



The Calm Before the Storm

Is Your Portfolio Ready?

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Asking institutional clients a simple question like “what are you thinking about these days?” often provides great insight into issues that will likely challenge the stock market in the future. One of the top concerns that many of our clients are discussing right now is the potential for increased market volatility and how to position for it.

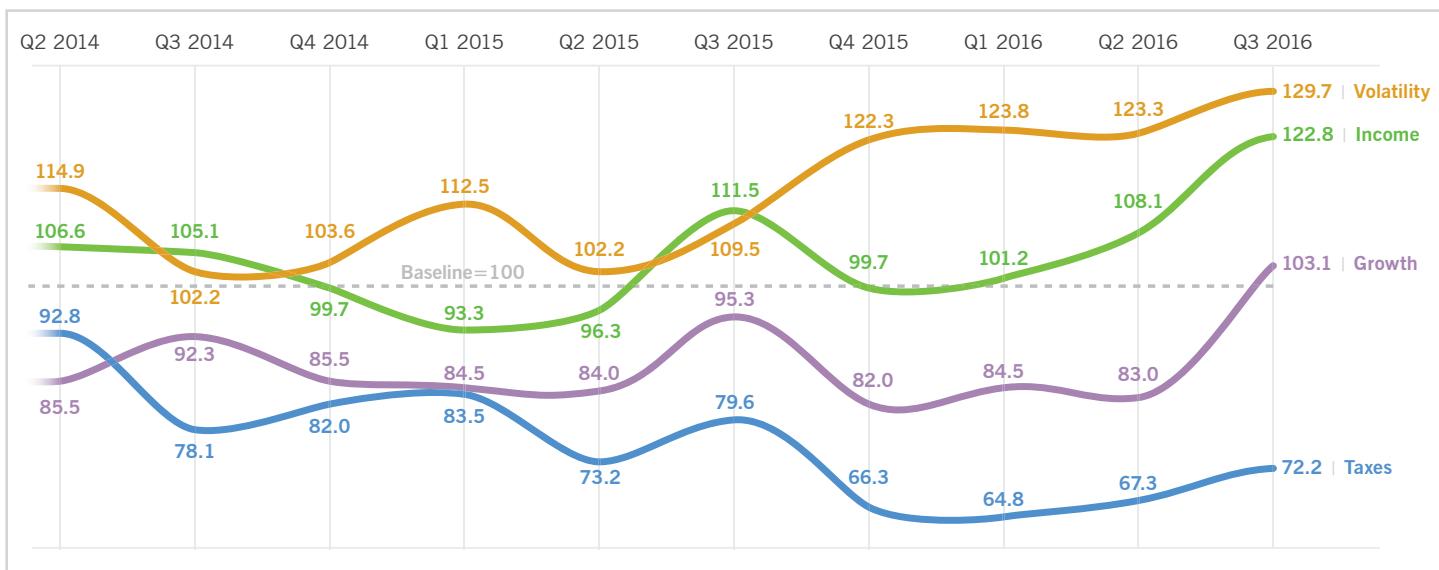
Eaton Vance, our majority owner, conducts a quarterly survey where they ask over 1000 financial advisors what they are thinking about. The Advisor Top-of-Mind Index (chart 1) clearly shows that volatility is “top-of-mind” with individual investors and their consultants as well.

Heightened concern around rising market volatility makes sense. U.S. equities are in the seventh year of a bull market,

recent July 2016 reading was 11.6—not far from the all-time low reading of 10.4 seen just prior to the start of the Financial Crisis. (chart 2)

The VIX® is designed to be a short-term gauge of expected volatility. For a longer term view of realized volatility, we can look at measures like the rolling 3-year standard deviation of a broad market index like the S&P 500. In chart 3, we can see that volatility increased dramatically from 2008 to 2010 during the financial crisis. Since that peak, volatility has been falling. The July 2016 reading of 11.36 is well below the long-term average of 14.8, coming close to lows last seen just prior to the 2008 Financial Crisis and the 2000 Dot-Com bust.

Chart 1: Eaton Vance Advisor Top-of-Mind Index



Source: Eaton Vance Advisor Top-of-Mind Index

domestic stock indices are near all-time highs, and bond yields are near all-time lows. For many investors, the key question today is how to position an equity portfolio for the potential for increased volatility.

Where is Volatility Now?

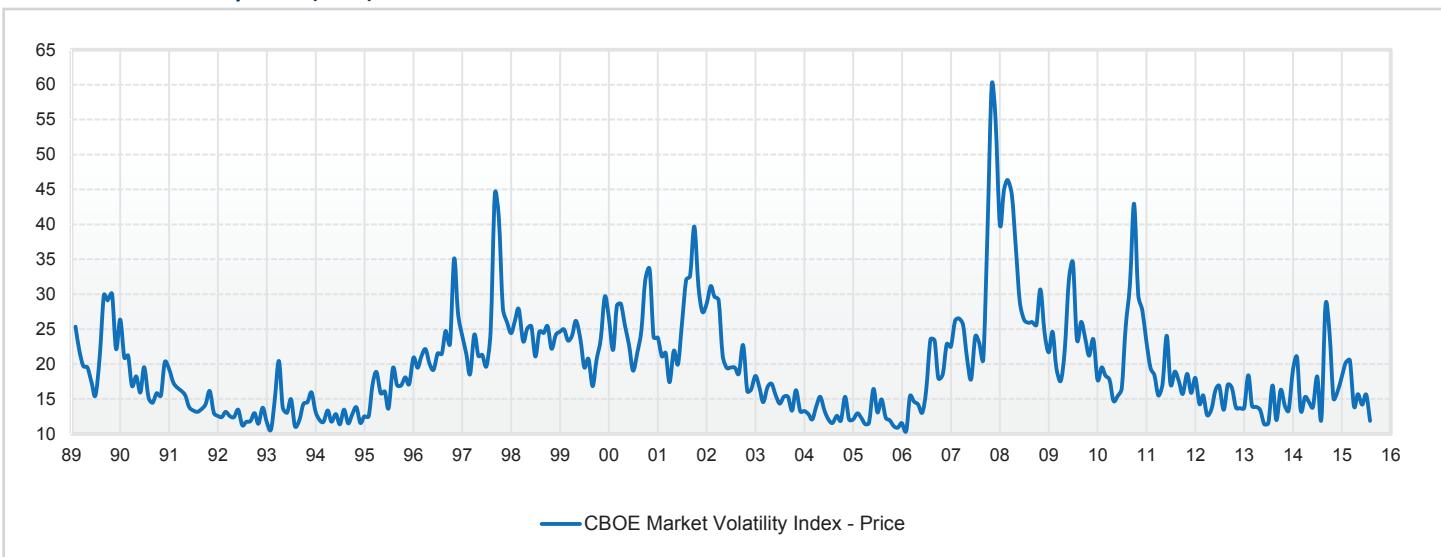
There are lots of ways to measure equity market volatility. But no matter how you look at it, current market volatility is low.

The CBOE Volatility index®, better known simply as the VIX®, has become a popular measure of volatility. The VIX measures the implied/expected level of volatility in the S&P 500 over the next 30 days. Since its inception in 1990, the average monthly reading for the VIX has been 19.8. The

What to do? It may all depend on your outlook for volatility

Over the last seven years, the U.S. stock market has generally gone one way—up. During the same time, market volatility has largely gone one way—down. This combination of declining volatility and strong returns has resulted in a challenging investment environment for many active managers. Broadly speaking, active management looks to take advantage of market dislocations and security pricing inefficiencies. Seven straight years of falling volatility has created an environment where there have been fewer and fewer pricing inefficiencies, creating a lot of frustration for clients and active managers alike. It is little surprise that this “one way” market has driven strong growth in passive strategies.

Chart 2: CBOE Volatility Index (VIX®)



Source: Factset as of July 2016

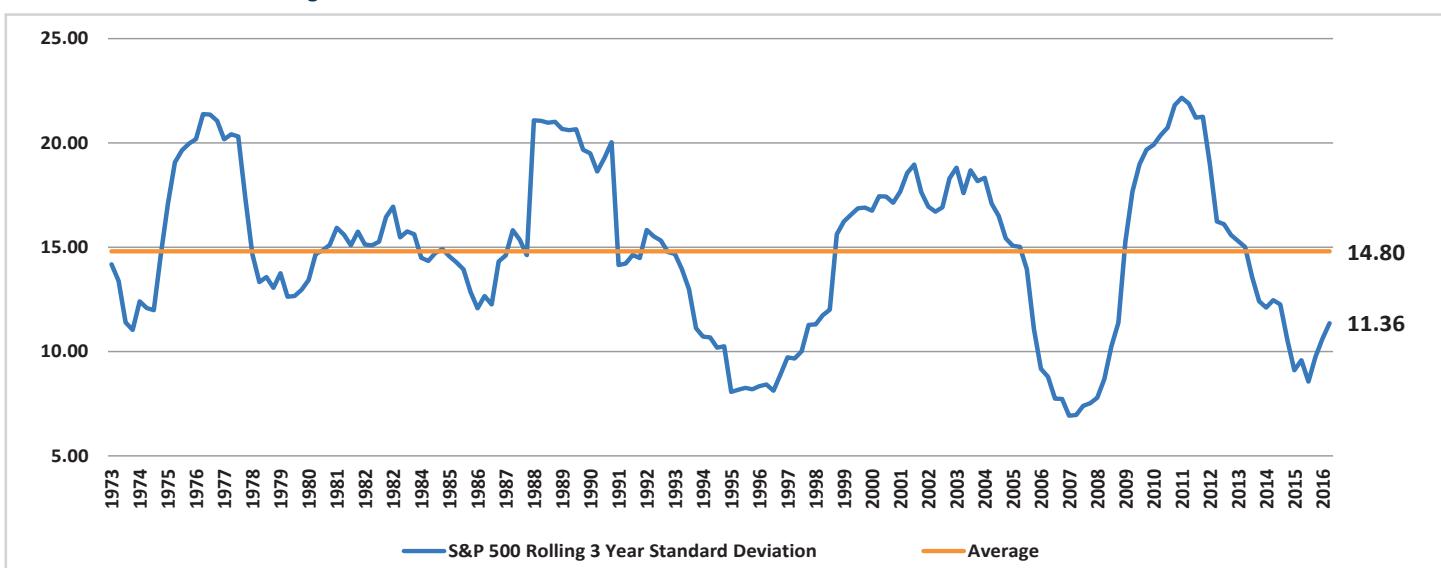
The question for investors now is will volatility remain at low levels, or could we see volatility return to historic norms or even higher? How you answer that question will have a great impact on how you might want to position your portfolio going forward.

If you believe equity volatility will remain low, then keeping an allocation to the broad market (i.e. low cost, passive market investments like ETFs) probably makes sense. But if you believe that volatility may increase from here, passive exposures in your portfolio may prove risky. Just as passive investments have participated in the majority of the bull market over the last seven years, they are likely to participate in the majority of any market declines that result from increased market volatility.

Rising Volatility = Rising Risk of Market Declines

If you are concerned about the risk of increasing equity volatility, one possible solution would be to focus on equity strategies that perform well when markets decline. Fortunately, there is a well reported metric that helps you to do that—it is called Down Market Capture. Down Market Capture (DMC) measures how well or how poorly a manager or strategy has performed when the market declines. If the market is down 10%, a DMC of 150% implies that the manager would have a -15% return—i.e. “capturing” 150% of the down market. Conversely, a manager with a DMC of 50% would only “capture” half of the down market, and have a -5% return. So if you are looking for managers

Chart 3: S&P 500 3-Year Rolling Standard Deviation



Source: eVestment as of July 2016

that have a good record of minimizing losses in declining markets, you want to see a DMC less than 100%.

We recently completed a detailed study on Down Market Capture within active U.S. Large Cap Equity managers (see “Risks are Rising: Is Now the Time for Down Market Protection?”¹, available on our website). Our research universe used performance data from eVestment and included 233 separate account U.S. Large Cap products with ten years of gross-of-fees performance history as of December 31, 2014. Our first objective was to see if active U.S. Large Cap managers have been able to provide protection in down markets during the ten-year period. What we found was that the median manager in our universe provided very little protection in down markets. So if you are interested in hiring a manager for down market protection, our research shows that only a small portion of active managers have been able to provide that outcome.

The second objective of our study was to see if a manager’s ability to protect in down markets had any impact on their long-term investment returns. After examining manager performance over a variety of market conditions, we found that managers with strong down market protection had a higher likelihood of outperforming the Russell 1000® index.

To be clear, no one knows if or when volatility will return to U.S. equity markets. But we can all agree that over the last seven years, we have seen equity markets reach new all-time highs while volatility has approached all-time lows. While the duration and price gain of the current bull market is “above average,” we all know that U.S. equity markets could move higher. This leaves investors with a dilemma—how do you maintain exposure to equities, but also protect your hard-earned gains from future market declines? We believe that one solution is to increase your exposure to equity strategies that provide a meaningful level of down market protection.

Successful investing is a combination of what you make in up markets **and** what you keep in volatile markets. The time to prepare for the storms of high volatility is during periods of relative calm/low volatility.

¹The referenced study, “Risks are Rising: Is Now the Time for Down Market Protection?” is available on our website www.atlcap.com, or by calling us at 404-876-9411. Study results were completed using eVestment data on U.S. Large Cap Core managers as of December 31, 2014. Please see the full study for detailed findings.

Index Description: The Russell 1000® Index includes the largest 1000 companies in the Russell 3000® Index. The S&P 500® includes 500 leading companies in leading industries of the U.S. economy. The indexes provide a measure of large cap U.S. stock market performance. Indexes are unmanaged and do not incur management fees, transaction costs or other expenses associated with separately managed accounts. It is not possible to directly invest in an index.

Eaton Vance Advisor Top-of-Mind (ATOMIX) Methodology: ATOMIX is calculated based on the findings of a survey of 1,000 financial advisors from a diverse group of companies. Eaton Vance contracted with a third party to conduct the online survey from June 24, 2016 – July 20, 2016. ATOMIX uses a similar methodology as the U.S. Consumer Confidence Index* (which has no affiliation with Eaton Vance) in that it calculates a weighted average of current perceptions (40% of the Index) and what advisors think about the trends (60% of the Index). The Index set a baseline average of 100 for April 2014. Each component measured is tracked quarterly to illustrate changes in advisor perceptions and changes in trends over time. Future surveys will sample different financial advisors and may produce different results.

*The monthly Consumer Confidence Survey®, based on a probability-design random sample, is conducted for The Conference Board by Nielsen, a leading global provider of information and analytics around what consumers buy and watch. The Consumer Confidence Index was started in 1967 and is benchmarked to 1985=100. The Index is calculated each month based on a household survey of consumers’ opinions on current conditions and future expectations of the economy. Opinions on current conditions make up 40% of the index, with expectations of future conditions comprising the remaining 60%.

Down Market Capture measures a portfolio’s compound return when the benchmark was down divided by the benchmark’s compound return when the benchmark was up; the smaller the value the better. The ratio is determined by the benchmark, which has a down-capture ratio of 100% when the benchmark is performing negatively; if a manager captures less than 100% of the declining market it is said to be “defensive.” The Russell 1000® Index is used as the benchmark in all down market capture calculations in this material. Individual portfolios included in the DMC calculations may be managed to a different market benchmark. Down market protection cannot ensure a profit or eliminate a loss. Research utilized data from eVestment.

eVestment is a third-party database provider. The company collects self-reported portfolio data from institutional investment managers globally. eVestment provides no assurances regarding the reliability of such information. eVestment utilizes this data to identify a manager’s style and then assigns them to a particular peer universe, such as U.S. large cap core, based on its own predetermined criteria. In addition to data collection, eVestment also provides a suite of analytical tools which a user can utilize to screen, sort and compute portfolio level measures such as down market capture and relative excess return. Atlanta Capital has prepared this report. eVestment does not endorse it or guarantee, review or endorse Atlanta Capital’s products.

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