Defensive Assets: Is playing too safe too risky?

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*This blog is the first instalment of our new blog series on Defensive Assets: '**Offense wins games but defence wins championships'.***

2020, a year of uncertainty

As discussed in our latest WisdomTree Outlook, 2020 is in a lot of ways the year of uncertainty. The uncertainty around the resolution of the US-China Trade deal, the uncertainty around the long-term impact of the US$14trn of negative yielding debt, the uncertainty around the outcome of the highly volatile US elections in November. In fact, a few weeks into the year, this uncertainty has gained impetus following the unfolding of events in the Middle East and the sudden increase in tensions between the US and Iran. Considering equities, in uncertain times like this one, there is an inherent tension to prepare for two similarly likely scenarios: a sudden crash and a late cycle rally.
Against such a macroeconomic background, portfolio construction can be paramount. The objective should be to build versatile portfolios that can adapt to quickly changing market conditions and can resist unexpected events. In other words, portfolios that while behaving defensively can also participate in market rallies.

When it comes to constructing portfolios for such uncertain times, so called Defensive Portfolios, investors have 3 main avenues opened to them:

•Through Asset Selection, using "naturally" defensive assets, i.e. assets that are defensive or diversifying by nature

•Through Asset Allocation, using non derivative based systematic defensive strategies like Vol Targeting (regular rebalancing between high volatility and low volatility assets to maintain risk around a certain level), Capital Protection mechanism (Constant Proportion Portfolio Insurance….) and so on

•Through Derivatives and non-linear instruments to protect the portfolio and transform non-defensive assets in defensive assets

In the course of the next 8 weeks, we will aim to cover the first two; Asset Selection and Asset Allocation extensively, starting with the defensive assets themselves. Derivative based strategies are completely different in nature and they tend to be very expensive to maintain over the long term which is why we will

not cover them in this series. In this first instalment we will focus on how to find and define those naturally defensive assets.

What is a defensive asset?

In a typical multi asset portfolio, by virtue of the risk embedded in each individual asset class, the biggest source of risk is a large negative performance in equities, i.e. an equity drawdown. In fact, the analysis of an example common portfolio allocation invested for 60% in European equities and 40% in Euro Fixed Income shows a 90% risk contribution from equity risk. It is therefore only natural that defensive assets tend to be defined in opposition to equities, “anti-equities” assets so to speak i.e. assets that do well in equity drawdowns.

In Figure 1 we focus on this initial definition and look at performances across asset classes in 6 well known equity drawdown periods: the Tech Bubble (September 2000 to March 2003), the Financial Crisis (July 2007 to March 2009), the Euro Crisis I (April 2010 to July 2010), the Euro Crisis II (My 2011 to October 2011), the China Crisis (April 2015 to February 2016) and Q4 2018. The bottom part of Figure 1 shows he performance of the STOXX Europe 600 total return index over those periods in particular (grey shading).

Source: WisdomTree, Bloomberg. In EUR. See at the bottom of the page for more details on the indices used in the figure.

Historical performance is not an indication of future performance and any investments may go down in value.

Quite clearly, all equities behave cyclically and therefore historically underperform in the above-mentioned crisis. Commodities as well as High Yield Bonds also behave quite cyclically showing negative performances during all 6 drawdown periods albeit less so than equities. On the other end of the spectrum, historically Gold, Cash and Government Bonds deliver strong positive performances in all those periods. Interestingly, Japanese Yen also does well in most periods exhibiting a Safe Haven-type behaviour.

In some ways Figure 1 could be the alpha and the omega of our analysis. Gold, Cash, Yen or Government Bonds do perform well in equity drawdowns and would counterbalance equity drawdowns nicely. However, most equity drawdowns are violent and are triggered by unpredictable events. Most (all?) investors do not have a crystal ball to tell them when to switch in the above defensive assets i.e. just before the drawdown. Therefore, they could consider the need to stay invested in defensive assets for long periods of time in preparation for possible shocks. The opportunity cost of doing so could be significant and varies a lot from one asset to another. This is why we introduce a more detailed framework to classify those assets. This framework is based on 4 considerations:

•Risk Reduction i.e. reduction of drawdowns, volatility...

•Asymmetry of returns i.e. versatility, capacity of the asset to capture more of the performance of an asset when it goes up than when it goes down and to reduce opportunity cost (i.e. the performance that an investor did not benefit from because he was invested in another asset)

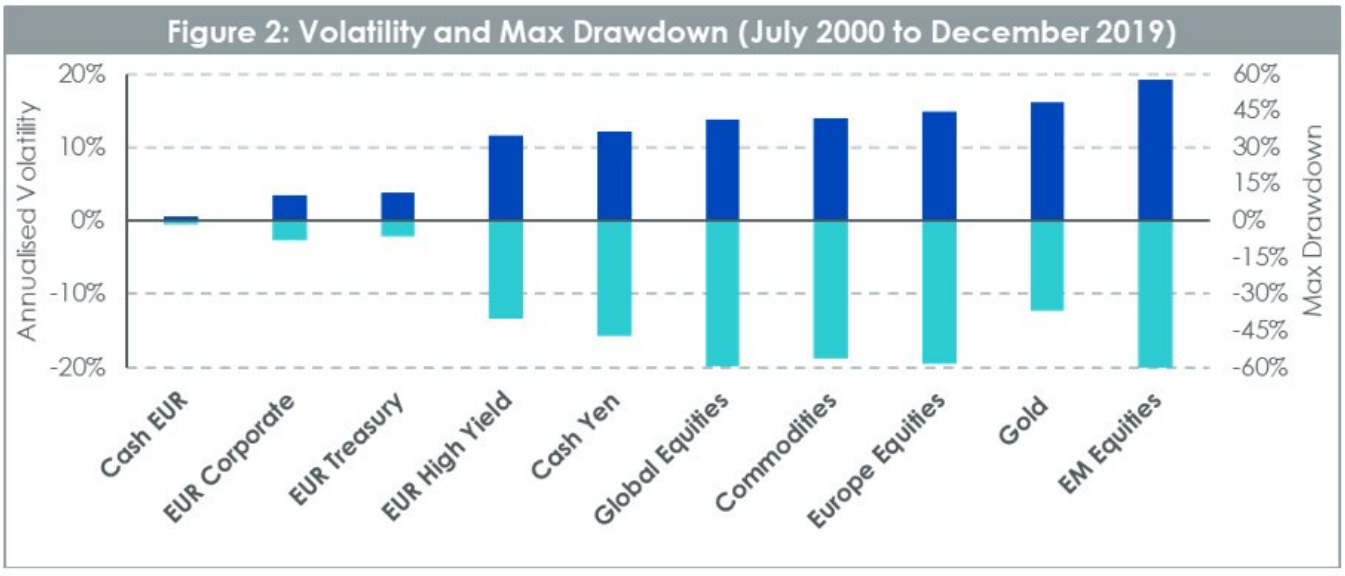
•Diversification i.e. uncorrelated behaviour to the rest of the portfolio and in particular to equities

•Valuation i.e. a cheaper asset usually exhibits less room for negative performance and less crowding as well

In order to improve the versatility of a portfolio, it is important to consider all 4 aspects for potential investments.

An asset class overview

Overall risk is an interesting starting point. There are in fact multiple ways to express risk in finance: volatility, tracking error, relative drawdown, max drawdown and so on. Contrary to common beliefs, such metrics are not fully fungible and ranking assets versus one measure does not give the same results as ranking versus another one. Comparing Figure 1 and 2, some assets which behaved well in equity drawdowns exhibit low volatility and drawdown like Cash or EUR Treasuries but others like Gold exhibit higher volatilities. Looking at Figure 2 on its own, volatility and drawdowns are not perfectly aligned. Gold exhibits equity like volatility but it does not exhibit equity like drawdowns benefitting from its inherent positive skewness.
So overall, the choice of risk metrics would vary depending on investors constraints and objectives. In the course of this series, we will focus mostly on realised performance during equity drawdowns.



Source: WisdomTree, Bloomberg. Period July 2000 to December 2019. Calculations are based on monthly returns in EUR. See at the bottom of the page for more details on the indices used in the figure.

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Five assets out of the 10 considered in Figure 3 show positive historical performance when the economy is slowing down (Cash, Yen, EUR Treasury, EUR Corporate and Gold) but only two of those also show significantly positive performance when the economy is doing a little bit better or a lot better: Gold and EUR Corporate. Those assets are therefore the most asymmetrical. On the contrary Cash and Japanese Yen performance during those periods is lacklustre to negative which means that in any other scenario than an equity drawdown they might drag on a portfolio's performance.

Source: WisdomTree, Bloomberg. Period July 2000 to December 2019. Calculations are based on monthly returns in EUR. See at the bottom of the page for more details on the indices used in the figure.

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In a portfolio context, diversification is key. Some assets have such asynchronous behaviour that they provide a benefit to a portfolio independently of the rest of their attributes. Treasury Bonds Yen and Gold, for example, stand out in Figure 4 with strongly negative correlation to equities.

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Our last attribute, valuation, applies mostly inside each asset class since its measure will vary greatly and this is why we will not look at it across asset classes.

In this first instalment, we have created the necessary framework to help investors assess which asset and investments could help them navigate uncertain times and ride through potential future crisis. Gold and Government Bonds have already proved themselves strong contenders but in the next weeks we will go systematically through each asset class in more details, starting with equities.

Europe Equities is proxied by the STOXX Europe 600 net total return index. **Global Equities** is proxied by the MSCI World net total return index. **Emerging Market Equities** is proxied by the MSCI Emerging Markets net total return index. **Cash Euro** is proxied by a series of daily compounded Eonia. **Cash Yen** is proxied by a series of daily compounded overnight Japanese yen rate. **EUR Treasury** is proxied by the Bloomberg Barclays EUR Aggregate Treasury total return index. **EUR Corporate** is proxied by the Bloomberg Barclays EUR Aggregate Corporate total return index. **EUR High** Yield is proxied by the Bloomberg Barclays EUR High Yield total return index. **Commodities** is proxied by the Bloomberg Commodity total return index. **Gold** is proxied by the LBMA Gold Price PM index.

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