April 3, 2020

TIME TO ADD RISK?

Although the direct trigger of each bear market is different and unexpected, there are often similarities in the performance of the major asset classes. The 2008 bear market was caused by over-leveraged housing and undercapitalized banks, while the current one has been caused by a pandemic with the resulting economic impact from the necessary social distancing implemented in major economies.

The chart below highlights the performance for major asset classes and the SLG High Growth Portfolio during the past two bear markets:

	2008	2009	2010	2020 Q1
Emerging Market Equities	-53%	+79%	+19%	-24%
US High Yield Corporate Bonds	-26%	+58%	+15%	-12%
Developed Countries (X-US)	-43%	+33%	+8%	-23%
US Small Cap Stocks	-34%	+27%	+27%	-31%
S&P 500	-37%	+27%	+15%	-20%
US Investment Grade Bonds	-5%	+6%	+7%	-3%
***SLG High Growth Portfolio**	-49%	+61%	+31%	-16%

*SLG claims compliance with the Global Investment Performance Standards (GIPS). The start date for the composite level return for the SLG High Growth Portfolio is 4/1/2009. The 2008 return represents a sample account.

The indiscriminate sell-off in February and March was triggered by the wide spread of coronavirus in Europe and the USA, supposedly governments with the time and resources to contain the outbreak. The crash in oil prices from both: (i) a pause in travel/demand, and (ii) a sudden price war between Saudi Arabia and Russia, exacerbated the market sell-off.

All risk assets were marked down and unsurprisingly, US Small-cap equities and Emerging Market equities were the two worst performers. In 2008, the S&P 500 did more poorly relative to US Small-caps due to problems originated from Large-cap Financials, one of the largest sectors at the time.

Emerging Markets started to lag US equity markets in March due to the triple whammy of capital outflows, lower commodity prices and weaker currencies; although the relative underperformance was much smaller this time. China has been the best performing equity market in the first quarter of 2020 after the virus outbreak was contained there. This time, both the Technology and Healthcare sectors did the best while Energy, Financials, Industrials, Materials and Consumer Discretionary sectors did the worst, as the latter industries were more impacted by the social distance measures. In contrast, Financials, Materials and Tech were the worst performing sectors in 2008.

The sharpest sell-offs in the 2008-09 bear market lasted about 6 months, with a few dead cat bounces in between. Stocks had bottomed in March 2009 well before the bottom in economic data. For example, the unemployment rate did not peak until October 2009. Assuming the peak of this pandemic in major economies will largely be over by June, we would expect the market to find a bottom before that.
As we can see from the asset returns in 2009 and 2010, the big winners are the asset classes that were sold down the most, such as Emerging Market equities and High Yield bonds.

Takeaway #1: A little incremental risk exposure can go a long way to boosting portfolio returns when markets finally turn higher. Even slight shifts in portfolio weightings in late 2008 to riskier asset classes like Emerging Markets or even High Yield bonds delivered dramatic results in 2009. And if you missed the 2009 moves, the same was still true in 2010.

Takeaway #2: Asset classes feed off each other on the way up as much as on the way down. For example, US Small-cap companies are often unprofitable, so high yield corporate bond spreads are an important indicator of their access to cost of capital. When high yield markets rallied in 2009 and spreads declined, this had a positive knock-on effect for Small-caps.

Takeaway #3: Crisis lows can make for some unexpectedly strong asset class returns in the subsequent upturn. In 2009, US High Yield corporates beat every equity asset class except Emerging Markets. In 2010, they bested the S&P 500 and EAFE (developed market ex. US) equities. However, in 2008 High Yield spreads widened to 2000 bps vs. the current crisis, where they've only widened to 900 bps. This could mute High Yield returns in this recovery.

Next: S&P Large Cap Sector (only those that outperformed):

2009

Technology:	+61.7%
Materials:	+48.6%
Consumer Discretionary:	+41.3%
Real Estate:	+27.1%
S&P 500:	+26.5%

2010

Real Estate:	+32.3%
Consumer Discretionary:	+27.7%
Industrials:	+26.7%
Materials:	+22.2%
Energy:	+20.5%
Telecomm:	+19.0%

Takeaway #1: Most of these sectors are classic early-cycle groups (Discretionary & Materials especially so). Real Estate features prominently because of a declining interest rate environment in 2009 – 10.

Takeaway #2: Financials are usually the textbook early-cycle group, but the Financial Crisis and its aftermath meant this sector underperformed in 2009 (+17.2%), 2010 (+12.1%) and even during the Greek debt crisis in 2011 (-17.1%). The group finally outperformed in 2012 (+28.8% vs +16.0%), 2013 (+35.6% vs. +32.4%) and 2014 (+15.2% vs. +13.7%), but that was out of its usual cyclical pattern. So far in this crisis, only Energy (-51%) has performed worse than Financials (-32%) despite banks being better capitalized.

Takeaway #3: The best single result listed above is Tech's 62% return in 2009 as markets finally relaxed and valuation multiples expanded, however, keep in mind that Technology actually underperformed in 2010 (+10.2%), barely kept pace in 2011 (+2.4% vs. +2.1% for the S&P) and lagged in 2012 (+14.8%) and 2013 (+28.4%). So far during this crisis Technology has been the best performing Large-cap sector, only down 12%. That's down even less than Utilities (-14%).

Final thought: The big winners in a cyclical upturn are often the asset classes and groups that were most unduly ill-treated on the way down. Due to the dramatic differences between the bear market in 2008-09 and this time around, certain industries might not snap back as quickly as in the past (e.g. Cruise Liners).

Sources: DataTrek Research and Novel Investor visualizations of annual returns: https://novelinvestor.com/asset-class-returns/ and https://novelinvestor.com/sector-performance/

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