Insights
Active Quantitative Equity (AQE)

June 2020

The Global Defensive Equity Strategy in the COVID-19 Era

Adhiraj Mallik
Portfolio Strategist
Active Quantitative Equity

- At this point in the COVID-19 crisis, it's unclear whether we're observing a bear market rally or a full-blown recovery in markets, with the economy to follow.
- Defensive equities can help investors faced with highly uncertain market conditions strike a productive balance by maintaining a sharp focus on risk mitigation while participating substantially in market rebounds.

In the COVID-19 era, investors face a difficult challenge: achieving return objectives in a persistently low-yield environment while still being mindful of risk as equity markets return to more normal levels of volatility. We believe that a nuanced approach to defensive equities that incorporates a dual risk *and* return mandate can help investors meet that challenge. In this piece, we'll take a close look at State Street Global Advisors' Global Defensive Equity strategy (also known as "GDE") to see how the strategy performed in the March 2020 drawdown and subsequent rally, and to explore how GDE might benefit long-term investors in the current investment landscape.

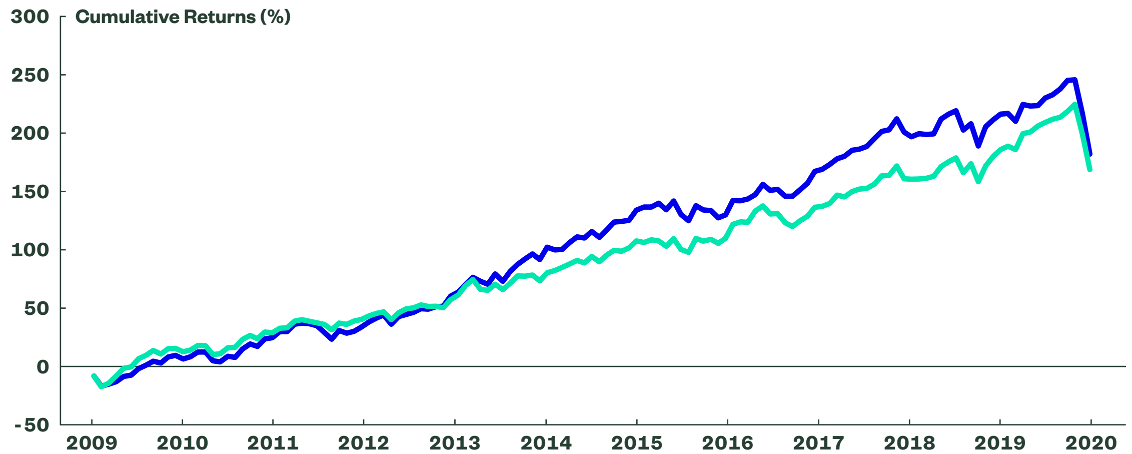
About Global Defensive Equity

The Global Defensive Equity strategy created by State Street's Active Quantitative Equity team seeks to add value by focusing on absolute return and absolute risk while remaining fully invested in the market. The GDE strategy is expected to deliver 80% upside capture when markets generate positive returns and 60% downside capture on down days. In a recent paper,[1] we demonstrated the efficacy of an "80:60" approach going back 120 years.

GDE's benchmark-unaware (i.e., tracking-error-unaware) approach allows the strategy to achieve higher returns while providing lower absolute risk compared with strategies that constrain tracking error, relative to the market-cap-weighted MSCI World Index. The GDE approach aims to deliver outperformance of 2% to 4% over a full market cycle while reducing total risk by 20% to 30%. The outperformance of the GDE strategy comes not only from an emphasis on reducing risk, but also from a proprietary, fundamentals-driven stock-selection model that focuses on the themes of value, quality, and sentiment.

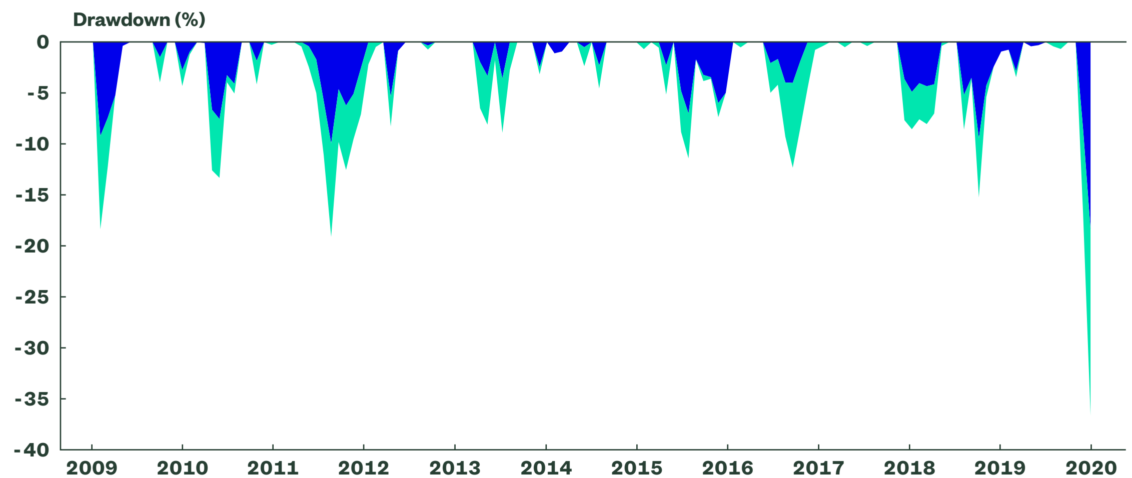
Since its inception in 2009, the strategy has meaningfully outperformed not just the MSCI World Index but also the MSCI World Minimum Volatility Index. Figures 1a and 1b demonstrate the long-term efficacy of the GDE approach in reducing risk and generating returns.

Figure 1a
Global Defensive Equity Cumulative Returns vs. MSCI World Index, Since Inception
(January 2009 to 31 March 2020)



Source: State Street Global Advisors, as of 31 March 2020. Past returns do not guarantee future results. The results shown here are gross of fees. Index returns are net of dividends. Returns are shown in USD.

Figure 1b
Global Defensive Equity Drawdowns Relative to MSCI World Index Drawdowns
(January 2009 to 31 March 2020)



Source: State Street Global Advisors as of 31 March 2020. Past performance does not guarantee future results. Returns shown here are gross of fees. Index returns are net of dividends. Returns are shown in USD.

A Differentiated Approach

Our investment approach in Global Defensive Equity is different from those used in traditional low-volatility portfolios. Traditional low-volatility approaches apply only risk criteria, which can cause them to miss out on the return potential of up markets. GDE is also different from other risk-adjusted, return-focused quantitative strategies because it only invests in the highest-conviction equity opportunities identified by our stock-selection model, resulting in a relatively concentrated portfolio of 100 to 120 stocks (compared with 400 to 500 stocks for many of its peers).

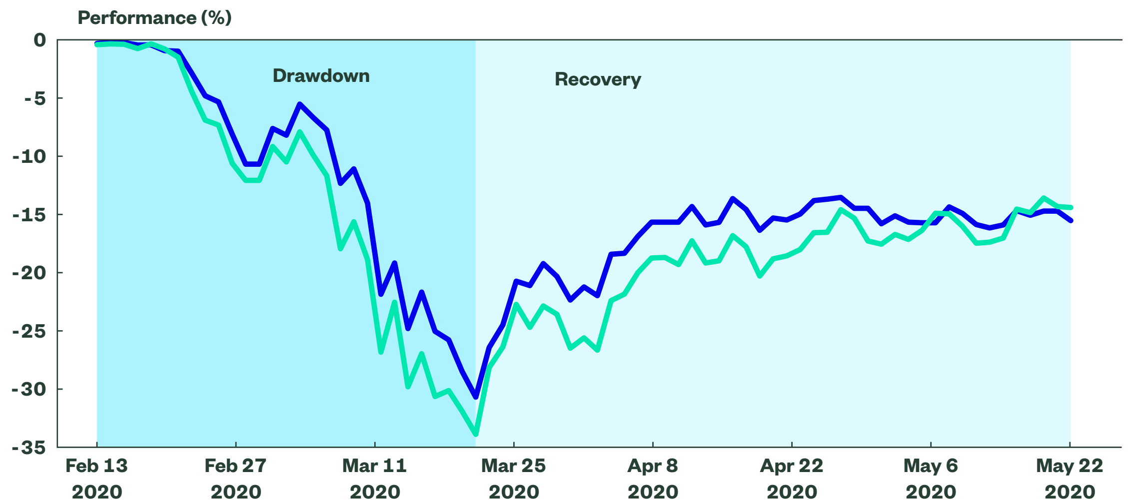
Our approach has led GDE to outperform the MSCI World Minimum Volatility Index by 7% on a cumulative basis, since inception. Over that same time period, GDE ranks in the top decile of strategies in terms of Sharpe Ratio (i.e., risk-adjusted returns) within the eVestment Global Large Cap Core universe.

Performance During the COVID-19 Crisis[2]

Since the initial COVID-19 related drawdown (13 February 2020) the Global Defensive Equity strategy has underperformed the MSCI World Index by 111 bps (as of 22 May 2020). To better understand the strategy's performance during this tumultuous period, we have divided the period into the initial drawdown and the subsequent recovery (see Figure 2).

Figure 2
Performance of Global Defensive Equity Strategy vs. MSCI World Index During the COVID-19 Drawdown and Recovery

Global Defensive Equity
MSCI World Index



Source: State Street Global Advisors, as of 22 May 2020. Past performance does not guarantee future results. Returns shown here are gross of fees and in USD. Index returns are represented as net of dividends.

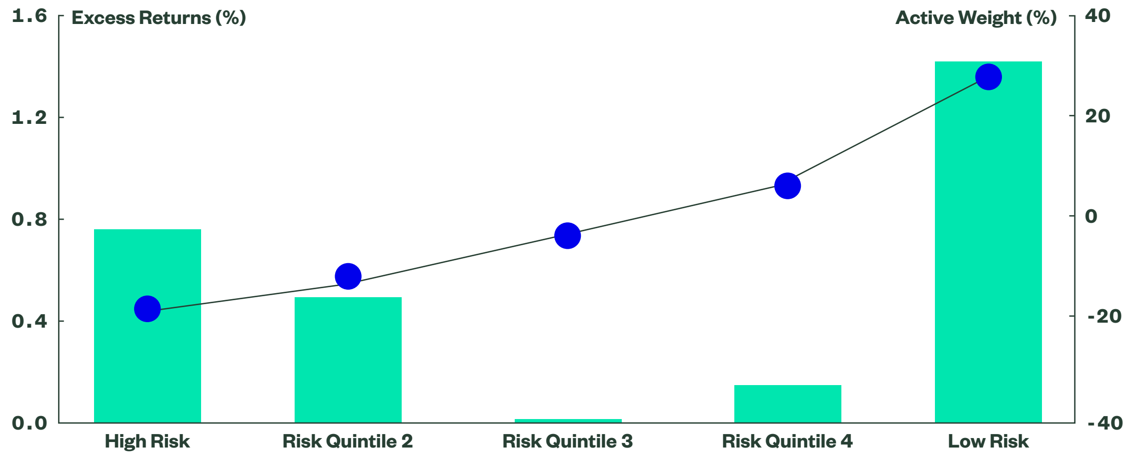
The Drawdown (13 February 2020 to 23 March 2020)

The market volatility and drawdown was unprecedented in its speed and breadth. To gauge the speed of the drawdown, it's helpful to compare it with previous crises. During the Tech Bubble, the drawdown took 241 days — approximately eight months — to lose 30%. During the Global Financial Crisis, it took more than five months (166 days) for global equity markets (using MSCI World as a proxy) to fall 30%. In contrast, during the COVID-19 crisis it took just 25 days to lose 30%.

The COVID-19 market drawdown was also unique because of its breadth, which represented a selloff across markets and sectors. The best performing sector in the COVID-19 drawdown outperformed the index by only 12.87%. In prior episodes such as the Global Financial Crisis and the Tech Bubble, the best performing sector outperformed the MSCI World Index by 20% and by 32%, respectively.

Despite the sharp nature of the COVID-19 drawdown, the GDE strategy still provided strong downside protection, outperforming the MSCI World Index by 324 bps, largely due to its inherent defensive posture. Evaluating the performance of the GDE strategy by risk quintiles (equally distributed by number of securities), we see that the underweight positioning in the high-risk quintile and the overweight positioning in the low-risk quintile drove a majority of the outperformance (see Figure 3).

Figure 3
Performance and Active Weights of Global Defensive Equity vs. the MSCI World Index
(13 February 2020 to 23 March 2020)



Source: State Street Global Advisors as of 31 March 2020. Past performance does not guarantee future results. Returns shown here are in USD and net of dividends.

The Recovery (23 March 2020 to 22 May 2020)

In the market recovery through 22 May, the Global Defensive Equity strategy has generated 22.86% in returns while the MSCI World Index has generated 29.92% in returns (one of the fastest 30% rises ever experienced in global markets).

While this underperformance may seem substantial on a relative basis, in absolute terms the strategy has delivered results in line with its design, which targets approximately 80% upside capture in up markets. If we dig a level deeper into what has been driving markets, we observe that the rally has been primarily focused in the risky and expensive pockets of the market — i.e., areas that the GDE strategy tends to avoid because, over time, they provide lower risk-adjusted returns.

Figure 4 shows returns by quintiles of value and risk for the MSCI World Index. It is evident that during the recovery we have seen a sharp rally in well-known Technology and Telecommunications names, which are both expensive and very risky. In addition, we have seen Energy emerge as the best performer during the recovery — another pocket of the market that is risky and which the GDE strategy continues to underweight. In sum, full participation in the equities rally we are observing would cause us to ignore our emphasis on valuation and risk — two key pillars of the GDE strategy's historical success — which would in turn jeopardize our ability to deliver against the strategy's objectives over the longer term.

Figure 4
Quintile Performance of Value and Risk for the MSCI World Index During the COVID-19 Recovery from Market Lows
(23 March 2020 to 22 May 2020)

Average Market Returns (%)			Risk				
			High Risk				Low Risk
			1	2	3	4	5
Value	Cheap	1	34.70	26.00	23.96	20.38	16.17
		2	36.92	27.39	25.60	20.57	20.42
		3	48.22	33.55	28.67	24.42	19.26
		4	44.77	36.84	30.65	29.80	24.73
	Expensive	5	52.71	45.00	36.27	33.43	30.78

Source: State Street Global Advisors as of 22 May 2020. Past performance does not guarantee future results. Returns shown are in USD and net of dividends.

Our Current Focus

The focus of the Global Defensive Equity strategy today remains where it's always been: We continue to concentrate our efforts on generating superior risk-adjusted returns for investors. Our risk model suggests that market risk levels continue to be elevated. As such, the GDE portfolio continues to maintain a defensive posture with increased positions in Consumer Staples, Utilities, and Health Care. In a recent article[3] we discussed Health Care as a sector that could not only weather the storms of the COVID-19 period, but also potentially outperform the market meaningfully in the future. In general, we are also adapting to current conditions by increasing our emphasis on the quality of the companies and businesses we invest in.

As active quantitative equity managers, we believe in sticking to our process and learning from the markets. Short periods of volatility can dampen near-term efficacy, but such periods can also reward a systematic process over the longer term by helping us to predict future returns.

Not Just a Tactical Allocation

Given the degree of uncertainty that all investors face, we in State Street's Active Quantitative Equity team believe that a permanent, strategic allocation to defensive equities can help investors meet their goals over the long term.

At this point in the COVID-19 crisis, it is unclear whether we're observing a bear market rally or a full-blown recovery in markets, with the economy to follow shortly after. Whatever path the recovery may take, we believe that investing in a strategy like Global Defensive Equity, which balances risk and return, is worth consideration.

Betting entirely on a full recovery — *or* entirely on another sharp drawdown — would not be a prudent choice for long-term investors. Defensive equity approaches like GDE can help investors strike a productive balance during uncertain market conditions, helping them maintain a sharp focus on risk mitigation while still keeping up with rebounding markets.

Endnotes

1 "Upside/Downside Capture: An '80:60 Strategy' Demonstrates the Benefits of a Defensive Equity Portfolio," by Bruce Apted and Adhiraj Mallik (State Street Global Advisors, September 2019).

2 The time period we cover in this section is 13 February 2020 to 22 May 2020.

3 "How We Approach Defensive Equity Investing: The Health Care Example," by Chee Ooi, Adhiraj Mallik, and Kishore Karunakaran (State Street Global Advisors, 21 May 2020).

About State Street Global Advisors

Our clients are the world's governments, institutions and financial advisors. To help them achieve their financial goals we live our guiding principles each and every day:

- Start with rigor
- Build from breadth
- Invest as stewards
- Invent the future

For four decades, these principles have helped us be the quiet power in a tumultuous investing world. Helping millions of people secure their financial futures. This takes each of our employees in 27 offices around the world, and a firm-wide conviction that we can always do it better. As a result, we are the world's third-largest asset manager with US $2.69 trillion* under our care.

* AUM reflects approximately $50.01 billion USD (as of March 31, 2020), with respect to which State Street Global Advisors Funds Distributors, LLC (SSGA FD) serves as marketing agent; SSGA FD and State Street Global Advisors are affiliated.

ssga.com

For investment professional use only

Glossary

Defensive equities While the term is generally used in connection with stocks that possess defensive characteristics, such as stable cash flows and lower volatility, it may also be used to refer to lower-risk securities such as government bonds and preferred shares. Defensive stocks may outperform their flashier counterparts like growth stocks during periods of economic uncertainty when equity markets display a declining trend, but will underperform during periods of economic expansion.

Please visit the below Worldwide Entities
State Street Global Advisors Worldwide Entities

Investing involves risk including the risk of loss of principal. The information provided does not constitute investment advice and it should not be relied on as such. It should not be considered a solicitation to buy or an offer to sell a security. It does not take into account any investor's particular investment objectives, strategies, tax status or investment horizon. You should consult your tax and financial advisor. All material has been obtained from sources believed to be reliable. There is no representation or warranty as to the accuracy of the information and State Street shall have no liability for decisions based on such information.

The views expressed are the views of Adhiraj Mallik through June 1, 2020, and are subject to change based on market and other conditions. This document contains certain statements that may be deemed forward-looking statements. Please note that any such statements are not guarantees of any future performance and actual results or developments may differ materially from those projected. Investing involves risk including the risk of loss of principal.

Actively managed funds do not seek to replicate the performance of a specified index. Equity securities may fluctuate in value in response to the activities of individual companies and general market and economic conditions. Investing in foreign domiciled securities may involve risk of capital loss from unfavorable fluctuation in currency values, withholding taxes, from differences in generally accepted accounting principles or from economic or political instability in other nations.

Investments in emerging or developing markets may be more volatile and less liquid than investing in developed markets and may involve exposure to economic structures that are generally less diverse and mature and to political systems which have less stability than those of more developed countries.

The MSCI World Index, MSCI World ex US and the MSCI US Index are trademarks of MSCI Inc. MSCI indices are the exclusive property of MSCI Inc. ("MSCI"). MSCI and the MSCI index names are service mark(s) of MSCI or its affiliates and have been licensed for use for certain purposes by State Street Global Advisors ("SSGA"). The financial securities referred to herein are not sponsored, endorsed, or promoted by MSCI, and MSCI bears no liability with respect to any such financial securities. No purchaser, seller or holder of this product, or any other person or entity, should use or refer to any MSCI trade name, trademark or service mark to sponsor, endorse, market or promote this product without first contacting MSCI to determine whether MSCI's permission is required. Under no circumstances may any person or entity claim any affiliation with MSCI without the prior written permission of MSCI.

For use in EMEA:

The information contained in this communication is not a research recommendation or 'investment research' and is classified as a 'Marketing Communication' in accordance with the Markets in Financial Instruments Directive (2014/65/EU) or applicable Swiss regulation. This means that this marketing communication (a) has not been prepared in accordance with legal requirements designed to promote the independence of investment research (b) is not subject to any prohibition on dealing ahead of the dissemination of investment research.

This communication is directed at professional clients (this includes eligible counterparties as defined by the appropriate EU regulator) who are deemed both knowledgeable and experienced in matters relating to investments. The products and services to which this communication relates are only available to such persons and persons of any other description (including retail clients) should not rely on this communication.

All the index performance results referred to are provided exclusively for comparison purposes only. It should not be assumed that they represent the performance of any particular investment.

The trademarks and service marks referenced herein are the property of their respective owners. Third party data providers make no warranties or representations of any kind relating to the accuracy, completeness or timeliness of the data and have no liability for damages of any kind relating to the use of such data.

The whole or any part of this work may not be reproduced, copied or transmitted or any of its contents disclosed to third parties without SSGA's express written consent.

© 2020 State Street Corporation.
All Rights Reserved.
ID224340-3115852.1.1.GBL.INST 0620
Exp. Date: 06/30/2021