Defensive Assets: The key to success is often the ability to adapt

Published 1 April 2020

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

Over the previous 7 instalments in this blog series, we have focused exclusively on how to use asset selection to increase a portfolio's protection against equity drawdowns. However, as discussed 7 weeks ago, there are other routes open to investors to do so. One of the main one is to use dynamic asset allocation. Those techniques use rotation between assets or between asset classes as their main tool to limit risk. In this blog, we will concentrate on systematic, rules-based methodologies to better understand how they work and what they could add to investors' portfolios.

Tactical Asset Allocation versus Risk Mitigating Strategies

Two main families are at the heart of dynamic asset allocation: Tactical Asset Allocation and Risk Mitigating Strategies.

Tactical Asset Allocation aims to actively balance and adjust weights in assets and asset classes to maximize portfolio return and keep market risk low compared to a given benchmark (usually the long-term investment guidelines of the investors or strategic asset allocation) using qualitative or quantitative signals. Those signals can fall into multiple categories such as:

- The "Fed model" signal: It compares stock earnings yields to nominal bond yields and invests in the asset with the higher yield
- Business-cycle/macroeconomic signals: Signals include term spreads, inflation, industrial production and so on
- Fundamental valuation signals: It includes dividend yield, P/B (price-to-book), P/E (price-to-earnings) ratio and so on
- Momentum signals: use past performance of the assets as allocation signals

Risk Mitigating Strategies use a predefined methodology to reach a given risk objective being volatility or tracking error target or cap or a max drawdown over a given time period. These methodologies include for example:

- Vol Target which rebalances on a regular basis the weight of its assets to ensure that the volatility of the portfolio remains inside a pre-defined band.

- CPPI or Constant Proportion Portfolio Insurance which rebalances between a risky asset (usually equity) and a safe asset (usually cash like instruments) to ensure that a pre-defined level of loss is never attained.

The objective of this blog is to compare the effectiveness of two examples Tactical Asset Allocations and two example Risk Mitigating strategies with the classic static allocation, the Illustrative Portfolio 60/40 (rebalancing monthly between Europe equities and EUR Aggregate) in order to understand how they work.

Tactical Asset Allocation can improve on static allocation, but it may be harder than it looks

- The Illustrative Fed Model Portfolio, which allocates monthly 100% to its assets in Europe Equities (Europe STOXX 600 net TR Index) if there earning yields is above the yield of nominal treasury bonds or 100% in the Bloomberg Barclays EUR Aggregate TR Index if not.
- The Illustrative Momentum Portfolio, which allocates monthly 100% to its assets in Europe Equities if in the last 12 months they have outperformed the EUR Fixed Income (through Bloomberg Barclays EUR Aggregate TR) or, 100% in Bloomberg Barclays EUR Aggregate TR Index if not.

Over the 18 years and a half, even simple dynamic allocation such as this one has outperformed the Illustrative Portfolio 60/40 by a large margin. It is very obvious from Figure 1 that the Illustrative Momentum Portfolio has almost entirely achieved this result by cutting the 2008 drawdown, switching to fixed income early in the crisis while the Illustrative Fed Model Portfolio did not do so. Both portfolios suffer from “false positive” i.e. allocation switches that did not yield positive results but those are overpowered by the time where the strategy did work.

Looking at the performance of those example Portfolios Year to Date, we observe that the Illustrative Fed Model Portfolio is suffering large losses, -22.6% at the end of March when the Illustrative Portfolio 60/40 is down -14.4%. It started the year with a 100% equity allocation and did not rebalance in time for the unexpected drawdown that we are experiencing. The Illustrative Momentum Portfolio is down -12.5% only because it rebalanced to Fixed Income at the end of February.

Risk Mitigation Strategies can deliver consistent results over time

In this blog, we look at two examples of classic risk mitigation techniques:

- The Illustrative 9% Vol Target Portfolio which allocates monthly between Europe Equity (Europe STOXX 600 net TR Index) and EUR Aggregate (Bloomberg Barclays EUR Aggregate TR Index) by calculating the last 12-month realized vol of both assets and calculating the weights that would have delivered 9% volatility over the period (not considering correlation effects). We picked 9% as the target because it would yield a similar risk profile as the 60/40 over the full period.
- The Illustrative CPPI Portfolio which allocates monthly between Europe Equity(Europe STOXX 600 net TR Index) and EUR Aggregate (Bloomberg Barclays EUR Aggregate TR Index). On a calendar year basis, the portfolio is not allowed to go under a floor level of 90% of the portfolio value at the start of the year. Each month, the strategy calculates the difference between the current value of the portfolio and the floor and multiple this by 6 (the multiplier) to determine the Equity exposure. At the start of the year, the equity allocation is therefore equal to 60% and then when the portfolio does well it increases and if it does not do well it decreases.

Again, over the 18 years and a half, those simple allocations have outperformed the Illustrative Portfolio 60/40 by a large margin. Both these example portfolios have similar volatility to the Illustrative 60/40 Portfolio (around 9%) and yet have historically delivered a steadier performance.

Source: WisdomTree, Bloomberg. Period July 2001 to December 2019. Calculations are based on monthly returns in EUR.

You cannot invest directly in an index. Historical performance is not an indication of future performance and any investments may go down in value.

Year to date those 2 example portfolios have suffered as well, with losses of -16.4 and -14.8% respectively, struggling to cope with the speed with which the market sentiment changed.

Momentum a surprisingly strong protection mechanism for our portfolios

Finally, let's concentrate on the performance of those portfolios in periods of equity drawdowns. Starting with the 4 biggest drawdowns in equities(we omitted the Tech Bubble drawdown due to data constraints (i.e. the portfolio can only start a year after the assets themselves).
What we observe is that the risk mitigating technique has on average reduced the size of the drawdowns. The Illustrative CPPI Portfolio outperformed the Illustrative 60/40 in 4 periods out of 5 and the Illustrative 9% Vol Target Portfolio in 3. The Tactical Asset Allocation ones give mixed results, in part because the portfolios are very simple with binary 0% or 100%, but also because they rely on predictive signals to anticipate the relative performance of the assets which is as we know always going to be a bit of a hit and miss. However, the Illustrative Momentum portfolio does pretty well with the best performance in 2 of the 4 drawdown periods.

Figure 4 focuses on the 9 worst European equity quarters since 2002 and we find the same behaviour as before. The Illustrative Fed Model Portfolio does either very well or very badly with a tendency to do worth than the rest. The Illustrative Momentum Portfolio is doing very well 7 times. The Illustrative 9% Vol Target portfolio and the Illustrative CPPI portfolio deliver consistent results across the board. In fact, the Illustrative CPPI Portfolio improves on the Illustrative Portfolio 60/40 in all the periods.

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Over the course of the last 8 weeks, we have been able to highlight how investors can prepare their portfolio for resilience. Balancing protection and upside potential is a difficult exercise, but depending on their own investment objectives and constraints, we hope investors will have found in this blog series some ideas and some inspiration on how to tackle it, whether it is through a dynamic asset allocation that rebalances between cyclical and defensive assets or through the selection of asymmetric defensive assets like gold, quality and high dividend equities or government bonds for example.

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