Defensive Assets: Are all equity strategies created equal?

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

Last week, we introduced a framework to help investors assess which asset and investments could help them navigate uncertain times and ride through a potential future crisis. This framework aims to highlight which assets could be best placed to fill the needs of investors looking to buttress their portfolios against a potential upcoming equity drawdown. It also highlights the potential opportunity cost for each asset in case this drawdown does not materialise. In the below, we show that traditionally defensive equities like minimum volatility (Min Vol) or utilities, typically exhibit strong defensiveness but also limited upside capabilities while factors such as Quality, High Dividend or Multi-Factor provide a more balanced risk return profile allowing for more versatility.

From a euro based investors point of view, there is an infinite number of equity baskets that could be invested in but for the purpose of this blog we will concentrate on some of the most classic ones such as regions (Europe, US and emerging markets), sectors and factors. For sectors we focus on 11 Global Industry Classification Standard (GICS) sectors in developed markets equities. For the factors we will concentrate on the 7 most classic i.e. Minimum Volatility, Quality, Value, High Dividend, Size, Growth and Momentum plus a Multifactor approach in developed equities as well (More details on the indices used are available at the end of the blog).

Balancing defensiveness with upside retention is like trying to square the circle

Our framework focuses on 4 aspects: Risk Reduction, Asymmetry of Returns or Versatility, Diversification and Valuation.
Focusing on Risk Reduction, Figure 1 exhibits the outperformance of the different equity baskets in periods of drawdowns versus the MSCI World. It clearly differentiates between 3 types of equity baskets:

•Higher risk baskets like Financials, IT or Europe that underperform in most periods and also deliver an overall underperformance to the market.

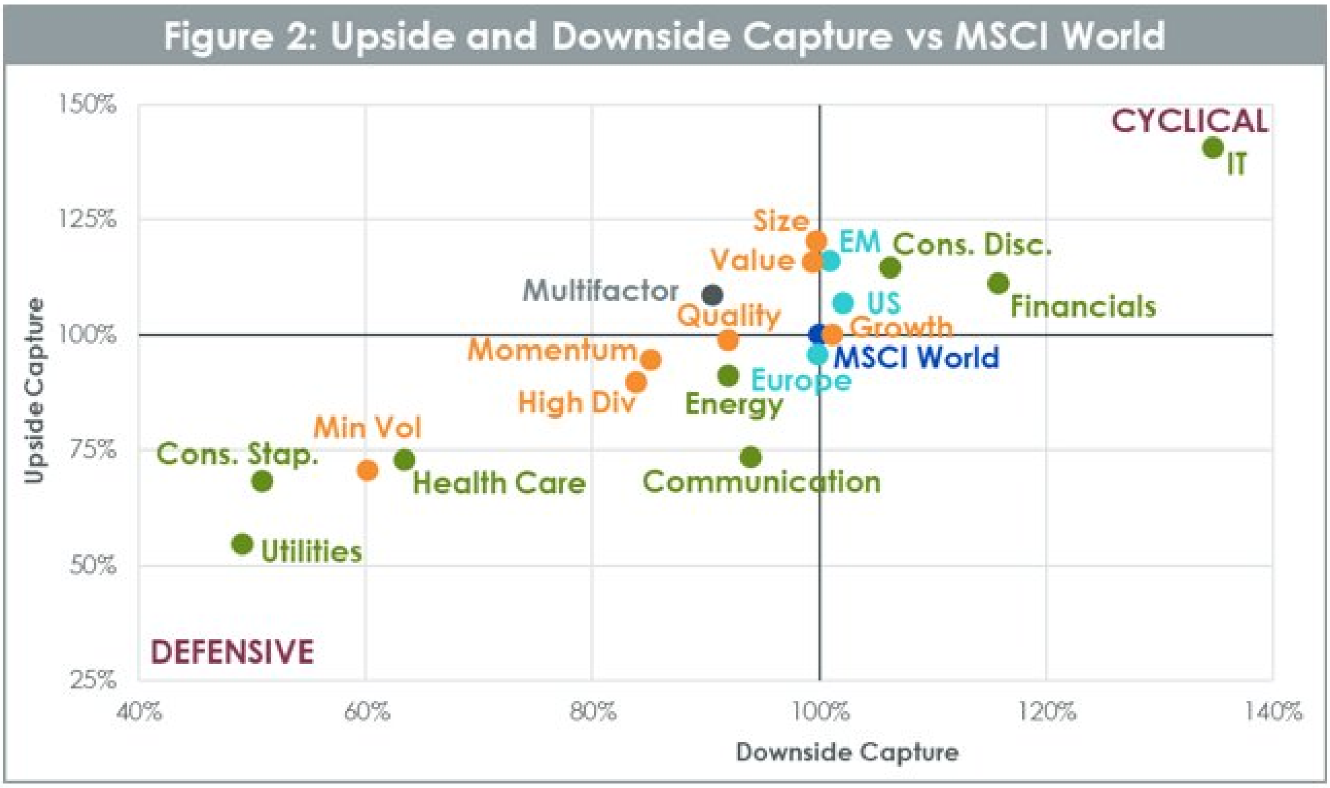
•Middle of the road baskets which do not who any strong inclination on the upside or the downside versus the benchmark. Emerging Market (EM) Equities show slightly improved performance overall and lower drawdowns in 4 periods, highlighting the strong benefit of geographical diversification. US equities benefit from the strengthening of the US dollars in periods of crisis.

•Defensive baskets that deliver outperformance in all periods and deliver a strong outperformance overall. These include sectors like Health Care, Consumer Staples and Utilities, styles like Min Volatility and Quality.

Source: WisdomTree, Bloomberg. In EUR. Before September 2018, MSCI World Communications is proxied by MSCI World Telecommunications. More details on the indices used in the figure are available at the end of the blog.

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

This first analysis highlights the 5 assets that have historically been the most protective in equity draw-downs. As the next step, we want to look at the upside potential of these same assets to assess their versatility.



Source: WisdomTree, Bloomberg. Period July 2000 to December 2019. Calculations are based on monthly returns in EUR. More details on the indices used in the figure are available at the end of the blog.

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In Figure 2, we compare how much of the negative performance of developed equities (respectively positive performance) is captured by the different equity baskets (called downside and upside capture respectively). Out of the 5 Defensive baskets that we singled out in Figure 1, four end up in the bottom left of Figure 2 which confirms their ability to historically cushion downturn in equities, but also highlights how much of the

upside is sacrificed. Min Volatility for example exhibits an upside capture of 70% only.
In the middle of the graph, 5 baskets, Quality, High Dividend, Momentum, Multi-Factor and Energy, seem to offer a more balanced trade-off with an upside capture above 90% and a downside capture below 95%. Such baskets would bring more versatility to a portfolio than the other three. Multi-Factor, in particular, exhibits a very interesting profile with a strong asymmetry between its upside capture ratio and its downside capture ratio.
Overall, Quality is the only asset which we highlighted as Defensive in Figure 1 but also exhibits a balanced trade-off in this analysis.

Geographical diversification remains strong

Regarding our third criteria, diversification, it tends to play a bigger role across asset classes, between equities and fixed income for example, than inside a given asset class. However, in Figure 1, Emerging Markets outperform slightly in every 4 out of the 6 considered periods demonstrating the power of diversifying away from an investor own market into other geographies.

Versatility and response to interest rate shocks

Moving away from our framework for a little bit, one interesting aspect of equity investing is the behaviour and correlation to interest rate moves. Coming back to our outlook 2020, the likelihood of rate increasing during the year is far from nil as illustrated by the fact that the yields are already deeply negative and at historical lows in Europe. It is therefore important to consider this aspect of the baskets behaviour.
Figure 3 clearly shows that the baskets that reduce drawdown the most like Min Vol or Utilities tend to underperform in periods where yield increases. However, more balanced baskets such as Quality, Energy or High Dividend appear less sensitive to those increases making them a strong candidate for selection in a defensive portfolio. Multi-Factor appears to be the most efficient among these defensive baskets from that angle showing strong performance in those periods.

Source: WisdomTree, Bloomberg. Period July 2000 to December 2019. Calculations are based on monthly returns in EUR. More details on the indices used in the figure are available at the end of the blog.

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Overall, it appears that among equity baskets that have historically reduced drawdowns, there are 2 relatively separated families. The first one, traditionally defensive assets like Min Vol or Utilities, exhibits very strong defensiveness but also limited upside capabilities and bond like characteristics with high rate sensitivity. The second one, which includes Quality, High Dividend, Multi-Factor or Energy, do provide defensiveness characteristics but in a more balanced way allowing for more versatility.

WisdomTree is focused on valuation-controlled strategies

One last aspect to consider is assets valuations. It is not rare to see some sectors or styles becoming very expensive following a period of exuberance in the market drive. Practitioners will remember the run to Min Volatility stocks in 2016 or more recently to the FANGs (Facebook, Amazon, Netflix, Alphabet).

At WisdomTree, we strongly believe in valuation discipline and that is why our strategy embeds some mechanism to control the valuation in our portfolios through stock screening and reweighting. Regular rebalancings also help to avoid weight drifting. In particular, our flagship equity exchange traded funds (ETFs) focus on Higher Dividend and Quality exposures through well-defined systematic strategies that, while investing in the most relevant stocks, weight them by cash dividend allowing to maintain a reasonable level of valuation over time.
Multifactor strategies, including WisdomTree's own, benefit from the fact that value is one of the factors that stocks are selected on and therefore valuations are quite controlled as well.

In the next instalment, we will focus exclusively on fixed income and, using the above framework, we will aim to unearth the asset that exhibits the most defensive characteristics.

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.

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