Defensive Assets: Lessons to be learnt from an eventful first quarter

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*This blog is a follow up to the blog series on Defensive Assets: '**Offence wins games but defence wins championships**'.*

As recently as January of this year, what happened over the course of the last quarter would have been unthinkable. A quarter of the world population is in lockdown, financial markets went through the fastest bear market in history to jump back into the fastest bull market, and Crude Oil went down by more than 60%[1].

When WisdomTree started its blog series on Defensive Assets, the world was very different, our 2020 Outlook pointed to lots of uncertainties around the way the year would unfold but no one could have predicted the current crisis. At the time, we wanted to create a quantitative framework that would uncover the investments best suited to navigate such a period of uncertainty. In hindsight, this quarter delivered significant uncertainty and unpredictability in spades and it is going to allow us to look back and see how our framework did.

An asset class by asset class review below shows that for a euro-based investor:

- Defensive Sectors such as Health Care and Consumer Staples have done extremely well
- Defensive Factors like Min Volatility have delivered protection in the downturn but have been outshone over the course of the quarter by Momentum, Quality or Growth
- Long Duration Government Bonds have delivered very strong, negatively correlated performance to equities
- Despite a liquidity crunch in the middle of the drawdown, Gold delivered strong positive return this quarter rewarding the faith of strategic investors
- The US Dollar has again acted as a Safe Haven, allowing most US dollar denominated assets to do very well.

Defensive assets, a recap

In the first instalment of the series, we laid the foundation of our framework, defining Defensive Assets not just as assets that do well in a period of equity drawdown but as assets that would help a portfolio more generally by providing:

- Risk Reduction
- Asymmetry of returns i.e. providing more downside protection than it is losing upside exposure
- Diversification i.e. uncorrelated behaviour to the rest of the portfolio and in particular to equities
- Controlled valuation because cheaper assets usually exhibit less room for negative performance and less crowding as well.

The advantage of such a framework is to allow investors to choose such investment not just in the middle of the storm when it is 100% certain that the market is going down, but also for longer periods, as soon as the uncertainty mounts. This way the overall performance of the portfolio relies more on the all-weather behaviour of the assets than on the market timing skills of the asset allocator.

Dissecting the first quarter of 2020

In the first quarter, we witnessed what looked like a full cycle in fast forward, from the continuation of the bull market to the crisis and finally the rebound. Looking at Figure 1, we observe 3 very separate periods in the performance of Equities (Through the example of the MSCI World Net TR Index):

- The 10 year Bull Run continues – 31 December to 19th February
- The Equity Drawdown – 19th February to 23rd March
- The Market Rebound – 23rd March to 31st March

In the following, we will study the performance of each asset class and of each of our preselected Defensive Assets through those 3 periods trying to assess how they behaved and how they performed.

A large dispersion of performance among equity baskets

Figure 2 shows the outperformance of a large selection of equity baskets versus the MSCI World across the full quarter and the 3 sub-periods. It is ranked from the basket that did the best in the Equity Drawdown (period 2) to the one that did the worst.
Starting with equities, it is clear that US equities have fared better over the quarter than European and Emerging Market equities. However, Emerging Markets outperformed counterintuitively during the drawdown and trailed during the two other periods.

Sector wise, HealthCare, Information and Technology (“IT”) and Consumer Staples did the best. Healthcare and Consumer Staples are traditional defensive sectors and they benefited from their strong performance in the equity drawdown. IT is a surprise but it benefitted from its strong performance in the first part of the

quarter and the unusual circumstances of the lockdown, where remote working and other social distancing measures, draw focus to companies in the sectors.
Finally, among equity factors, the best one during the equity drawdown is Minimum Volatility as expected, followed closely by Quality. However, over the quarter, Min Vol finishes only fourth, behind Momentum, Growth and Quality. Momentum and Growth benefitted from strong performance in the first period and from the performance in IT. Quality benefitted from its strong performance in the first period as well as during the equity drawdown.

Overall, purely defensive assets did well. Among the 3 strategies that we had highlighted in our series (here), High Dividend and Multi factor posted mixed results but Quality answered expectations with strong performance across the 3 periods.

Long Duration Government Bonds really rewarded the believers in Q1

In Fixed Income, as expected Government Bonds did relatively well over the full quarter especially compared to equities. Corporate Bonds delivered negative performance in line with their higher risk. Finally, High Yield Bonds delivered even deeper negative performance. So overall, Fixed Income assets behaved in line with their embedded credit spread risk.
It is worth noting that in line with what we observed historically, US Dollars acted as safe haven assets and therefore US Dollar denominated bonds did significantly better than bonds in other currency.

In our Defensive Assets blog focused on Fixed Income, we noted that Cash and Short duration Government Bonds can help cut the risk in the portfolio in drawdowns but that long duration Government Bonds are more all-weather as they also create diversification with the equity part of the portfolio. In Q1, they demonstrated their value, with US Government Bonds 10+ returning 22.9% and EUR Government Bonds10+ returning 1.3%. In fact, across all rating bands, Long duration Bonds outperformed shorter duration ones.

Gold the king diversifier

In Commodities, Precious Metals and in particular Gold significantly stood out this quarter. Gold delivered a +7.9% performance (see Figure 4) that helped portfolios and investors appeared to trust this asset as a long term holding. In the middle of the drawdown, Gold suffered from a form of liquidity crunch where investors were selling gold to cover margins calls pushing the price down (see more details here). But Gold then rebounded strongly benefiting investors.
As described in our Defensive Assets blog focused on Commodities , Gold is not just a doomsday asset and performed very well in the first and last period of the quarter as well delivering a well rounded performance. Enhanced Commodities, which represent “smart beta” in commodities where the strategy can invest further along the curve (i.e. not always in the front month future) to improve the roll yield available to the investor while delivering similar spot and collateral returns (More information on this topic is available on our website), continued to deliver improved returns. It outperformed the Broad Commodity Index in all 3 periods in Q1. For investment in commodities in general, Enhanced Commodities are actually showing their worth.
Energy finally and in particular Oil, suffered a bruising quarter with the OPEC descending in to open war. More details on the latest development around Oil can be found here.

Risk Off currencies once again

Currencies behaved exactly as expected in Q1 with Risk on currencies dropping significantly in price and risk off currency gaining in particular during the drawdown but also in the first part of the quarter, showing that the uncertainty was already weighing on investors' mind. The best currencies, for the period, were Japanese Yen, Swiss Franc and US Dollars.
As highlighted in the two currency focused blogs in the series (here and here), US dollar denominated benefitted from that safe haven status and delivered needed performance for portfolios.

In conclusion, over the quarter, both defensive and all weather type investments have done pretty well. Long Duration Government Bonds, Gold, Quality and Min Volatility equities have all benefitted investors that had put their trust in them.
Looking ahead to Q2, COVID-19 continues to disrupt our lives and our economies, equity markets have found a second wind and the Oil War is turning into a blitzkrieg. Uncertainty is clearly here to stay and it may be the time where all-weather investment outshine purely defensive assets.

Europe Equities is proxied by the STOXX Europe 600 net total return index. **US Equities** is proxied by the MSCI USA net total return index. **Emerging Market Equities** is proxied by the MSCI Emerging Markets net total return index. **Min Vol** is proxied by MSCI World Min Volatility net total return index. **Quality** is proxied by MSCI World Quality Sector Neutral net total return index. **Size** is proxied by MSCI World Small Cap net total return index. **High Div** is proxied by MSCI World High Dividend net total return index. **Value** is proxied by MSCI World Enhanced Value net total return index. **Growth** is proxied by MSCI World Growth net total return index. **Momentum** is proxied by MSCI World Momentum net total return index. **MultiFactor** is proxied by MSCI World diversified multi factor net total return index. **Energy** is proxied by MSCI World Energy net total return index. **Materials** is proxied by MSCI World Materials net total return index. **Industrials** is proxied by MSCI World Industrials net total return index. **Cons. Stap.** is proxied by MSCI World Consumer Staples net total return index. **Cons. Discr.** is proxied by MSCI World Consumer Discretionary net total return index. **Health Care** is proxied by MSCI World HealthCare net total return index. **Financials** is proxied by MSCI World Financials net total return index. **IT** is proxied by MSCI World Information Technology net total return index. **Communication** is proxied by MSCI World Communications net total return index. **Utilities** is proxied by MSCI World Utilities net total return index. **Real Estate** is proxied by MSCI World Real Estate net total return index. **Cash EUR** is proxied by daily compounded Eonia. All other Fixed Income indices in Figure 3 are proxied by their equivalent in the Bloomberg Barclays TR Index Family. **Broad Commodities (Commo)** is proxied by the Bloomberg Commodity Total Return Index. **Enhanced Commodities** is proxied by Optimized Roll Commodity Total Return Index. **Energy** is proxied by the Bloomberg Energy subindex Total Return Index. **Precious Metals** is proxied by the Bloomberg Precious Metals subindex Total Return Index. **Industrial Metals** is proxied by the Bloomberg Industrial Metals subindex Total Return Index. **Livestock** is proxied by the Bloomberg Livestock subindex Total Return Index. **Softs** is proxied by the Bloomberg Softs subindex Total Return Index. **Grains** is proxied by the Bloomberg Grains subindex Total Return Index. **Gold** is proxied by the LBMA Gold Price PM Index. **Silver** is proxied by the LBMA Silver Price index. **Cash Yen** is the performance of assets invested in short term cash in Japanese Yen from the perspective of a euro investors. **Cash USD** is the performance of

assets invested in short term cash in US Dollars from the perspective of a euro investors. **Cash CHF** is the performance of assets invested in short term cash in Swiss Franc from the perspective of a euro investors. **Cash CAD** is the performance of assets invested in short term cash in Canadian Dollars from the perspective of a euro investors. **Cash NZD** is the performance of assets invested in short term cash in New Zealand Dollars from the perspective of a euro investors. **Cash NOK** is the performance of assets invested in short term cash in Norwegian Krona from the perspective of a euro investors. **Cash AUD** is the performance of assets invested in short term cash in Australian Dollars from the perspective of a euro investors.

[1] Source WisdomTree, Bloomberg. Bloomberg WTI Crude Oil Subindex TR. Year to Date as of 20th April 2020

[2] Organization of the Petroleum Exporting Countries

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