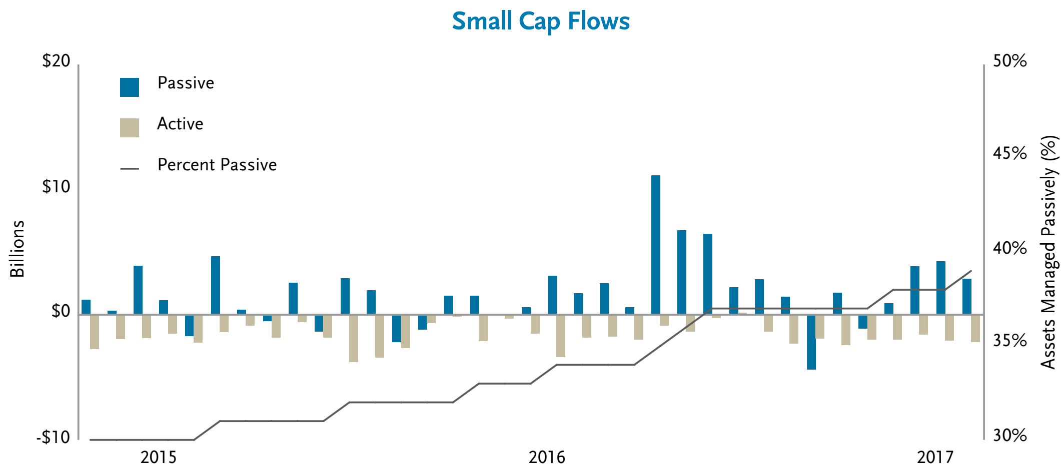
Source: TCW, Morningstar

*These calculations do not consider the impact of stock buybacks on P/E ratios.

The story has been similar in the small cap market but to a lesser degree. The flow from active to passive investing is continuing, but passive investing represents just less than 40% of the '40 Act market. As mentioned earlier, the small cap market is also much less concentrated than the large cap market. The top 10 return contributors in the Russell 2000 Index had a weight of only 1.7% at the end of the year.

We see this move to passive management as a double-edged sword for active managers: It should create more opportunities for sophisticated investors, but it will probably take longer to realize those opportunities as there would be less capital seeking mispriced companies. The opportunities are likely to be the greatest in the small cap market where many of the companies are not even covered by Wall Street equity analysts.

Small Cap Flows

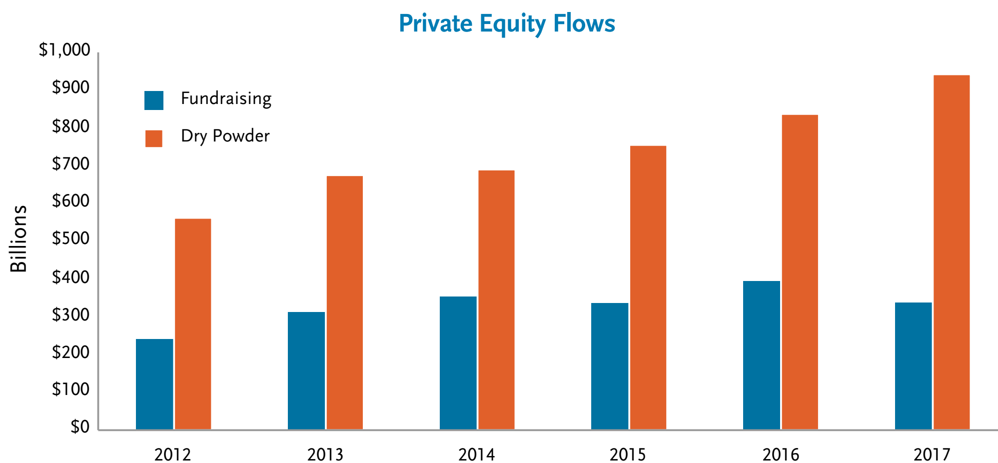


Source: TCW, Morningstar

Private Equity Dry Powder

Another observation of 2017 was the continued growth in assets in private equity. The returns in private equity have been impressive in recent years, and investors have been flocking to this market as a way to improve overall portfolio returns – regardless of the inherent equity beta. Clearly the run-up in the equity market over the past nine years has been a tail wind for private equity funds but it may also have made it more difficult to invest new assets. Based on information from Preqin, both annual new assets raised and cumulative dry powder in the private equity market has continued to grow.

Private Equity Flows



Source: Preqin

Generally speaking, private equity managers gravitate toward value stocks because these types of companies have the capacity to handle higher debt loads. That preference, combined with the large amounts of capital private equity funds have at their disposal, suggests that private equity may be able to provide a safety net of sorts for value stocks, at least relative to growth stocks.

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The FOMO Dilemma

Most investors tend to be concerned about equity valuations, but they are also reluctant to significantly reduce their exposure to the equity market. It's the fear of missing out (FOMO) that seems to drive this behavior. Twelve months ago, few, if any, investors were expecting the S&P 500 Index to return over 20% in 2017, but then they were not expecting a 12% return in 2016.

The Investor's Predicament

Rebalance the portfolio away from what they view as fully or overvalued-equities to mitigate risk while missing out on another potential double-digit year, or maintain the long equity positions in hopes that the market will continue to rally.

Black Swans

Investors want to generate returns to meet targets/obligations, and it is difficult to generate those returns when the risk-free rate is hovering around 1.5%. We are in situation in which investors are:

- Stretching for yield by taking short volatility positions
- Investing passively in an index that is becoming increasingly concentrated in technology on both a market value and risk basis
- Resisting the desire to reduce equity exposures for fear of missing out on the next rally

We believe that portfolio diversification is important and that the trends we've observed are resulting in less diversification. Additionally, the tendency to view dips as buying opportunities only delays the inevitable correction. While these are not black swans, we believe they do contribute to overall market risk – just as portfolio insurance was not a black swan in 1987.

Achieving diversification doesn't mean simply looking at historical correlations and standard deviations – neither is constant and the numbers don't reveal the entire risk story. It is important to understand the source of returns and risks and to think about how those returns may correlate in the future, especially in the event of a crisis.

One way to de-risk and stay in the equity market is to invest in value stocks. While an equity sell-off would probably also impact value stocks, they have not experienced the significant run-up that the growth stocks have experienced. Additionally, the dry powder in private equity funds could provide some support for value stocks in that environment.

Alternative strategies that have low beta to the market should also be attractive. Again, you want to be comfortable that the low beta relationship would persist in an extended market drawdown. Additionally, the move to passive management should result in more opportunities for active managers, especially in the small cap markets where there is little-to-no analyst coverage.

The inspiration for writing this piece was my personal search for black swans at the end of 2017. I'm pleased to say that I found them swimming on Meroo Lake on the South Coast of Australia. The search for black swans reminded me of the old Wall Street adage, "the market moves in the direction that hurts the most people." ■

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