Insights
Active Quantitative Equity (AQE)

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The Europe Defensive Equity Strategy in the COVID-19 Era

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- 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' Europe Defensive Equity strategy (also known as "EDE") to see how the strategy performed during the COVID-19 drawdown and the subsequent rally, and to explore how EDE might benefit long-term investors in the current investment landscape.

About Europe Defensive Equity

The Europe 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 EDE 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. We subsequently wrote about the efficacy of the this approach in international markets.[2]

EDE'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 Europe Index. The EDE 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 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.

A Differentiated and Balanced Approach

Our investment approach in Europe Defensive Equity ("EDE") is different from those used in traditional low-volatility or multi-factor portfolios. Traditional low-volatility approaches apply only risk criteria, which can cause them to miss out on the return potential of up markets. EDE 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 80 to 100 stocks (compared with 200 to 300 stocks for many of its peers). EDE's alpha model also differentiates it from other multi-factor "Smart Beta" approaches. The alpha model includes not just traditional fundamental factors, but also advanced signals derived from financial statements data and from nuanced non-traditional data sets.

The track record of the strategy (although relatively short) demonstrates the efficacy of this approach compared with its benchmark, the MSCI Europe Index, and compared with other alternatives available to investors, including standalone low-volatility exposures. Such low-volatility exposures include strategies tracking the MSCI Europe Minimum Volatility Index, as well as Smart Beta multi-factor approaches approximated by equally weighting MSCI Europe Value, MSCI Europe Minimum Volatility, MSCI Europe Quality, MSCI Europe Equally Weighted (to Represent Size), and MSCI Europe Momentum.

As the table in Figure 1 demonstrates, the strategy has generated meaningful outperformance since its inception in February 2016 compared with its reference index and with the low-volatility and multi-factor alternatives. This outperformance speaks to the long-term predictive power of the proprietary stock selection model, as well as to the nuanced portfolio construction approach employed for the Europe Defensive Equity strategy. In addition, the strategy's Sharpe Ratio (a measure of risk-adjusted returns) ranked in the top quartile in the eVestment's Europe Large Cap Core universe as of March 31, 2020.

Figure 1
Return and Risk Characteristics of Europe Defensive Equity versus Index and Alternate Exposures, Since EDE Inception
(February 2016–May 2020)

	Total Returns (%)	Total Risk (%)	Return/Risk
Europe Defensive Equity Strategy	4.98	11.78	0.42
MSCI Europe Index	3.27	13.03	0.25
MSCI Europe Minimum Volatility Index	3.42	10.21	0.33
MSCI Europe Multi-Factor Portfolio	4.23	12.19	0.35

Source: State Street Global Advisors, as of May 31, 2020. Returns shown here are gross of fees for the strategy. Index returns are net of dividends. Past performance does not guarantee future results. Returns are shown in EUR.
The performance shown is of a composite consisting of all discretionary accounts using this investment strategy. The above information is considered supplemental to the GIPS presentation for this Composite, which is available upon request.
Past performance is not a reliable indicator of future performance. Performance returns for periods of less than one year are not annualized. Some members of the composite may accrue administration fees.

Performance During the COVID-19 Crisis[3]

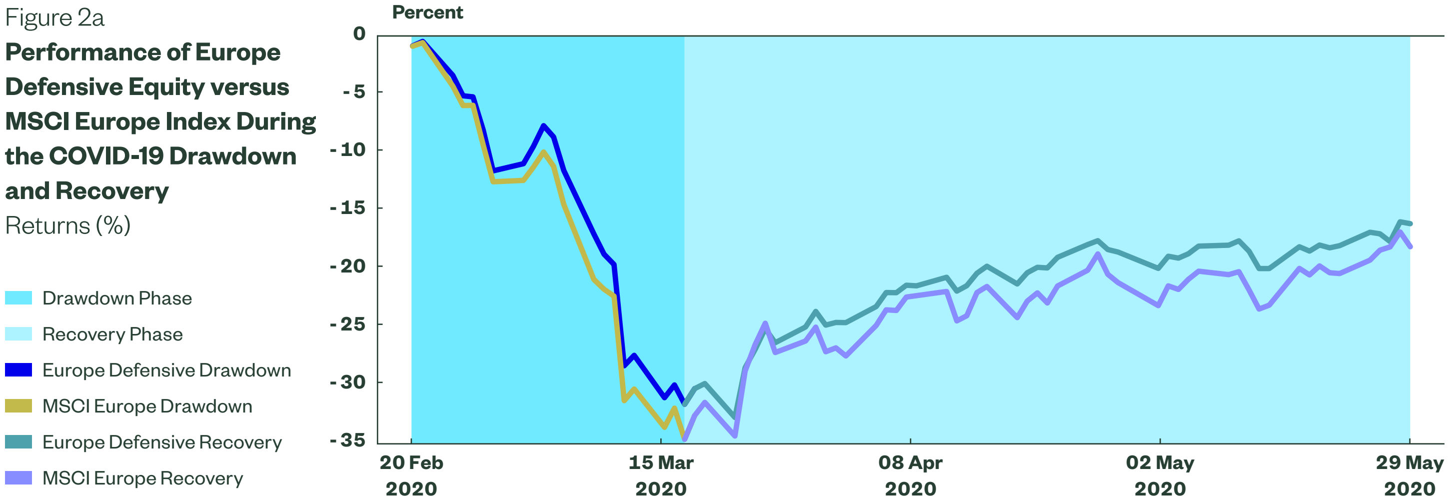
On a year-to-date basis, the Europe Defensive Equity strategy is outperforming the MSCI Europe Index by 6.98%. The outperformance can be attributed to the pre-COVID-19 regime (1 January 2020 to 20 February 2020), during which the strategy outperformed the index by 5.70%, and the subsequent COVID-19 regime (20 February 2020 to 29 May 2020), during which the strategy outperformed the index by 2.18%.

To better understand the EDE strategy's performance during the COVID-19 regime, we divided the period into the initial drawdown and the subsequent recovery (see Figure 2a). Figure 2b summarizes the performance of the strategy relative to the MSCI Europe Index during these periods.

Figure 2a

Performance of Europe Defensive Equity versus MSCI Europe Index During the COVID-19 Drawdown and Recovery

Returns (%)



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

Figure 2b

Performance of the Europe Defensive Equity Strategy versus the MSCI Europe Index During the COVID-19 Drawdown and Recovery

Returns

	COVID-19 Drawdown	COVID-19 Recovery	Entire Period
	20 Feb–18 Mar	18 Mar–29 May	20 Feb–29 May
Europe Defensive Equity (%)	-31.51	22.73	-15.95
MSCI Europe Index (%)	-34.71	25.41	-18.13
Difference (bps)	320	-268	218

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

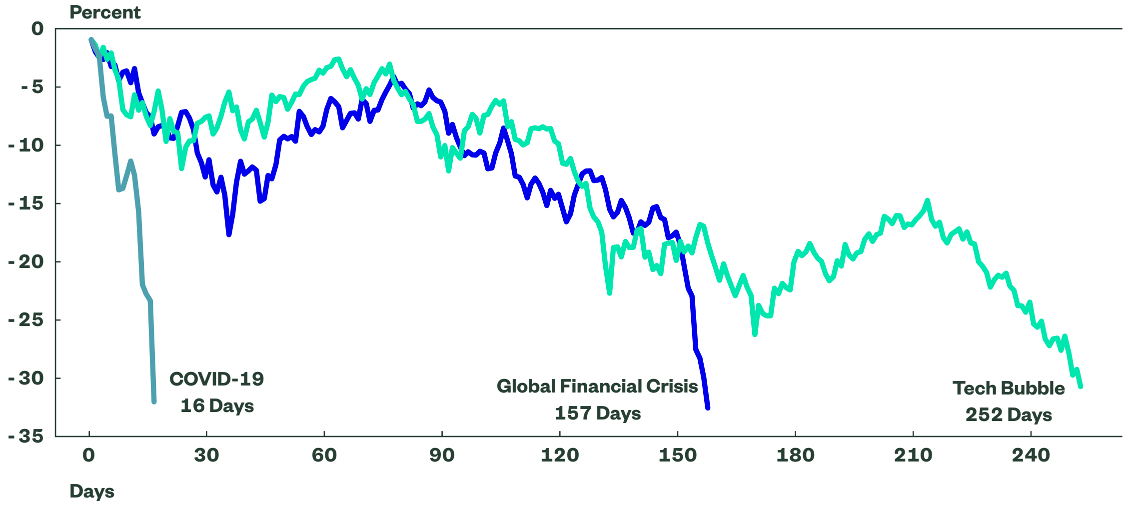
The Drawdown (20 February 2020 to 18 March 2020)

The COVID-19 drawdown was unprecedented in its speed and breadth. To illustrate the speed of the drawdown, it's helpful to compare it with previous crises, as shown in Figure 3. During the Tech Bubble, the drawdown took 252 trading days — over eight months — for European equity markets to lose 30%. During the Global Financial Crisis, it took more than 157 trading days (five months) for European equity markets to fall 30% (using MSCI Europe as a proxy). During the COVID-19 crisis, it took just 16 trading days for equity markets in Europe to lose 30%.

Figure 3

European Equity Market Drawdowns During Crises (Proxied by MSCI Europe Index)

Global Financial Crisis
Tech Bubble
COVID-19



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

The COVID-19 market drawdown was also unique because of its breadth, which represented an indiscriminate selloff across markets and sectors, as shown in Figure 4. The best performing sector in the COVID-19 drawdown outperformed the index by only 8.29%.[4] In prior episodes such as the Global Financial Crisis and the Tech Bubble, the best performing sector outperformed the MSCI Europe Index by 18.88% and by 27.12%, respectively. In short, the COVID-19 drawdown left even fewer places to hide than previous crises.

Figure 4

Breadth of European Equity Market Drawdowns During Crises (Proxied by MSCI Europe Index)

Index
Best Performing Sector
Worst Performing Sector

Source: State Street Global Advisors, Factset as of 31 May 2020. Returns shown are net of dividend and in EUR.
Past performance is not a reliable indicator of future performance.
Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable.

Due to the speed and severity of the COVID-19 drawdown, the Europe Defensive Equity strategy was unable to react to the rising risk regime to progressively become more risk-averse. As a result, the strategy's downside capture was 90% versus its target of 60%.

Despite this, the EDE strategy still provided downside protection, outperforming the MSCI Europe Index by 3.13%, largely due to its inherent defensive posture. Evaluating the performance of the EDE strategy by quintiles of value and risk, 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 5). However, the valuation tilt of the stock selection model reversed some of the effects due to strategy's underweight to the most expensive parts of the low-risk market (see, in particular, the bottom-right corners of the tables in Figure 5).

Figure 5
Active Weights and Active Performance of Europe Defensive Equity versus MSCI Europe Index by Quintiles of Risk and Value
(20 February 2020 to 18 March 2020)

Comparison of Active Weights by Quintiles of Value and Risk (%)			Risk					
			High Risk				Low Risk	Total Effect
			1	2	3	4	5	
Value	Cheap	1	-0.66	-0.34	-4.10	5.20	5.50	5.60
		2	-2.82	-3.22	-1.61	1.73	4.17	-1.75
		3	-1.27	-3.81	-3.14	-0.08	22.14	13.83
		4	-1.10	-3.52	-2.34	-0.72	6.49	-1.19
	Expensive	5	-1.94	-1.75	-3.40	-8.65	-2.87	-18.61
		Total Effect	**-7.79**	**-12.65**	**-14.59**	**-2.52**	**35.43**	

Comparison of Active Performance by Quintiles of Risk and Value (%)			Risk					
			High Risk				Low Risk	Total Effect
			1	2	3	4	5	
Value	Cheap	1	0.38	0.13	0.52	-0.54	0.41	0.89
		2	0.55	0.45	0.90	-0.03	-0.45	1.43
		3	0.13	0.47	0.05	-0.10	0.65	1.19
		4	0.13	-0.02	-0.10	1.33	0.09	1.43
	Expensive	5	-0.09	0.27	-0.30	-0.71	-0.91	-1.73
		Total Effect	**1.10**	**1.30**	**1.06**	**-0.06**	**-0.21**	

Positive Performance   Negative Performance

Source: State Street Global Advisors. Value shown here is the proprietary Value signal of the Active Quantitative Equity team at State Street Global Advisors. As of 31 May 2020. Past performance does not guarantee future results. Returns shown here are gross of fees. Returns shown in EUR.

The Recovery (18 March 2020 to 29 May 2020)

In the market recovery through 29 May, the Europe Defensive Equity strategy has generated 22.73% in returns while the MSCI Europe Index has generated 25.41% in returns, underperforming by 2.68%.

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 deeper into recent market drivers, we observe that the rally has been primarily focused in the risky and expensive pockets of the market — areas that the EDE strategy tends to avoid because, over time, they provide lower risk-adjusted returns.

Figure 6 shows returns by quintiles of value and risk for the MSCI Europe Index. As the figure shows, the expensive and high-risk areas of the market drove the recent rally (see the bottom left corner of the table) — areas that the strategy either completely avoids or significantly underweights. In sum, full participation in the equities rally we are observing now would cause us to ignore our emphasis on valuation and risk — two key pillars of the EDE strategy's historical success — which would in turn jeopardize our ability to deliver against the strategy's objectives over the longer term.

Figure 6
Average Market Returns of MSCI Europe Index by Quintiles of Risk and Value
(18 March 2020 to 29 May 2020)

Average Market Returns by Quintiles of Value and Risk (%)			**Risk**				
			HIgh Risk				**Low Risk**
			1	**2**	**3**	**4**	**5**
Value	**Cheap**	1	33.93	26.06	26.76	18.54	14.27
		2	27.06	29.67	26.54	23.27	18.19
		3	38.88	45.60	20.20	20.42	17.07
		4	39.77	34.61	26.22	23.34	17.59
	Expensive	5	41.18	38.99	40.02	31.77	30.86

Source: State Street Global Advisors as of 31 May 2020. Past performance does not guarantee future results. Returns shown here are in EUR and net of dividends. Value and Risk are measured by proprietary metrics of the Active Quantitative Equity team at State Street Global Advisors.

Our Current Focus

The focus of the Europe 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 EDE portfolio continues to maintain a defensive posture with increased positions in Consumer Staples, Telecommunications, and Health Care. In a recent article[5] 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. Figure 7 shows the positions on expected return and expected risk dimensions, respectively, as derived from our proprietary return and risk models. We continue our efforts on staying within the lower-risk band of the market while trying to maximize the return potential for investors (see Figure 7).

Figure 7
Portfolio Positioning of Europe Defensive Equity vs. MSCI Europe Index Based on Our Proprietary Assessment of Expected Return and Expected Risk

Source: State Street Global Advisors, as of 29 May 2020. The size of each position is reflected by its bubble size. The results shown represent current results generated by our Europe Defensive Equity model. The results do not reflect actual trading and do not reflect the impact that material economic and market factors may have had on State Street's decision-making. The results shown here were achieved by means of a mathematical formula, and are not indicative of actual performance, which could differ substantially. Expected Risk is Axioma Total Risk. Expected returns and characteristics are based on estimates and reflect subjective judgement and assumptions. There can be no assurance that developments will transpire as forecasted and that the estimates are accurate.

Although the COVID-19 market environment is quite challenging, 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 Europe 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 EDE can help investors strike a productive balance during uncertain market conditions, helping them to maintain a sharp focus on risk mitigation while still keeping up with rebounding markets.

Appendix: Performance of Europe Defensive Equity Strategy

Figure 8
EDE Annualized Performance (%) in EUR as of June 30, 2020
Strategy Inception: February 2016

Period	Composite Return	Benchmark Return	Return Difference
Since Inception	4.82	3.92	0.91
Quarter To Date	11.29	12.60	-1.31
3 Months Return	11.29	12.60	-1.31
Year To Date	-7.40	-12.84	5.44
1 Year Return	-0.72	-5.48	4.76
3 Year Return	2.06	0.51	1.55
5 Year Return	N/A	N/A	N/A
7 Year Return	N/A	N/A	N/A
10 Year Return	N/A	N/A	N/A

The performance shown is of a composite consisting of all discretionary accounts using this investment strategy. The above information is considered supplemental to the GIPS presentation for this Composite, which is available upon request.
Past performance is not a reliable indicator of future performance. Performance returns for periods of less than one year are not annualized. The performance figures contained herein are provided on a net of fees basis, reflecting the deduction of investment management fees. Some members of this composite may accrue administration fees. The performance includes the reinvestment of dividends and other corporate earnings and is calculated in EUR.
N/A = Not applicable (strategy inception was February 2016).
Source: State Street Global Advisors, as of June 30, 2020.

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 "An Evaluation of 80:60 Strategies in Various Global Equity Markets," by Bruce Apted and Adhiraj Mallik (State Street Global Advisors, March 2020).

3 The time period we cover in this section is 20 February 2020 to 29 May 2020.

4 Best performing sector was Information Technology.

5 "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).

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* This figure is presented as of June 30, 2020 and includes approximately $69.52 billion of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated.

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Marketing Communication

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.

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