

Volatility and portfolio construction

Volatility markets are well suited to provide investors with both **attractive returns** and **cost-effective protection**. We believe volatility strategies are valuable tools investors can use as part of their portfolio construction to **increase returns and reduce risk**.

The investment challenge

Many investors hold a large portion of their assets in equities. Two key challenges for portfolios dominated by equities are how to manage the risk of large losses associated with equity crashes (especially for investors close to, or in, retirement) and how to earn additional returns on top of the base asset class returns.

Investors often use a range of defensive assets (such as cash and bonds) to address the former challenge and look to active equity managers to address the latter challenge (often through stock-picking and/or style tilts).

One problem with the first approach is that defensive assets are expected to earn lower returns over the long-term compared to growth assets. In addition, unstable correlation between equities and bonds may make bonds unreliable diversifiers going forward.

Challenges with the second approach include that it is very difficult to consistently add positive returns over a long time period through stock-picking or style tilts.

Benefits of volatility*

Volatility strategies can help address both these challenges by providing defensive alpha and cost-effective protection.

Volatility alpha strategies are driven by a genuine risk-transfer risk premium that we believe is clear, logical and sustainable. The aim of defensive volatility alpha strategies is to harvest this risk premium to provide consistent, reliable, predictable returns.

As investors know too well, market volatility tends to increase when markets fall. The aim of cost-effective protection strategies is to use this relationship to provide positive returns in large equity falls while limiting the cost at other times.

Volatility strategies can be combined with cash to create an investment that aims to provide the type of diversification benefits associated with defensive assets while providing higher returns. Including some of this investment in their defensive portfolio can help investors improve long-term returns.

Volatility strategies can also be combined with equities to create an investment that aims to reduce losses in large equity falls while providing additional returns at other times.

Key findings

In this paper we use data since January 2007 to examine the performance of adding volatility strategies to defensive and growth portfolios of Australian equities and Australian bonds.

For a 50/50 defensive portfolio, one of the key challenges is how to increase the expected return of the defensive assets without increasing their risk.

Our analysis shows that moving half of the bonds to a defensive investment that combines cash and volatility strategies would have improved returns by 1.9% p.a., while delivering better returns during large equity falls (+12% during the GFC, +2% during Covid-19).

For an 80/20 growth portfolio, one of the key challenges is how to decrease the risk of the growth assets without decreasing their expected return.

Our analysis shows that moving half of the equities to a growth investment that combines equities and volatility strategies would have improved returns by 2.0% p.a., while delivering better returns during large equity falls (+14% during the GFC, +2% during Covid-19).

** For an introduction to options see our paper 'Using options to improve risk and return'.*

For a discussion of how volatility can be used to create defensive alpha and cost-effective protection see our paper 'Volatility for alpha and protection'.

for investors close to, or in, retirement that want to reduce risk, rather than reducing expected returns by moving to a more defensive asset mix, incorporating volatility strategies may provide the ability to reduce portfolio risk while increasing expected returns



Including volatility strategies in defensive assets

SouthPeak Alternative Alpha Fund

Investors that prefer not to take on a large amount of investment risk often invest in defensive portfolios that have a large allocation to defensive assets.

While this approach should reduce the risk of large and sudden losses, defensive assets are expected to earn lower returns than growth assets. As such, in an effort to reduce risk a defensive portfolio may actually expose investors to the risk of earning lower returns over the long-term.

To address this risk, investors should explore ways to increase the expected return of their defensive assets without increasing their risk. One way could be to include a defensive investment that combines cash and volatility strategies in the portfolio.

the aim of including volatility strategies in defensive assets is to create a diversifying investment with low correlation to equities, but higher returns than traditional defensive investments

To illustrate, figures 1 and 2 compare a defensive portfolio of 50/50 Australian equities and bonds to the estimated performance of a portfolio that moves half of its defensive assets from bonds to the SouthPeak Alternative Alpha Fund ('SP AAF'), an investment that combines cash with volatility strategies.

Over the period examined the portfolio with volatility strategies would have earned an additional 1.9% p.a. and experienced lower drawdowns in large equity losses (2008, 1Q2020, mid 2022, 2Q2025).

Figure 1: Including volatility strategies in defensive assets

ESTIMATED*

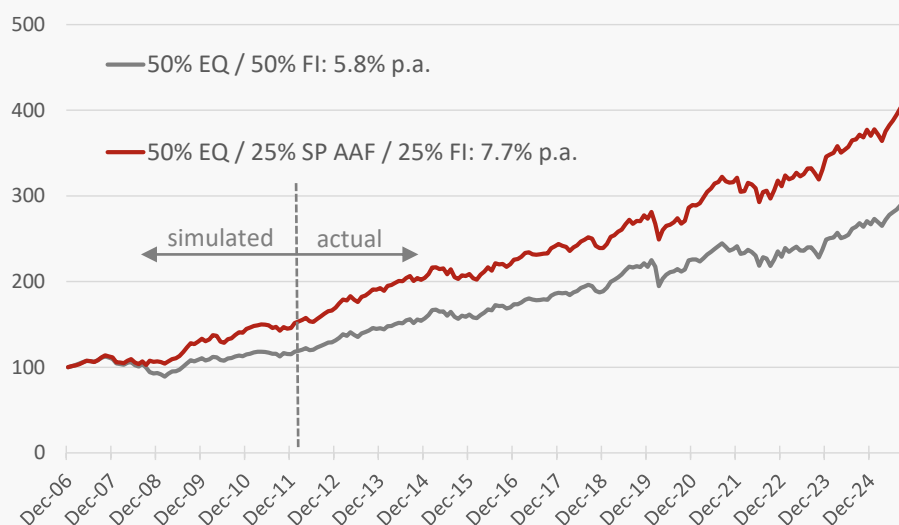
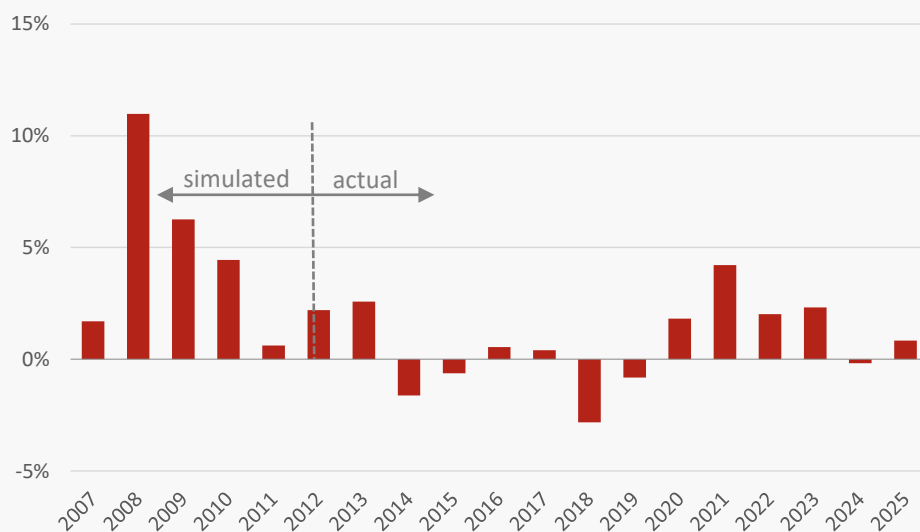


Figure 2: Annual outperformance of the defensive portfolio with volatility strategies



* SouthPeak Alternative Alpha Fund returns for Feb 2012 – May 2025 are estimated from the actual returns of the fund's strategies in SouthPeak's real diversification funds together with AUD cash. Returns from June 2025 are from the SouthPeak Alternative Alpha Fund. Returns are estimated, unaudited and subject to adjustment. Returns prior to Feb 2012 are simulated. Simulations have been created using models with assumptions and may have the benefit of hindsight. No actual investments were made. There can be sharp differences between simulated and actual results for many reasons. Estimated returns are net of estimated transaction and management fees. Cash returns are RBA cash, RBACTRD Index. Equity returns are the S&P/ASX 200 Total Return Index, AS51T Index. FI returns are the Bloomberg AusBond Composite 0+ Yr Index, BACMO Index. Past performance is not an indicator of future performance. See important information on the last page. Source: Bloomberg, SouthPeak.



Including volatility strategies in growth assets

SouthPeak Australian Equity Fund

Investors seeking higher returns often invest in growth portfolios that have a large allocation to growth assets.

While this approach should result in higher long-term returns, growth assets are subject to large and sudden losses. For investors that are in or near retirement, the timing of these losses introduces sequencing risk, which could result in lower long-term returns despite being invested in a growth portfolio.

To address this risk, investors should explore ways to decrease the risk of their growth assets without decreasing their expected return. One way could be to include a growth investment that combines equities and volatility strategies in the portfolio.

the aim of including volatility strategies in growth assets is to create an investment that should outperform equities in 'normal' markets and outperform by more in large equity falls

To illustrate, figures 3 and 4 compare a growth portfolio of 80/20 Australian equities and bonds to the estimated performance of a portfolio that moves half of its growth assets from equities to the SouthPeak Australian Equity Fund ('SP AEF'), an investment that combines equities with volatility strategies.

Over the period examined the portfolio with volatility strategies would have earned an additional 2.0% p.a. and experienced lower drawdowns in large equity losses (2008, 1Q2020, mid 2022, 2Q2025).

Figure 3: Including volatility strategies in growth assets

ESTIMATED*

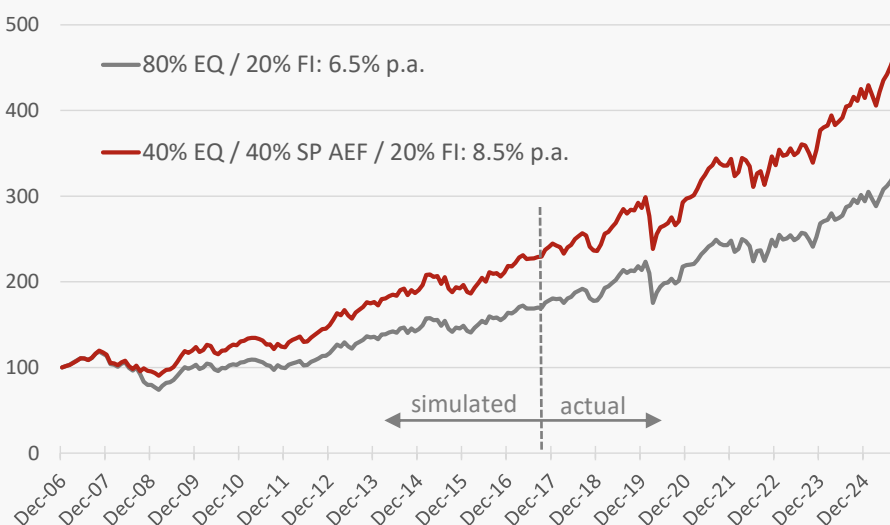
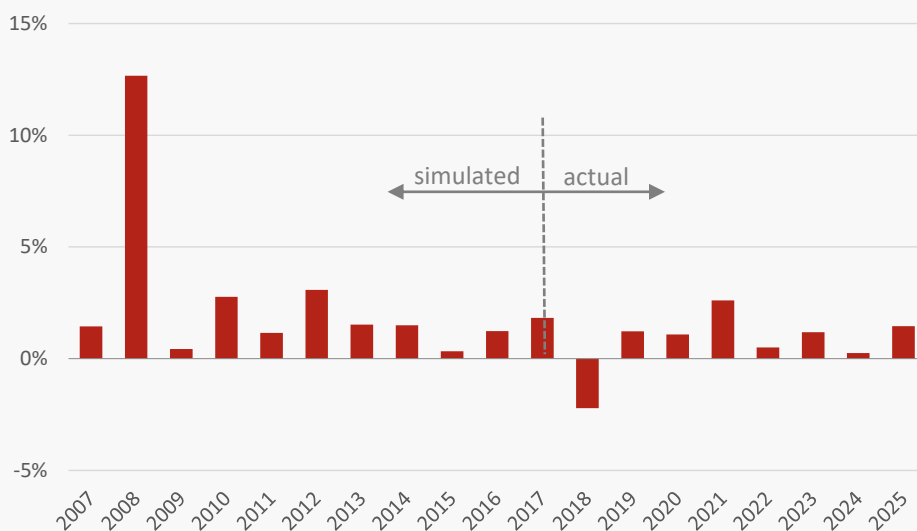


Figure 4: Annual outperformance of the growth portfolio with volatility strategies



* SouthPeak Australian Equity Fund is expected to launch in Nov 2025. Returns from Oct 2017 are estimated from the actual returns of the fund's strategies in SouthPeak's real diversification fund together with equity index total returns. Returns are estimated, unaudited and subject to adjustment. Returns prior to Oct 2017 are simulated. Simulations have been created using models with assumptions and may have the benefit of hindsight. No actual investments were made. There can be sharp differences between simulated and actual results for many reasons. Estimated returns are net of estimated transaction and management fees. Equity returns are the S&P/ASX 200 Total Return Index, AS51T Index. FI returns are the Bloomberg AusBond Composite 0+ Yr Index, BACMO Index. Past performance is not an indicator of future performance. See important information on the last page. Source: Bloomberg, SouthPeak.



Portfolio analysis results

Table1: Portfolio analysis 31 Dec 06 to 30 Sep 25	Growth assets		Defensive assets		Estimated performance summary			
	Equities	Equities + Vol Strategies	Bonds	Cash + Vol Strategies	Annualised return	Annualised volatility	31 Oct 07 to 28 Feb 09	31 Jan 20 to 31 Mar 20
Traditional Portfolios								
- Equities	100%				6.8%	14.0%	-47%	-27%
- Bonds			100%		4.3%	3.8%	+15%	+1%
- Defensive Portfolio	50%		50%		5.8%	7.3%	-21%	-13%
- Growth Portfolio	80%		20%		6.5%	11.3%	-38%	-22%
Portfolios with Volatility Strategies:								
- Defensive Portfolio	50%		25%	25%	7.7%	7.3%	-9%	-11%
- Growth Portfolio	40%	40%	20%		8.5%	10.8%	-24%	-20%

Returns for including volatility strategies in defensive assets for Feb 2012 – May 2025 are estimated from the actual returns of the relevant strategies in SouthPeak’s real diversification funds together with AUD cash. Returns from June 2025 are from the SouthPeak Alternative Alpha Fund. Returns are estimated, unaudited and subject to adjustment. Returns prior to Feb 2012 are simulated.

Returns for including volatility strategies in growth assets from Oct 2017 are estimated from the actual returns of the relevant strategies in SouthPeak’s real diversification fund together with equity index total returns. Returns are estimated, unaudited and subject to adjustment. Returns prior to Oct 2017 are simulated.

Simulations have been created using models with assumptions and may have the benefit of hindsight. No actual investments were made. There can be sharp differences between simulated and actual results for many reasons. Estimated returns are net of estimated transaction costs and management fees.

Equity returns are the S&P/ASX 200 Total Return Index, AS51T Index.

Bond returns are the Bloomberg AusBond Composite 0+ Yr Index, BACMO Index.

Cash returns are RBA cash, RBACTRD Index.

Past performance is not an indicator of future performance. Source: Bloomberg, SouthPeak.

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volatility strategies can be used in portfolios to aim for better long-term returns by increasing returns and decreasing losses, which helps compounding and reduces sequencing risk

Important information

DISCLAIMER. This document has been prepared for wholesale investors for the purpose of providing general information, without taking account any particular investor’s objectives, financial situation or needs. It does not constitute a recommendation, offer, solicitation or invitation to invest. Investors should obtain their own independent advice.

This document contains “forward looking statements” which are based on assumptions that contain risk and uncertainty, and the views of SouthPeak’s principals at a point in time. These are subject to change without notice. Actual results and events may differ materially from those in any forward-looking statements.

No representation is made that SouthPeak’s strategies, investment process or risk management will be successful, or that any investor will not suffer loss of principal. Subject to any law to the contrary, SouthPeak disclaims all liability for any loss or damage suffered by any person acting on information provided in, or omitted from, this document.

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About SouthPeak

SouthPeak is a specialist volatility manager providing alpha and protection.

We aim to deliver attractive outperformance with low correlation to bonds and equities.