Insights
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Active Management of Downside Risk During Long Market Cycles

Investors Should Avoid Complacency, as Higher Volatility Brings New Opportunities

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The performance of low volatility strategies has generally been disappointing since the Global Financial Crisis (GFC). In order to better understand this underperformance, it helps to have a long-term perspective on the current market cycle and the typical forces driving market cycles. One way to gain this perspective is to use the long-term characteristics of an 80:60 defensive equity strategy and proxy its long-term performance for DJIA historical returns going back to 1900.

The 80:60 concept — trying to capture 80% of the market upside and to participate in only 60% of the market downside — has been largely realized in the long-term performance of leading defensive equity strategies.

Figure 1 shows the performance of a portfolio that captured 80% of DJIA upside and 60% of the index downside, on a monthly basis since 1900. The analysis gives us 12 decades of performance data, which provide a good perspective on the long-term return characteristics.

Figure 1
80:60 Portfolio Characteristics Applied to 120 Years of DJIA Returns
By Decade

	Return DJIA (%)	Return 80:60 (%)	Excess Return (%)	Annualized Standard Deviation on DJIA (%)	Proportion of Up Months (%)	Proportion of Down Months (%)
1900–1910	4.2	8.5	4.3	18.5	54	45
1910–1920	0.8	5.8	5.0	19.2	55	42
1920–1930	8.8	12.3	3.6	19.7	55	45
1930–1940	-4.9	6.8	11.7	35.2	56	44
1940–1950	2.9	6.2	3.3	14.2	58	42
1950–1960	**13.0**	**12.9**	**-0.1**	**11.4**	**64**	**36**
1960–1970	1.7	4.9	3.2	12.5	57	43
1970–1980	0.5	4.8	4.4	15.9	51	49
1980–1990	12.6	13.6	1.0	16.3	56	44
1990–2000	**15.4**	**15.1**	**-0.2**	**13.8**	**68**	**32**
2000–2010	-1.0	3.7	4.7	15.6	53	47
2010–2020	**10.6**	**11.1**	**0.5**	**12.1**	**69**	**31**

Source: Dow Jones, State Street Global Advisors. The sample 80:60 portfolio returns shown are based on the returns of the underlying market indices in the proportions shown. The returns of the "80:60" strategy were achieved by multiplying positive monthly returns by 80% (0.8) and negative monthly returns by 60% (0.6). Months with performance of 0% remained as such.

The analysis shows that, in all but 3 of the 12 decades, investing in an 80:60 strategy would have delivered outperformance over the index. This is not surprising, as previous research has shown that, over the long term, strategies with lower volatility objectives have superior returns — generally because investors' behavioral bias toward taking on the riskiest assets drives high volatility (while suppressing long-term returns).

In an up market cycle, investors get overly optimistic and take on excessive risk, driving up asset valuation in the process. Excessive valuation eventually becomes unsustainable, leading to a correction and downward pressure on asset pricing. In a down market cycle, the pendulum swings to the opposite side, leading to excessive pessimism on asset pricing and driving down asset valuation (but setting the stage for eventual price recovery).

How, then, do we explain the three decades when we saw an extended up market cycle yet low volatility underperformed? We believe market cycles can be extended when a perfect storm of strong macro forces comes together to feed an increasing appetite for risk.

In the 1950s, it was the post-war peace dividend and population expansion from the Baby Boom driving an extended cycle of consumption and economic expansion. Likewise, the extended cycle in the 1990s was driven by China's and India's rising participation in the global economy, as well as by low inflation, low interest rates, and abundant opportunities for growth in corporate earnings from outsourcing and cost reduction. As might be expected, in both instances, human behavioral bias for excess eventually led to a sharp market correction over the following decade.

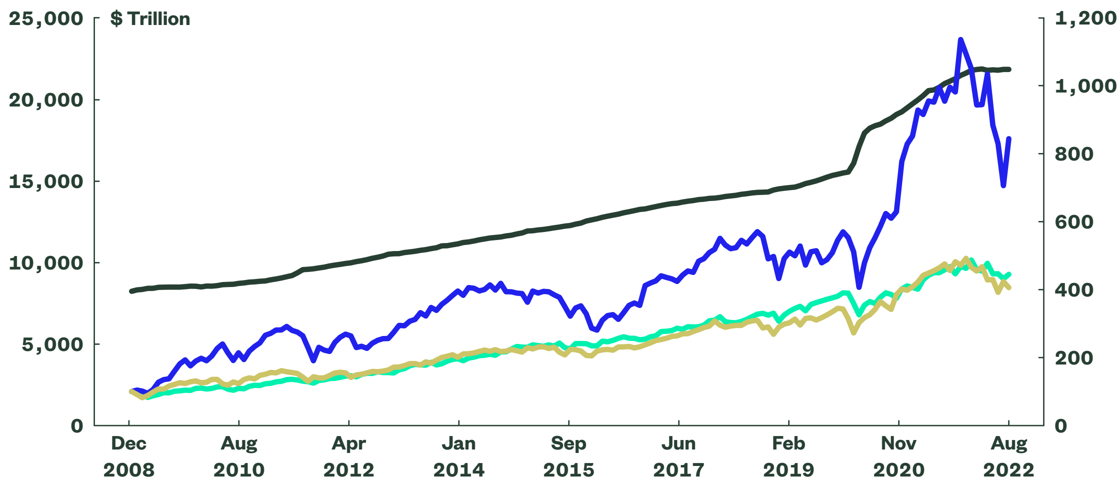
The Current Extended Market Cycle

The decade from January 2010 to January 2020 was one of the most favorable environments in 120 years of market history. It was a decade of unusually low volatility, exceptionally high return, and consistent upside in markets. In fact, that favorable environment persisted until the beginning of 2022 (with a brief interruption from Covid-19). Once again, very powerful market forces came together to propel the extended market cycle. Since 2010, the balance sheets of the G4 nations have grown almost fourfold from $6 trillion to $23.7 trillion.[1]

It is also useful to step back and review the big picture over the last 14 years (see Figure 2). The GFC was a difficult period that led to unprecedented steps that included bailouts, emergency Fed window programs, and several rounds of Quantitative Easing. This inevitably led to a significant buildup of the M2 money supply, which is now almost $22 trillion. During this period, the cost of capital was also extraordinarily low compared with historical norms, which helped the MSCI World Index return 500% for this time period as of the end of 2021 (still up more than 400% as of this writing).[2]

Figure 2
Money Supply and Market Returns
From GFC to Present

M2 Money Supply (LHS)
Low Beta (RHS)
High Beta (RHS)
MSCI World (RHS)

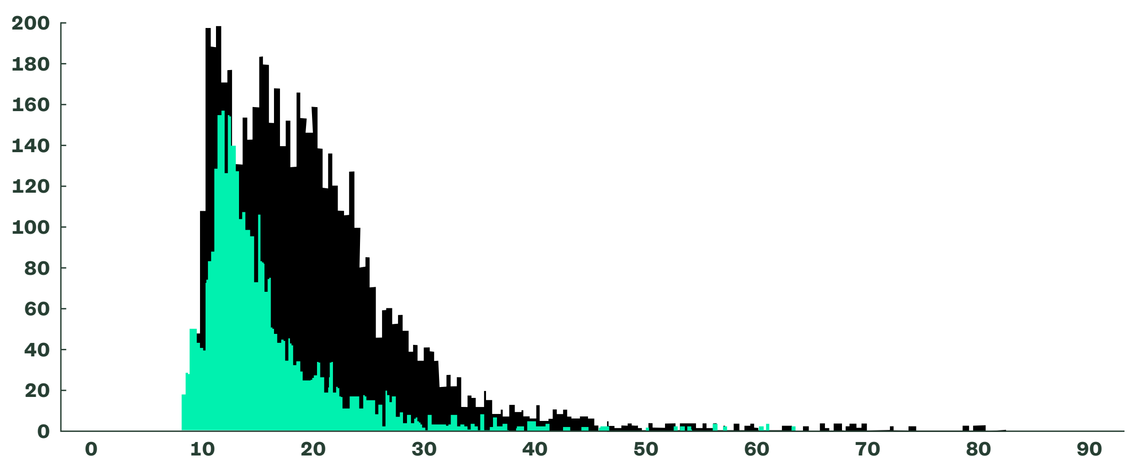


Source: Bloomberg, Ken French Website, as at August 31, 2022. Past performance is not a reliable indicator of future performance. Index returns reflect capital gains and losses, income, and the reinvestment of dividends.

As a consequence, the US Federal deficit has grown more than fivefold from $0.5 trillion in 2008 to $2.8 trillion in 2021.[3] That's just the US. The story was the same across most of the developed economies. Since the end of the GFC, we have had a constant deluge of liquidity. That excess liquidity has been the fuel that powered unprecedented low volatility, high returns, and a generally upward-trending market. Figure 3 shows that the distribution of the VIX after July 2012 markedly shifted lower. The historical distribution of the VIX from its inception until June 2012 was much higher.

Figure 3
VIX Distribution, Pre and Post June 2012

Pre-June 2012
Post-June 2012

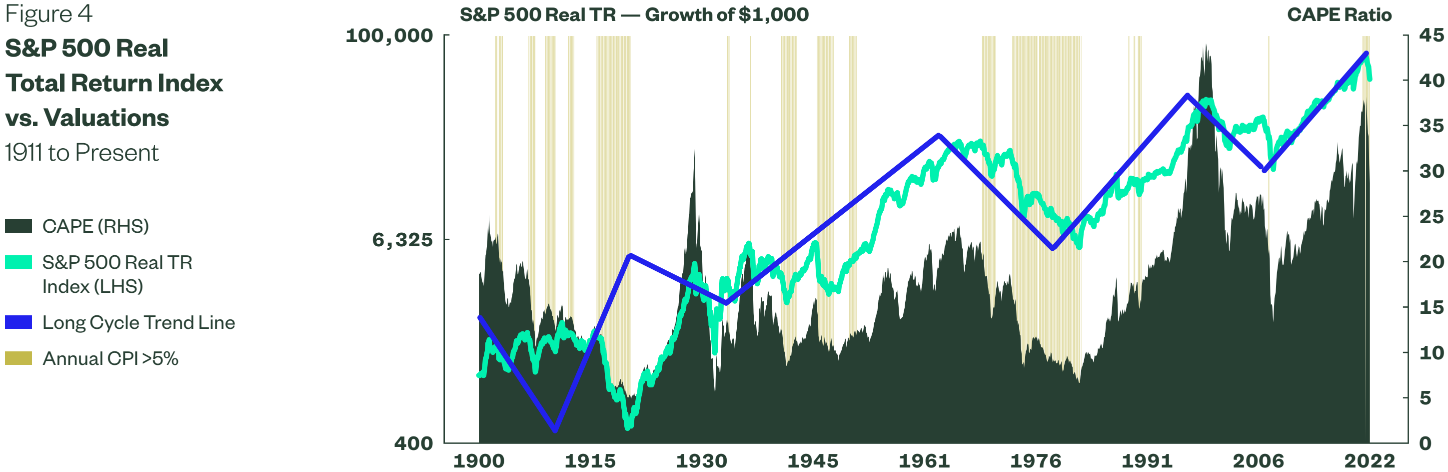


Source: CBOE, VIX data website.

The Imperative of Managing Equity Risk

The long-term history of markets has shown us how investors get complacent (see Figure 4). We are seeing signs today of investors over-extrapolating the good times far into the future, leading to a substantial re-rating of market valuation.

Figure 4
S&P 500 Real Total Return Index vs. Valuations
1911 to Present



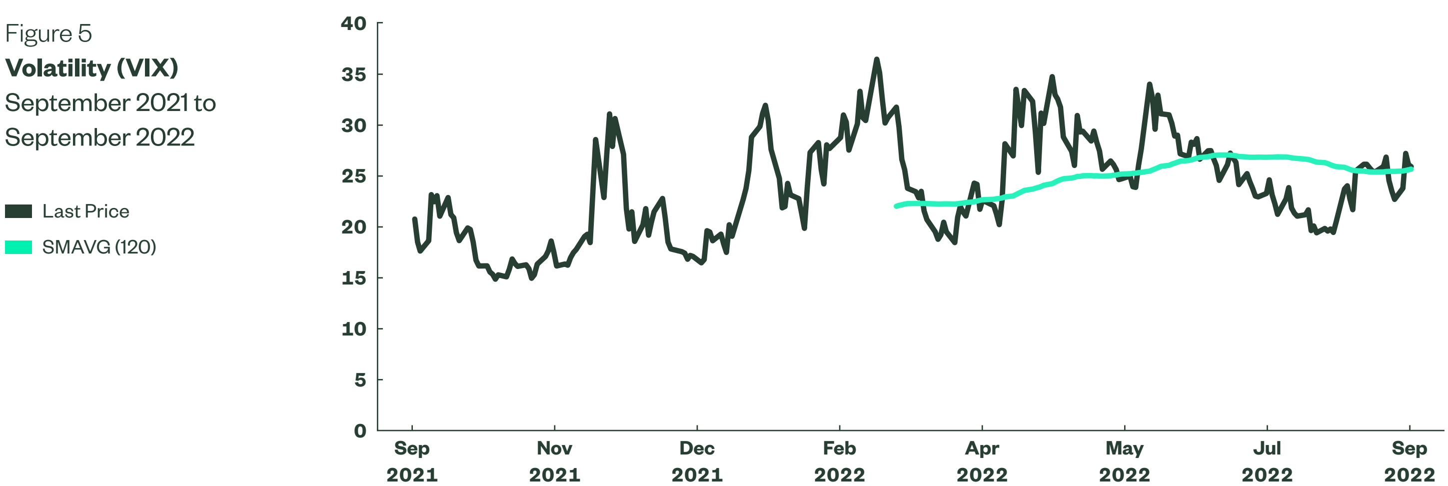
Source: Part 1: An Overview of Secular Trends Shaping the Post-Pandemic Cycle — SSGA Insights, Michael Lin, as at June 30, 2022. Past performance is not a reliable indicator of future performance. Index returns reflect capital gains and losses, income, and the reinvestment of dividends.

All these are worrying signs for the market, especially as we observe many of the favorable market forces starting to reverse. Low inflation has turned to high inflation, with energy prices skyrocketing because of the war between Russia and Ukraine. Favorable forces that have kept inflation in check — high labor force participation, globalization, offshoring of manufacturing, and low commodity prices — are all under significant pressure. And with inflation rearing its head, central banks around the world have had to combat this threat with tighter monetary policy.

What Should Investors Do?

Downside risk remains very real, as uncertainty around inflation expectations continues to increase alongside a possibility of policy errors. Furthermore, volatility has settled on a new medium-term average in recent months (see Figure 5). Typically, higher volatility allows for opportunities to add value as an active manager. And regardless of directional moves in the market, volatility will remain a key player in markets for the foreseeable future.

Figure 5
Volatility (VIX)
September 2021 to September 2022



Source: Bloomberg, CBOE, as at September, 2022.

Investors should come to terms with the fact that returns will be scarce going forward and, additionally, they should heed the dangers of excessive equity risk. Equity risk has to be managed diligently and carefully, paying attention to the less-visible risks. Since investors' paths are likely more ridden with pitfalls, in our opinion, an active approach where the various permutations are examined meticulously is appropriate.

We therefore believe that prudent investors should investigate and evaluate proven strategies where downside risks are actively managed. For information on defensive equity strategies, contact your State Street representative.

Endnotes

1 As of August 2022.

2 Source: MSCI.

3 Source: US Treasury.

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* Pensions & Investments Research Center, as of December 31, 2021.
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