Volatility is Back! How did the AEWM Diversified Income Portfolio Perform?

November 1, 2018

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CAPITAL ADVISORY SOLUTIONS

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Volatility is Back!

Concerns about the Fed's future interest rate path, peak earnings, and ongoing global trade tensions fueled a rapid and substantial pullback in asset prices during October. This resulted in a 7.82% decline in the equity market, as represented by the MSCI ACWI IMI. The S&P 500 Index did not perform much better, down 6.84%. We can also look to bonds and see a negative return, with the Bloomberg Barclays Aggregate Bond Index down 0.79% for the month and high yield returning -1.60% (Bloomberg Barclays US Corporate High Yield Index). In addition, a diversified portfolio comprised of 50% equity and 50% fixed income fell just over 4.00% (50% MSCI World Index/50% Bloomberg Barclays Aggregate Bond Index).

One portfolio in particular stood out over the month – the AEWM Diversified Income Model. The portfolio's focus on income stability, risk management and utilization of uncorrelated assets played a large role in the portfolio's strong relative returns during the month.

In fact, the model's return was approximately half of the diversified portfolio mentioned above. To use industry jargon, that is a 57% down capture ratio!

Equity Allocation Results

While the portfolio's high dividend yield and growth equity exposure has been out of favor throughout much of the past few years, these dividend-focused companies that often protect capital during bouts of market stress, again, did so in October. The model's allocation to long-only, dividend-focused equity funds significantly outperformed the equity index. In fact, each underlying long-only, dividend-focused equity fund outperformed the index.

Another allocation that speaks to downside protection is the portfolio's covered call writing exposure. In times of volatility, this allocation has typically outperformed the broad benchmark as option premium income serves as a cushion in a down market. This, again, was the case in October as the model's underlying manager outperformed the index.

Fixed Income Allocation Results

From a fixed income perspective, the utilization of uncorrelated asset classes once again benefitted returns. The model's catastrophe bond allocation was the top performer over the month, up over 0.40%.

Keep in mind that this return came as Hurricane Michael made landfall with sustained winds of 155 mph, making it the strongest storm to make landfall in the continental U.S. since Hurricane Andrew in 1992. Economic damage (so far) totaled over $11 billion while insurance damage was approximately $2 billion. The result of the model's underling manager was a positive return for the month! While 0.40% may not seem like not a substantial return, when put in context of the S&P 500 returning -6.84%, the return looks much more appealing.

Emerging markets have also been in the headlines over the month with concerns surrounding Argentina, Turkey and China, just to name a few. The broad emerging market debt index was down over 2%. On the other hand, the Diversified Income Model's underlying manager was flat for the month. That is a significant contribution to overall returns, especially when both the asset class and broad markets are down.

Volatility is Common

While volatility has been muted for much of the recovery following the Global Financial Crisis, largely due to the Federal Reserve and monetary policy, it is important to remember that a market correction of greater than 10% has occurred on average every 1.5 years from 1945 to 2013. As we are now in an environment of higher interest rates and quantitative tightening, maintaining a diversified and risk-focused portfolio is paramount. This is the type of environment in which the Diversified Income Model has historically thrived. We believe the portfolio remains positioned to protect capital during future instances of volatility and deliver on its 4-6% income distribution target.