Positioning for Late Cycle with Defensive Equity

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Central Issue of the Paper

As of October 31, 2018, the MSCI World Index delivered an annualized return of 10.02% while cash returned 0.34%, representing an annualized 10-year equity risk premium of 9.68%. There are two big questions on the minds of many investors: where will things go from here, and how we should position our portfolios as we potentially enter the "late cycle?"

Approach Employed by Paper

Are we in a bubble?

The authors look at two basic metrics to try to determine the current stage of the equity market: narrowness of the equity market and current valuations. They specifically compare these two metrics to those of the late 1990's dot-com bubble.

The first metric the authors analyzed was market breadth, or the narrowness of the market. For many years, U.S. equity market performance has been dominated by five stocks: Facebook, Apple, Amazon, Netflix, and Google (Alphabet), otherwise known as FAANG+. In fact, these five stocks were up roughly 104% over the 18-months leading up to June 2018, when the S&P 500 was up only 25% over the same period. More broadly, this magnitude of return dispersion between the 10 largest stocks in the index and the rest of the stock market has only been reached three previous times: 1997, 1999, and 2012.

The second metric the authors analyzed was market valuation, specifically the valuation multiples of the top 10 stocks in the index. Despite the runup in technology stocks over the past few years, valuations multiples have remained relatively contained on a P/E and P/B basis. This is because most of the tech companies leading the charge this cycle are mature and established businesses relative to the many that performed so well in the dot-com bubble.

Still, the authors note that the large dispersion between growth stocks and value stocks is reminiscent of the late 1990s and worth concern.

How can we position for the future?

The authors explore the possibility of a more efficient way to capture most of the upside of a capitalization-weighted index and protect capital in a down market. To do this, they create basket portfolios to back-test performance in different market environments. The three basket portfolios are as follows:

1. A capitalization-weighted portfolio that mirrors the MSCI World Index (MSCIWI)
2. A constrained minimum variance portfolio (MV) which holds the lowest volatility stocks from the MSCI World Index
3. A simulated defensive equity multi-factor portfolio (DEMF) that targets stocks with favorable scores on value, quality, momentum, and diversification to the MSCI World Index

In the paper, they display the back-tested results of these portfolios during the late 1990s/early 2000s dot-com-era, citing their belief that the current market backdrop is so similar.

Not surprisingly, the authors find the MSCIWI portfolio captured 100% of the up- and downside of the market, since it replicates the index. This happens to be the most upside and the most downside of the three. The back-tested MV portfolio captures the least amount of upside (59%) and the least amount of downside (36%). Finally, the DEMF captures most of the upside (91%) of the MSCIWI portfolio, but captures less downside (59%), leading to an attractive asymmetric up/down capture.

Findings of the Paper

The authors find that each of the three portfolios individually has a place during different parts of the cycle. However, it is very difficult for an investor to pinpoint the current stage of the equity market cycle (bull, bubble, burst). Therefore, the authors believe it is prudent for investors to seek portfolios that offer more robust results and asymmetric risk-reward patters across the different stages of the cycle.