Look Out Hare, Here Comes the Tortoise

- The Tortoise (Defensives) Vs. the Hare (Cyclicals)
- Stable earnings offer a longer term advantage
- Slow and steady wins the race

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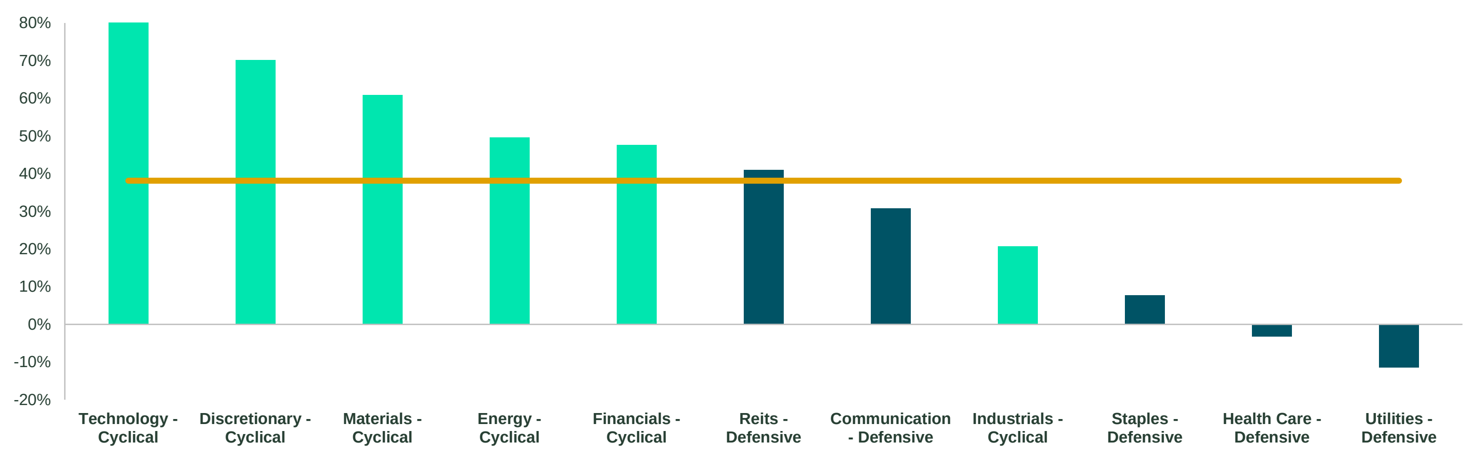
The Tortoise (Defensives) and the Hare (Cyclicals)

The Tortoise and the Hare is a well-loved fable. The Tortoise is known to be slow and steady and the Hare is known to be quick but with less stamina, as well as over confident. The Hare continually ridicules the Tortoise about his lack of speed and in frustration the Tortoise challenges the Hare to a race. In the early stages of the race, the Hare sprints to a quick lead but then being tired from the sprint and over confident, decides to have a rest and falls asleep. Meanwhile the slow and steady Tortoise marches on and eventually passes the sleeping Hare and wins the race. This fable feels especially relevant to the current equity market.

In the last 12 months we have seen a stunning rally in equity markets[1]. The S&P/ASX 300 Index is up 38%[2] but the spread between the best and the worst sectors is extreme. The top 3 sectors (all cyclical) were up 70% while the bottom 3 sectors (all defensive) were down -2%[3]. If you were invested in the cyclical sectors like Technology, Discretionary and Materials you did very well. If you were invested in the defensive sectors like Utilities, Healthcare and Staples you did very poorly.

Figure 1. Cyclical Sectors Outperformed – Defensives Underperformed (31 March 2020 – 16 March 2021)



Source: Factset. Performance of the S&P/ASX 300 Index sectors from 31 March 2020 to 16 March 2021. Past performance is not a reliable indicator of future performance. Performance returns for periods of less than one year are not annualized. Index returns reflect capital gains and losses, income, and the reinvestment of dividends. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. This information should not be considered a recommendation to invest in a particular sector or to buy or sell any security shown. It is not known whether the sectors or securities shown will be profitable in the future.
Defensive Definition: S&P/ASX 300 Sectors: Consumer Staples, Health Care, Real Estate, Communication Services, Utilities
Cyclical Definition: S&P/ASX 300 Sectors: Industrials, Consumer Discretionary, Energy, Financials, Information Technology, Materials .

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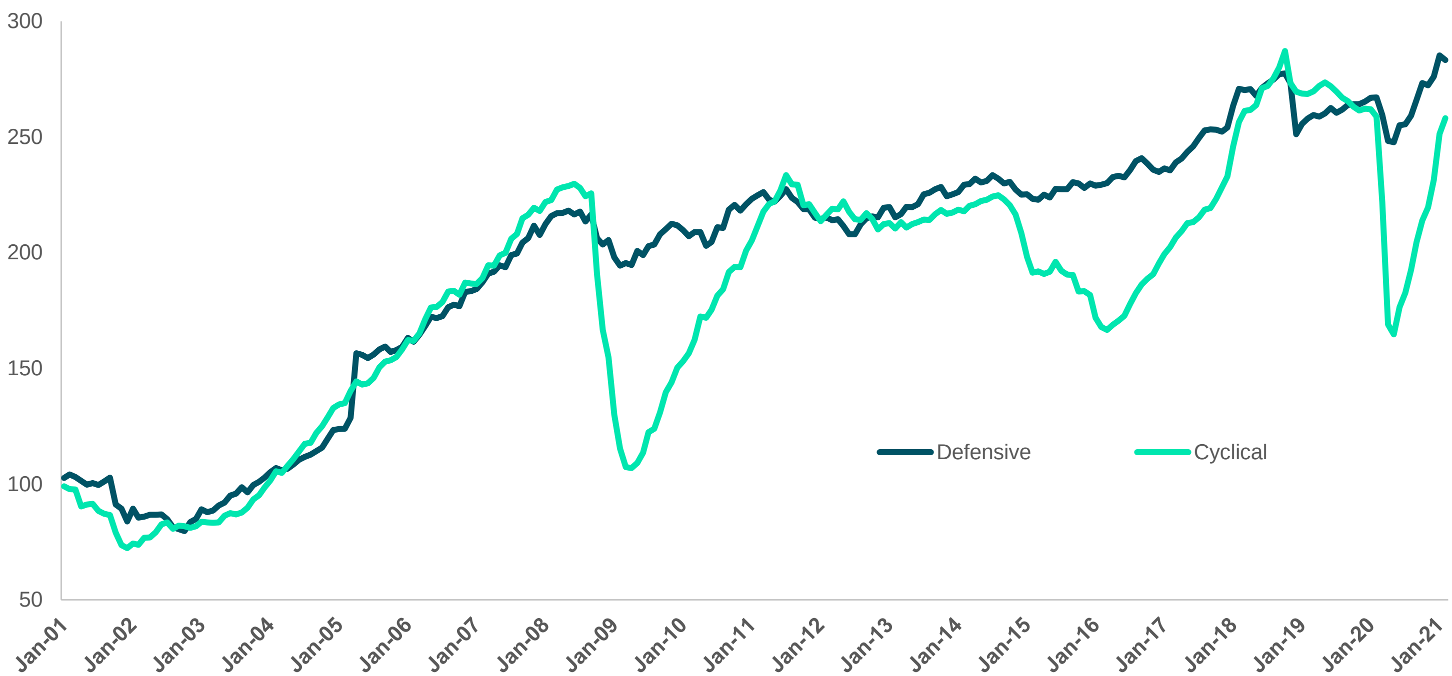
[1] Fueled by a super accommodative central banks, aggressive fiscal stimulus and the vaccine rollout.
[2] Source: Thomson Reuters – for the period 31 March 2020 – 16th March 2021.
[3] Source: Thomson Reuters – for the period 31 March 2020 – 16th March 2021.

Cyclicals exhibit greater volatility in earnings and share prices

Whilst cyclical sectors have had outsized returns in the last 12 months it should be remembered that they tend to exhibit greater volatility and higher beta. Whilst they have greater exposure to global growth improving, they also have the exposure should those growth expectations moderate. In the last 12 months the cyclical equities such as Energy, Materials and Financials have moved to higher prices and now reflect the bullish consensus global growth outlook[4]. After these increases in share prices they are now more fully priced and more vulnerable to any moderation in the growth outlook. During the February reporting season we observed underperformance in the Technology sector as many of the results were not positive enough to keep the fully valued share prices moving higher.

Figure 2, below, highlights the volatility in earnings of the MSCI World Index defensive sectors (the Tortoise) compared to the cyclical sectors (the Hare).

Figure 2. Longer Term Perspective on Earnings Variability of Cyclical vs Defensive Companies.



Source: Factset as of 16 March 2021. Composite earnings of the cyclical and defensive sectors for MSCI world sectors.

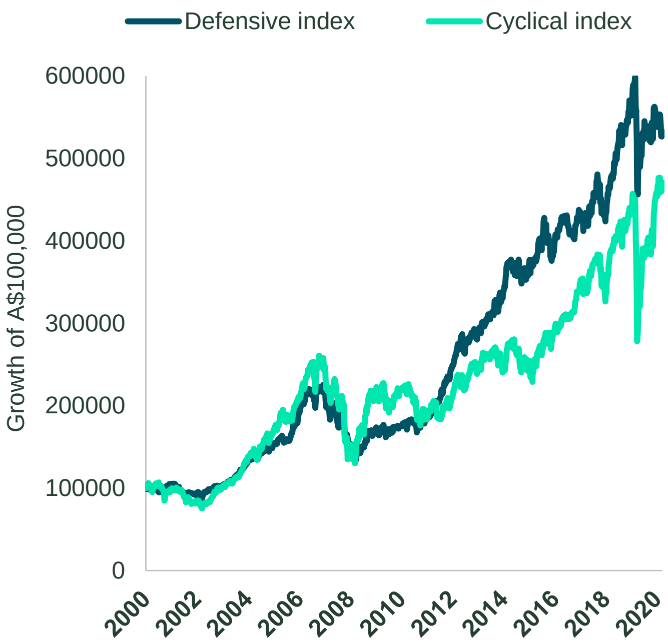
Many defensive companies have been out of favour for the last 12 months, especially since the vaccine was announced in November 2020, but now offer better relative value. In the most recent February reporting season, most defensive businesses reported sound results but underperformed in a market searching for growth. Defensive businesses like the Tortoise will more than likely continue to generate more consistent cash flow, dividends and long term capital growth.

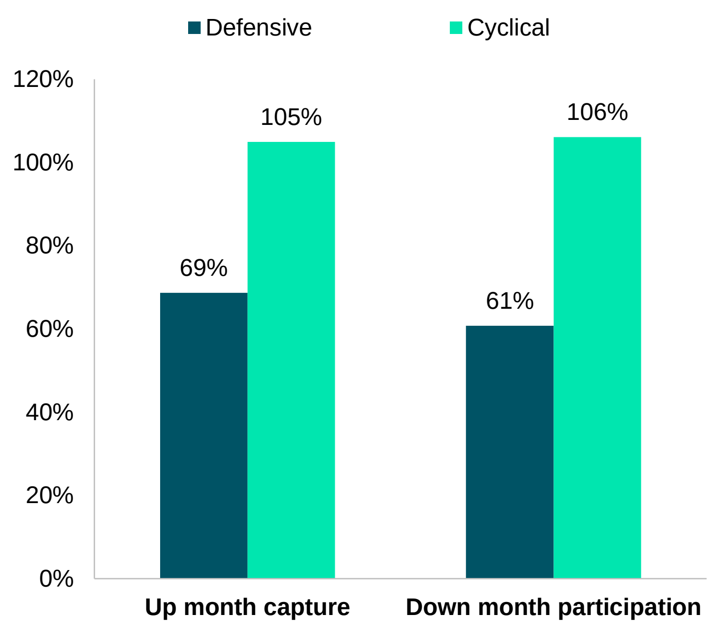
[4] Based on Bank of America Global Fund Manager Survey report released 16 March 2021.

The Slow and Steady Defensive Sectors Typically Outperform with Lower Risk

As in the Tortoise and Hare fable the Hare might have some great sprints but it is the Tortoise that typically wins in the longer term. Figure 3, below, shows the performance of the defensive stocks going back to 2001. The defensive sectors returned 8.6% p.a. with only 12% volatility while the cyclical sector returned 7.9% p.a. with 17% volatility. The defensive sector has much lower upside capture but equally has much lower downside participation which provides an edge for outperformance over the longer term. In contrast the cyclical stocks are high beta typically outperforming in up months but underperforming in down months.

Figure 3. Defensive Companies Have Been Outperforming Cyclical Companies since 2001





Source: Factset as of 16 March 2021. Composite earnings of the cyclical and defensive sectors for S&P/ASX 300 Index.
Past performance is not a reliable indicator of future performance. Index returns reflect capital gains and losses, income, and the reinvestment of dividends. Index returns are unmanaged and do not reflect the deduction of any fees or expenses.

The Bottom Line:

Cyclical investments can have a place in a diversified portfolio but as they are more volatile they do introduce additional risk, especially after significant rallies. Many cyclical companies are now trading at higher valuations reflecting a bullish consensus which increases their risk of disappointment. Our investment approach recognises this increased risk and prefers more defensive positions right now and also from a longer term perspective. Figure 3 is a reminder that defensive businesses have many advantages over a longer term horizon. Should global growth expectations moderate from these levels we could see investors gravitate back towards more defensive businesses that can generate free cash flow, provide dividends to investors and longer term capital growth.

Disclosure

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