Commentary
Active Quantitative Equity (AQE)

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Volatility Among Historically Divergent Sectors is Now Converging. A Comparison of Utilities and Insurers Illustrates What This Means for Portfolio Construction.

Olivia Engel, CFA
Chief Investment Officer
Active Quantitative Equity

- Utility stocks are becoming more volatile and, from a valuation perspective, less attractive. Meanwhile, insurance stocks are currently expressing the risk and return attributes of a classically defensive exposure.
- At the same time, our proprietary macro-risk model adds important nuance to our risk and return assessments and, ultimately, to our defensive-portfolio positioning.

Utilities could perhaps be considered the quintessential "defensive" stock, due to their reputation for relatively low volatility. But the picture for utilities today is more complicated.

Our investment process includes continual assessment of the risk and return potential of the thousands of individual stocks in our universe. Part of that assessment includes the application of a proprietary model of market risk that attributes volatility to macro-risk factors, including interest rates, credit conditions, oil prices, and other phenomena. Recently, that assessment has revealed that, from a risk perspective, utility stocks are becoming more volatile and, from a valuation perspective, they're becoming less attractive. Meanwhile, insurance stocks — not necessarily the first sector that would spring to mind when seeking defensive characteristics — are currently exhibiting the risk and return attributes of a classically defensive exposure.

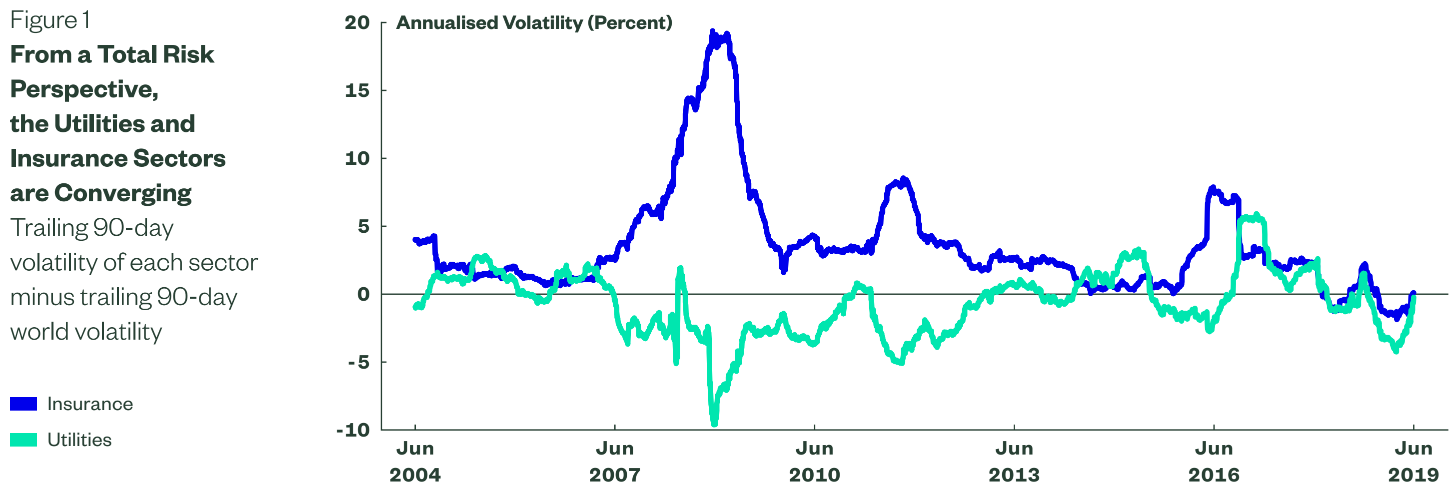
In general, this means that in our defensive portfolios, we may consider reducing our exposure to utilities in favor of insurance stocks. At the same time, however, the application of our proprietary macro-risk model — in particular, what that model reveals about sensitivity to interest rates in each of these sectors — adds important nuance to our assessment and, ultimately, to our defensive-portfolio positioning.

Comparing Risk and Returns

From a total-volatility perspective, the utility and insurance sectors look remarkably similar in the current environment. This is a substantial change; historically, the total volatility of the utility sector and the total volatility of the insurance sector have deviated substantially from one another (see Figure 1).

As we see in Figure 1, historically utilities have experienced lower volatility than the broad market on average, while the insurance sector has experienced higher volatility. That gap has now collapsed — and total risk for utilities is currently increasing. This means that the relative benefit of investing in utilities from a risk reduction perspective is now limited.

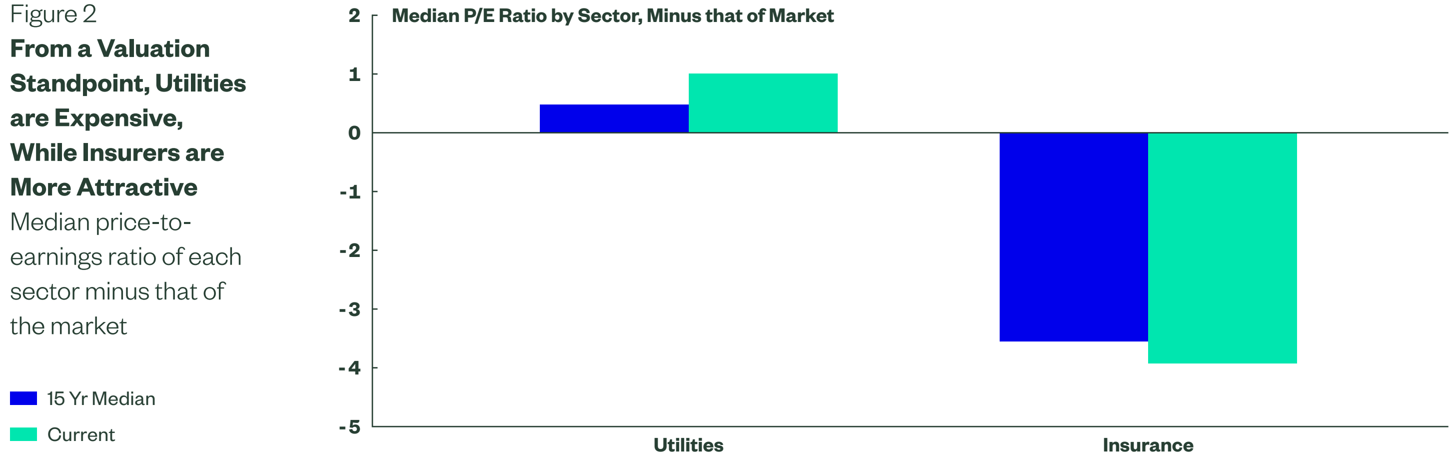
Figure 1
From a Total Risk Perspective, the Utilities and Insurance Sectors are Converging
Trailing 90-day volatility of each sector minus trailing 90-day world volatility



Source: Bloomberg Finance L.P. as at June 27, 2019. Calculation is trailing 90-day volatility of returns to GICS Utilities Sector and GICS Insurance Industry Group within MSCI World Index minus the trailing 90-day volatility of aggregate MSCI World Index.

From a return perspective, our assessment of utilities has been declining. As utilities become increasingly expensive, it's more difficult to find utility names at reasonable value. Insurance stocks look better from a valuation perspective. As we see in Figure 2, over time, the market capitalization-weighted price-to-earnings ("P/E") ratio is higher than market for utilities, and lower than market for insurers (cf. 15-year median P/E ratios); this suggests that over the long run, utilities tend to be expensive, while insurers tend to carry more attractive valuations. Currently, the cap-weighted median P/E ratio for the utilities sector is even higher than the 15-year average for the sector, indicating that utilities are exceptionally expensive.[1] The opposite is true for insurers; the median P/E ratio for the insurance sector is currently even lower than their 15-year average, suggesting that valuations for insurers have become even more attractive. This means that, from both a risk and return perspective, insurers are currently the better complementary exposure to hold in a portfolio context, compared to utilities.

Figure 2
From a Valuation Standpoint, Utilities are Expensive, While Insurers are More Attractive
Median price-to-earnings ratio of each sector minus that of the market



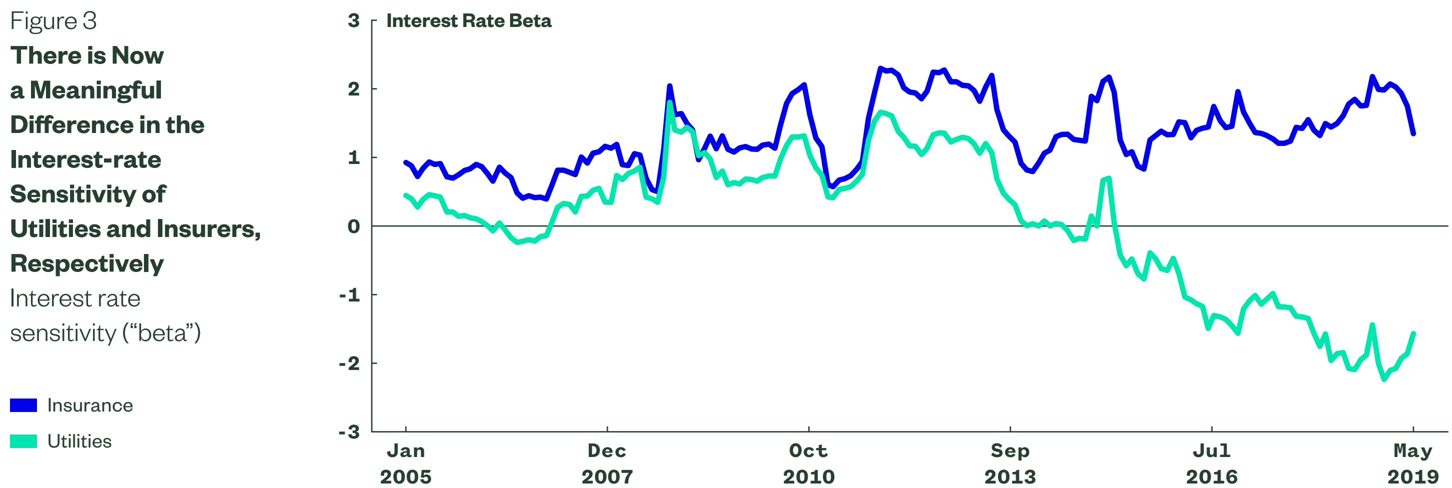
Source: Bloomberg Finance, L.P. as of June 28, 2019. P/E used 12 month Blended Forward Estimate of earnings. The long-term, 15-year median is calculated between 30 April 2005 and 27 June 2019.

The Influence of Interest Rates

The dimensions of risk and return that we've discussed so far are certainly important in our assessment, but they are far from the only relevant points to consider. We look at a wide range of robust metrics to assess stocks' return and risk characteristics. We also have a proprietary model of market risk that attributes stock-price volatility to macro risk factors including interest rates, credit conditions and many more.

According to our model, the difference between the sensitivity of the utilities segment to interest rates and the sensitivity of the insurance segment to interest rates was barely noticeable as recently as 2014. Today, however, there is a meaningful difference (see Figure 3).

Figure 3
There is Now a Meaningful Difference in the Interest-rate Sensitivity of Utilities and Insurers, Respectively
Interest rate sensitivity ("beta")



Source: State Street Global Advisors analysis of Global Developed Market Equities in proprietary large cap universe, as of May 31, 2019. Interest rate beta is measured as the expected excess return (%) to the sector in response to a 1% move in medium-term US government bond yields. For example, if beta is 1.5, then a 1% upward move in the bond yield would lead to a 1.5% excess return for that sector.

Applying this model adds important nuance to our risk and return assessments. We can see from this analysis that the market's reaction to changes in interest rates is making utilities and insurance good complements to each other from an interest-rate risk perspective. In general, insurers are positively exposed to interest rates — that is, when interest rates go up, their return prospects and stock prices improve. The opposite is true of utilities and other equities with bond-like characteristics; when interest rates increase, their performance and stock prices tend to suffer. As the difference in sensitivity between the two sectors deepens, they become better complements to one another from a portfolio perspective. It is especially important to capture the benefit of this complementary relationship now, because interest-rate sensitivity continues to be a major theme driving market volatility this year.

The Bottom Line

We're currently considering the implications of these market trends, and may consider reducing our exposure to utility stocks and increasing our exposure to insurance names, if our assessment of the return potential and expected risk in each sector continues on this trajectory. At the same time, if trends in interest-rate sensitivity also continue according to our market-risk model, we would also be likely to retain some exposure to utility stocks to offset the interest-rate exposure embedded in insurance stocks. Continual assessment of return and risk attributes using a wide range of measures — including a robust assessment of macro risk factors such as interest rates — can sometimes point in somewhat surprising directions. This is precisely why we believe it's so important to follow a disciplined and data-driven investment process. In this way, we're able to paint a fuller picture of expected risk and expected returns as market conditions change.

Endnotes

1 See our April commentary, "Lower-Risk Stocks Rallied in March. Here Are the Key Investment Themes to Watch Now" for more on this trend.

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Marketing communication.

Glossary

Cap-Weighted A capitalization-weighted index is a type of market index with individual components that are weighted according to their total market capitalization.

Valuation Valuation is the analytical process of determining the current (or projected) worth of an asset or a company.

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