Commentary
Active Quantitative Equity (AQE)

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Active Quantitative Equity

Don't Overpay to Be Defensive

- When defensive equity positions become more appealing, stocks that exhibit lower-risk attributes, including low beta stocks and stocks in traditionally defensive sectors, can become expensive.
- Risk measures are not sufficient to construct a defensive portfolio; valuation is also important, as are measures of financial strength, growth capability, and other measures of company quality.

In recent months, increasing equity market volatility has led many investors to pursue a more defensive positioning in their equity portfolios. As they've done so, many have used risk measures such as beta[1] to select stocks that will withstand shocks in the market.

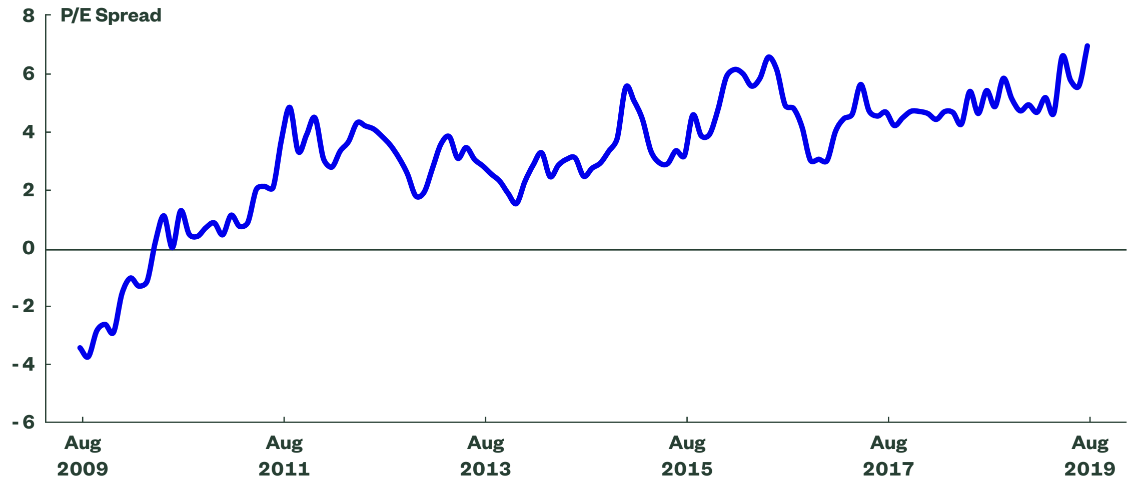
Risk is certainly a useful input when constructing a defensive portfolio, but in Active Quantitative Equity (AQE) we believe that focusing on risk alone in this context is far from optimal. By considering a wide range of risk *and* return drivers, as well the relationships among stocks, we seek to maximize long-term returns while managing risk in our defensive portfolios.

This is important because — as recent market trends show — when defensive equity positions become more appealing, stocks that exhibit lower-risk attributes, including low beta stocks and stocks in traditionally defensive sectors, can become expensive, and stocks in sectors *not* conventionally considered "defensive" can exhibit defensive traits. This commentary will explore these recent trends and outline AQE's robust and nuanced approach to constructing defensive portfolios.

Low Beta Stocks and Traditionally "Defensive" Sectors Are Expensive

One common path to building a more defensive equity portfolio is to favor low beta stocks. These stocks have become popular among investors — so popular that their prices now represent stretched multiples of forecast earnings. Figure 1 shows that the valuation spread between low and high beta stocks has climbed steadily over the last 10 years, including a sharp rise in recent years. At the end of 2016, the spread was around 3.1 multiple points. Now, the spread is around 7.

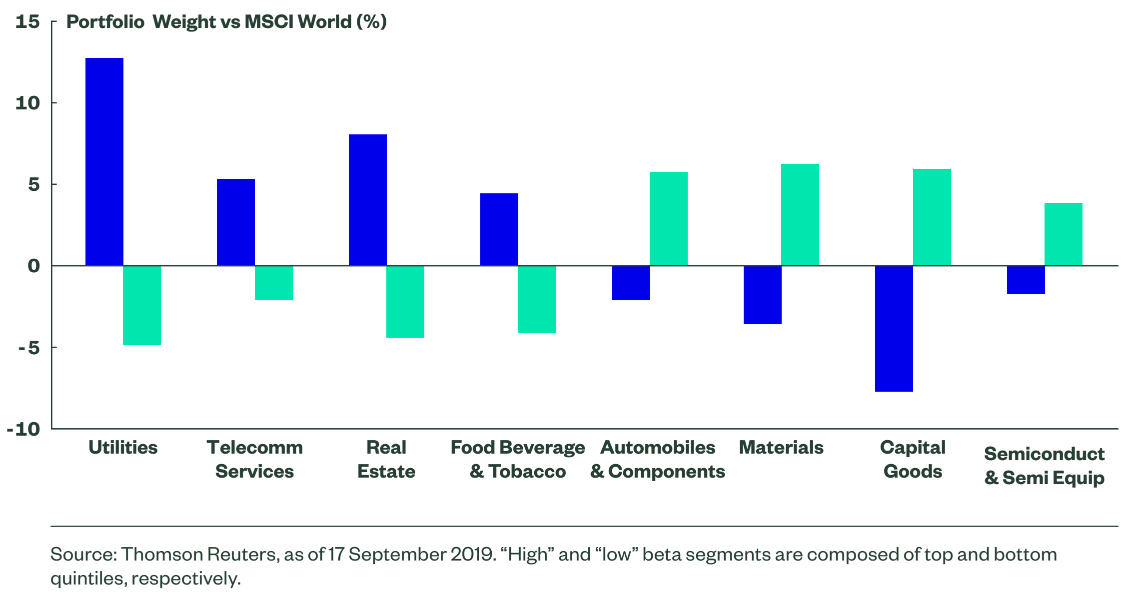
Figure 1
The Valuation Spread Between Low and High Beta Stocks Has Climbed Steadily
Historical Price-to-Earnings (P/E) Spread Between Low Beta and High Beta Stocks, 2009–2019



Source: FactSet, as of 31 August 2019. Chart depicts MSCI World constituents grouped into top and bottom quintiles of beta.

A second well-worn path toward a more defensive equity positioning is choosing sectors that are typically considered to be "defensive." It shouldn't be a surprise that there is substantial overlap between these two paths: A portfolio constructed exclusively of stocks in the lowest quintile of beta tends to be dominated by market segments traditionally labelled as defensive. Figure 2 shows that utilities, real estate, and food & beverage are the industry groups most highly represented in a low beta portfolio — and all are considered typically defensive sectors. The industry groups most highly represented in a high beta portfolio are autos, materials, and capital goods — all conventionally considered to be cyclical sectors.

Figure 2
There is Substantial Overlap between Low Beta Stocks and Stocks from Sectors that Are Typically Considered "Defensive"
Active Weight (vs. MSCI World Index) of Portfolio that Selects Equal-Weighted Group of Companies



Source: Thomson Reuters, as of 17 September 2019. "High" and "low" beta segments are composed of top and bottom quintiles, respectively.

Prices relative to earnings in low-risk and conventionally defensive segments have coincided with market flows. For example, in the past 12 months, ETF flows have been positive in utilities, consumer staples, real estate and communication services, but have been negative in discretionaries, industrials, energy, materials and IT. They have been sharply negative in financials. Flows into low volatility ETFs have accelerated in the last 12 months, accumulating almost USD26Bn in that time.

The problem with choosing stocks based on risk measures, such as beta or volatility, is that the other dimensions of risk are not taken into account. These risk dimensions can become return opportunities. For example, what is the interest rate sensitivity of the portfolio? What is the valuation multiple being paid for these low volatility or low beta stocks? If the goal is to generate strong returns on a risk-adjusted basis, then many more dimensions must be considered to create a portfolio of stocks built to navigate market uncertainty.

Looking at the valuation of each of the conventionally defensive sectors, we see that the utilities and real estate segments as a whole are trading on a multiple of forecast earnings around 2 points higher than their long-term average. The utilities stocks in the low beta group on average are currently trading at a multiple of 19 times earnings, and the real estate and food & beverage segments are trading at an average of 30 and 21 times earnings, respectively.

When we think about investing defensively, risk measures are not enough. Valuation is also important, as are measures of financial strength, growth capability, or other measures of company quality. And the individual assessment of each stock is also not enough. Consideration of the interaction of stocks with one another (correlation) matters, too.

During September, we saw glimpses of the risks associated with holding overvalued companies. In the 10 days between September 2 and September 13, the global equity market underwent a sharp rotation to favor cheaper, higher beta companies. The catalyst was a combination of economic data, monetary and fiscal stimulus, easing trade tensions and a stabilization in bond yields. During this period, the MSCI World index returned +3.7%; however, the worst performers were the typically defensive sectors, several of which showed negative total returns in September — utilities (-0.5%), consumer staples (-0.4%) and real estate (-1.0%). Financials, including banks and insurers, were very strong, as were semi-conductors, automobiles, capital goods and resources companies. The traditionally defensive segments sharply underperformed, particularly those with the most stretched valuations.

Opportunities for Defensive Positioning

We certainly see a role for stocks from some traditionally labeled defensive sectors in a well-constructed defensive equity portfolio. For example, we favor some utilities for their defensive characteristics. We also see a role for European insurance stocks, Asia-Pacific telecoms and some European pharmaceuticals. Insurance stocks contribute from a valuation standpoint, as well as providing a complementary interest rate exposure.[2] We have also found attractive names in stocks with a higher beta that have *not* conventionally been considered defensive, such as banks, software and retailing.

The Bottom Line

Don’t overpay to be defensive. Consider a wide range of risk and return drivers to increase the likelihood that a portfolio will stay resilient in times of stress, and strive not to lose sight of the portfolio’s return potential.

Endnotes

1 Beta is a measure of a stock's volatility in relation to the market. By definition, the market has a beta of 1.0, and individual stocks are ranked according to how much they deviate from the market. A stock that swings more than the market over time will have a beta above 1.0.

2 See our July 2019 commentary, "Volatility Among Historically Divergent Sectors is Now Converging. A Comparison of Utilities and Insurers Illustrates What This Means for Portfolio Construction."

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Glossary

Defensive Positioning Defensive investment strategies are designed to deliver protection first and modest growth second. With an offensive or aggressive investment strategy, by contrast, an investor tries to take advantage of a rising market by purchasing securities that are outperforming for a given level of risk and volatility.

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