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Investor Info

Investment Commentary

Football strategy in asset management

Defensive and cyclical sectors perform differently depending on the economic cycle. The following article looks at which sectors are preferable in the current environment based on historical experience.

Companies can be roughly divided into cyclical and non-cyclical sectors. A company is considered cyclical if its earnings performance shows a high correlation to the economic cycle. On the other hand, the earnings of non-cyclical companies remain more or less stable independently of recession and growth phases. Stock prices are typically subject to the same volatility as earnings. This is demonstrated in the various sector betas: while defensive sectors such as Utilities, Consumer Staples or Health Care show much lower fluctuation and thus lower betas versus the market as a whole, cyclical sectors such as Materials, Consumer Discretionary or Industrials are much more volatile, which is why their betas are also significantly higher.

Optimizing performance

The different betas can be utilized to optimize the risk/earnings ratio of a portfolio. The key is to align sector allocation with the economic cycle. Because cyclical sectors react very negatively to economic contraction phases, securities in these sectors should be sold off whenever possible before the start of a significant weakening period or recession and replaced by investments in defensive sectors. A study[1] by US financial services provider MSCI found this exact correlation between sector performance and economic cycles over a period of 33 years. The results of this study confirm the importance of sector allocation for the portfolio: as expected, the cyclical sectors[2] performed 11.5% better during economic growth phases than the defensive sectors[3]. In contrast, in contraction phases, the latter performed even better by 16%. These findings make two important aspects equally clear: First, outperformance of the market can be generated through clear sector positioning[4].

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[1] Kang, Nielson, Fachinotti: "The *New Classic* Equity Allocation," 2010
[2] Consumer Discretionary, Industrials, IT
[3] Consumer Staples, Health Care, Utilities
[4] Which, as we know, many asset managers are incapable of doing.

Second, defensive sectors seem to perform better in the long term than cyclical sectors, as their relative outperformance of cyclical sectors in contraction phases appears to outweigh their relative underperformance in growth phases. Thus, it must be possible to beat the market without sector rotations or even the timing problems and lower transaction costs associated with shifting.

Defensive beats cyclical

Let us examine the performance[5] of the S&P 1200 global stock index alongside the S&P Consumer Staples (defensive) and S&P Consumer Discretionary (cyclical) indices over a period of ten years:

An analysis of past performance shows that the cyclical Consumer Discretionary sector (black line) performed virtually just as poorly as the market as a whole (red line) at -39% in the last ten years. The defensive Consumer Staples sector (green line), on the other hand, did markedly better at -9%. Our flagship ARVEST Global Stars Fund was in turn able to outperform the latter sector over the same period by 36% as a result of the favorization of defensive sectors along with the timing of sector rotation and dynamic asset allocation.

Current market situation

In evaluating the current market situation, let us keep our attention on the above-mentioned two sectors. A price-to-book analysis shows that the Consumer Discretionary sector has reached a valuation level that is not much different from the high level seen in 2007. This sector has thus been able to keep pace with the economic recovery and stabilization of the financial markets. The defensive Consumer Staples sector, on the other hand, has thus far performed below average.

As the reality of the markets has shown time and again, prices do not simply keep climbing endlessly. Investors who want to better protect themselves from possible large corrections in the future would be well advised to reduce the market risk of their portfolios by shifting toward solid, defensive securities. Those who find this strategy too boring should keep in mind that in asset management, much like in the defensive football formation catenaccio, it is results that matter most.

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[5] Performance including dividends and in CHF.