Commentary

Active Quantitative Equity (AQE)

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Sectors that Surprised in the Coronavirus Market Drawdown

- Retailing and Autos as well as Software & Services generated unexpectedly elevated returns.
- Sector-level assumptions about potential resilience or weakness during a market drawdown are not always borne out.

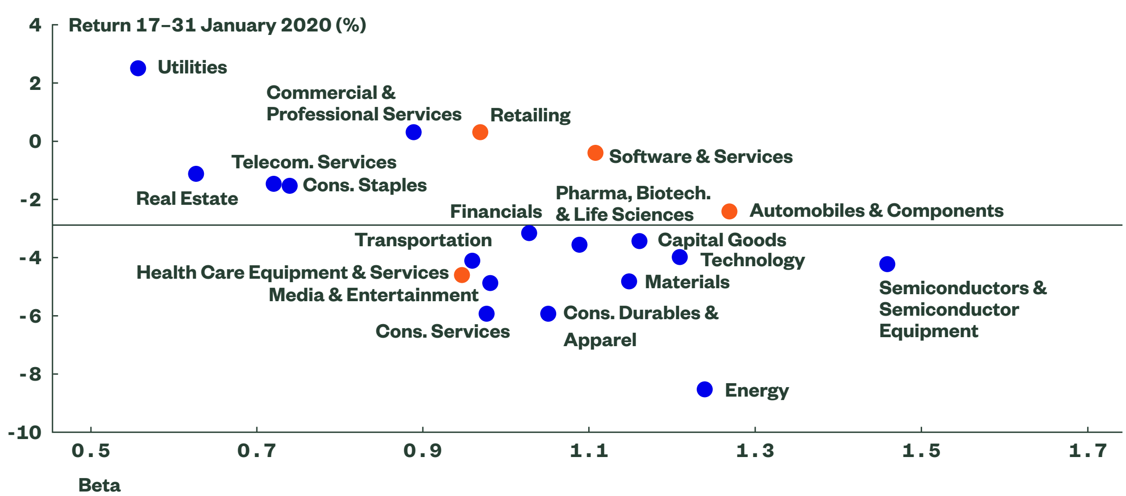
Between January 17 and January 31 of 2020, world markets fell 2.98% as news reports about the coronavirus saturated the media.[1] In this commentary, we'll compare actual sector performance during the January market drawdown with typical expectations for sector performance under these types of market conditions. For a few sectors that were particularly surprising, we'll explore reasons why expectations and performance diverged.

Performance Across Sectors During the Drawdown

A review of GICS[2] segment performance as news of the coronavirus broke reveals a few surprises. Figure 1 plots sector returns during the January 17–31 period against beta.[3] The blue dots represent sectors in which the market reaction was in line with conventional expectations for a broad market selloff. The orange dots highlight sectors in which the market reaction ran contrary to expectations.

Figure 1
Sector-level Returns Versus Beta From January 17 Through January 31

In Line With Typical Expectations
Contrary to Typical Expectations



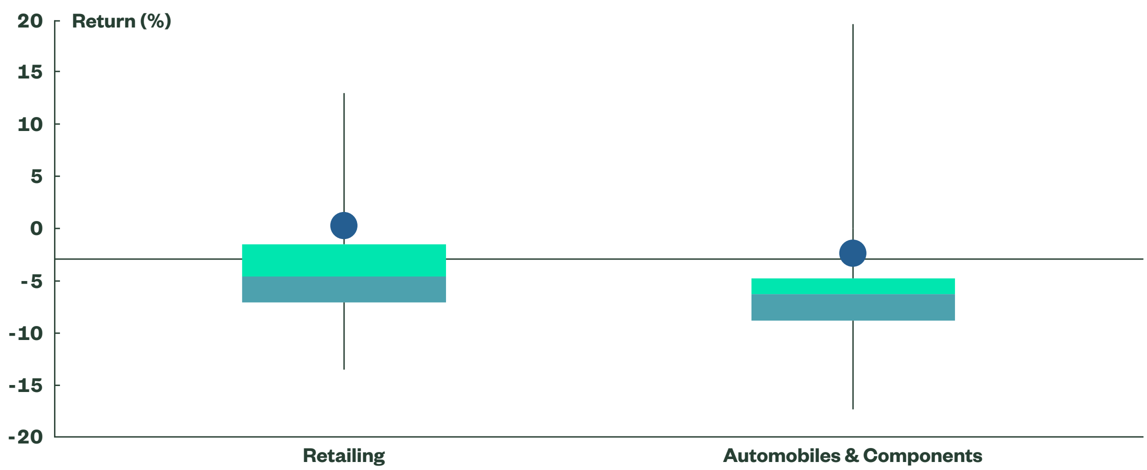
Source: Axioma, Bloomberg Finance L.P., as of 31 January 2020. GICS Sectors and Industry Groups in MSCI World Universe represented. Axis crosses at -2.98%, the aggregate return of MSCI World Index from January 17 through January 31.

In general, Figure 1 shows that performance of different segments turned out as expected. Traditionally defensive sectors such as Utilities and Real Estate did very well; cyclical sectors such as Energy, Consumer Durables, Consumer Services, Materials and Transportation did poorly. But a few sectors — Retailing, Automobiles, Software & Services, and Health Care Equipment & Services — defied expectations.

Retailing and Autos (cyclical sectors) as well as Software & Services (generally a high-beta sector) each generated unexpectedly high returns over the period. Digging deeper by sector illuminates the underlying reasons for these positive sector-level surprises.

In Retailing and Autos, megacap outliers lifted aggregate returns, while the rest of the segment suffered a large decline. Most Retailing companies, for example, showed returns worse than -5%, but one particular megacap internet retailer's stock surprised on earnings and lifted the overall average for the sector. Autos delivered relatively strong returns in aggregate, but the distribution of returns in Autos was skewed by one electric car manufacturer with off-the-charts returns (up 27%). The median return across the Autos segment was close to -6% (see Figure 2).

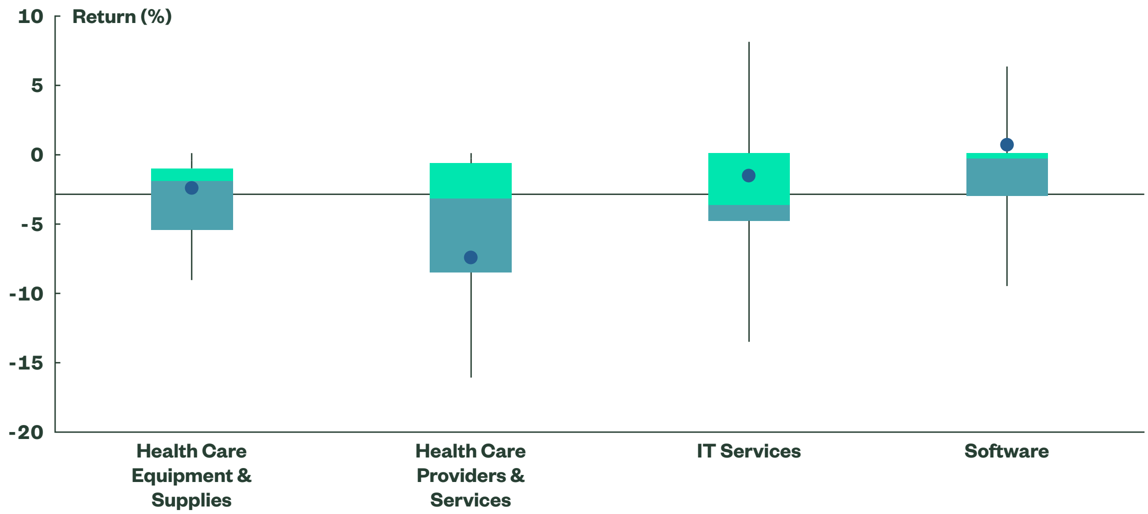
Figure 2
Spread of Security Returns Within Each GICS Industry Group (box plot) and Aggregate Return for the Group (dot)



Source: MSCI, Bloomberg Finance LP, as of 31 January 2020. MSCI World stocks; axis crosses at -2.98%, the aggregate return of MSCI World over that period. Box plot crosses at the median return for all stocks in the segment.

Drilling deeper into the underlying GICS segments is necessary to understand performance in the Software & Services and Healthcare Equipment & Services sectors. In the Software sector, many stocks in the cloud computing segment delivered very strong earnings that surprised the market, driving returns upward. Software stocks and their intangible assets also seemed to be unaffected by concerns tied to the very tangible effects of the coronavirus. The weakness in Healthcare was driven by substantial declines for Healthcare Providers, including Health Insurance companies, which suffered amid expectations of increasing costs related to treating patients with the virus. Healthcare Providers, including Insurers, returned -7.6% over the period, while Healthcare Equipment & Supplies firms slightly outperformed the market on average, but still experienced negative absolute returns of -2.5%.

Figure 3
Spread of Returns Within Each GICS Industry Group (box plot) and Aggregate Return for the Group (dot)



Source: MSCI, Bloomberg Finance LP, as of 31 January 2020. MSCI World stocks; axis crosses at -2.98%, the aggregate return of MSCI World over that period. Box plot crosses at the median return for all stocks in the segment.

Our Current Views of these Segments

Retailing Some Retailing stocks are attractive, but in general this is not a key sector for us right now. The megacap stock dominating the sector is too expensive on all valuation angles.

Software & Services In aggregate, both the Software and IT Services segments are much more expensive than other segments of the market. Investors have been rewarding these companies, and earnings forecasts are being revised upward, so sentiment is very positive. We find better quality characteristics in some of the more mature companies in the IT Services segment and have found select names there to invest.

Autos As a whole, autos are relatively cheap, but sentiment on this segment has not improved much beyond the small turnaround caused by last year's relaxation of trade tensions. Therefore we hold positions in only select names in this sector.

Health Care Equipment & Services We prefer Pharma over Providers and Services, but we also like some Health Care Equipment companies. We've been reducing our position in Healthcare Providers due to elevated risk connected to upcoming elections, so our portfolios have relatively little exposure there.

The Bottom Line

When seeking defensive equity positions, it's wise to avoid relying solely on sector-level assumptions about potential resilience or weakness during a market drawdown. We believe careful stock selection which takes value, quality, and sentiment into account is much more likely to be effective over the long term.

Endnotes

1 MSCI World Index.

2 Global Industry Classification Standard.

3 "Beta" measures the risk that arises from overall movement in markets. A portfolio of all investable assets has a beta of exactly 1. A beta value larger than 1 generally indicates higher volatility compared to the market.