QUANTITATIVE EQUITIES

‘Bear’ in mind defensive stock reversals

- Past five-year returns have predictive power for next five-year returns
- Defensive stocks tend to outperform after cyclical rallies
- The outlook for defensive equities is optimistic

As market trends ebb and flow, investment styles can shift in and out of favor. In recent years, defensive approaches – known for their focus on capital preservation and stability – have been challenged. This was especially noticeable in the years preceding 2022, when high-flying, tech-related stocks largely propelled global equity markets, particularly during the Covid pandemic. However, 2022 served to remind us that bull markets inevitably give way to bear markets, underscoring how the invaluable role that defensive strategies play within diversified portfolios should not be understated.

Now, as the Wall Street party resumes in 2023, it is an ideal time to reconsider defensive strategies in their often overlooked context. With the narrow leadership of ‘big tech’ once again driving global equity markets upwards, maintaining defensive strategies can trigger a fear of missing out, particularly given the accelerated rise of artificial intelligence (AI). In this environment, we recognize why defensive companies may lose favor yet caution against forsaking them.

While the returns generated by defensive stocks might not always match the returns of cyclical stocks during upward-trending markets, their added value should be valued within an overall portfolio context. Their strengths – reducing downside risk, curbing overall portfolio volatility, offering stable dividends, and diversifying portfolios – should not be underestimated.

From a contrarian perspective, it is precisely during periods of rallying markets that the true value of defensive investing emerges. By staying committed during these phases, investors are more likely to shield their portfolios from significant losses when market sentiment eventually shifts. Against this backdrop, we delve deeper into the concept of market overreaction, examining the subsequent five-year performance of defensive and cyclical stocks after their past five-year relative performance. Our research suggests that defensive stocks bounce back after a period of underperformance, allowing contrarian investors to benefit from cyclical overreaction patterns.

Understanding defensive versus cyclical returns

To understand this phenomenon, let’s analyze the performance of defensive and cyclical stocks across market cycles since 1929. Defensive stocks are typically categorized by their industry – for example, consumer staples,

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energy, healthcare and utility sectors are classified as defensive under methodologies such as the global industry classification standard (GICS), while other groups are labeled as cyclical.[1]

However, the drawback of GICS is that sectors transition from cyclical to defensive over time. For instance, communication stocks were cyclical in the early 2000s, but became more defensive in the 2010s. Moreover, within a cyclical sector, some stocks may be more defensive (like a stable information technology services firm) and vice versa (a leveraged utility company).

Therefore we have divided the broad US stock market into two parts, similar to the value/growth categorization, based on historical volatility. The advantage of this data-driven classification is that it can be used over extensive periods, and the split mirrors a 50/50 percent division of the market.[2]

“ Data-driven classification better than GICS

Assessing the performance of these two stock categories from January 1929 to May 2023 reveals that defensive stocks are less volatile and have a lower risk profile than their cyclical counterparts. Defensive stocks, with a beta of 0.75, respond less to market movements compared to cyclical stocks with a higher beta of 1.27. This lower sensitivity makes defensive stocks an attractive option for investors seeking to mitigate their exposure to market fluctuations.

The average geometric return for defensive stocks over this full sample period is 10.0%, outpacing the 9.2% gain delivered by their cyclical peers – this slightly higher return, coupled with a lower market beta, results in a compounded (Jensen’s) alpha of 2.9% per annum. The final row in Table 1 shows how USD 1 invested in January 1929 has grown to USD 8k for defensive stocks and USD 4.2k for cyclical companies in May 2023. This also illuminates the power of compounding as even a small difference in return (0.8%) can lead to significant disparities in end wealth.

Table 1 - Long-term defensive and cyclical returns over full sample period, January 1929-May 2023

	Defensive	Cyclical	Market
Average return	10.0%	9.2%	9.4%
Volatility	14.6%	24.2%	18.6%
Market beta	0.75	1.27	1.00
Alpha	2.9%	-2.8%	-
End wealth	USD 8,037	USD 4,238	USD 5,017

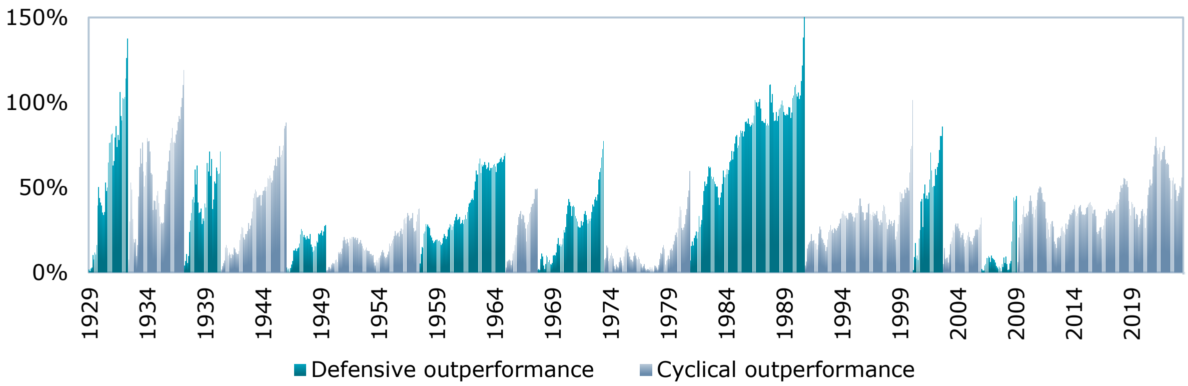
Source: Robeco.com/data

Evaluating return cycles

While defensive stocks outperform cyclical ones throughout our comprehensive sample, this phenomenon is not consistent over time. Each category outperforms the other about half the time, and the shifts in performance can be stark and lengthy. Figure 1 shows the relative performance through time, with cycles defined by when the style reaches an all-time relative high. We observe that performance cycles, characterized by at least a two-and-a-half-year span with a return difference exceeding 25%, typically last between three and ten years.

1 https://www.msci.com/eqb/methodology/meth_docs/MSCI_Cyclical_and_Defensive_Sectors_Indexes_Methodology_Nov18.pdf
2 Source: Robeco.com/data. Data from January 1929-December 2022. Defensive stocks include 30% of the stocks with below-average volatility and cyclical ones 70%. Despite this difference, they make each make up 50% of the total market capitalization. The low-volatility index (SPLV) and Nasdaq index (QQQ) are used as proxies for defensive and cyclical performance for the January 2023-May 2023 period.

Figure 1 - Relative performance of defensive and cyclical stocks over full sample period, January 1929-May 2023



Source: Robeco

Figure 1 also reveals the dynamics of defensive and cyclical stocks over time. The late 1950s and early 1960s, characterized by a steady and prosperous economic climate as well as low inflation in the US, nevertheless saw defensive sectors such as utilities, consumer staples, and healthcare excel due to geopolitical uncertainty, especially between the US and the Soviet Union. Conversely, the 1990s witnessed a sharp bull market rally for cyclical stocks, culminating in the internet bubble of 1999. The preceding decade had defensive stocks outperforming cyclicals by nearly 150% due to high inflation, volatile interest rates, and an early-decade recession.

> *" Defensive stocks outperform cyclical stocks, but not consistently over time*

During the 'longest bull market ever' which started in March 2009, cyclical stocks outperformed their defensive counterparts by 80%, yielding an annual difference of 5% over 12+ years. Following the global financial crisis, accommodative monetary policies and global economic expansion fueled the boom in cyclical sectors such as consumer discretionary, industrials, information technology and financials. Meanwhile, defensive stocks, though still generating positive returns, significantly trailed their cyclical counterparts.

It's worth noting that temporary defensive rallies did occur in this period, such as during the European debt crisis in 2012 and recession fears in late 2018. And while stagflation worries spurred a defensive rally in 2022, strongly rebounding cyclical stocks have dominated markets year to date. As of June 2023, given the recent cyclical performance, it is difficult to determine whether the defensive reversal has already begun or is impending.

Long-term reversal

Historically, 'losing' stocks tend to yield higher future returns, while their 'winning' peers typically produce lower future returns. In their seminal study, De Bondt and Thaler showed that stock prices mean-revert over a five-year period, and attribute this long-term reversal to market participant overreaction.[3] This phenomenon can also be interpreted as an easy-to-implement value strategy that does not require challenging-to-acquire accounting data.[4]

Interestingly, defensive stocks outperformed cyclical ones in 51% of past five-year periods over the full sample period, with cyclical stocks leading in the remaining 49% – reflecting a broadly even split. Table 2 illustrates the returns in the subsequent years following these defensive and cyclical rallies.

[3] De Bondt, W. F., & Thaler, R. (1985). Does the stock market overreact? *The Journal of finance*, *40*(3), 793-805. For further evidence of overreaction see: Lakonishok, J., Shleifer, A., & Vishny, R. W. (1994). Contrarian investment, extrapolation, and risk. The journal of finance, 49(5), 1541-1578.
[4] Fama, E. F., & French, K. R. (1996). Multifactor explanations of asset pricing anomalies. *The journal of finance*, *51*(1), 55-84.

Table 2 - Past five-year and next-five-year returns over full sample period, January 1929-May 2023

	Cyclical rally (49%)				Defensive rally (51%)		
	Defensive	Cyclical	Difference		Defensive	Cyclical	Difference
Past five-year return	12.5%	16.1%	-3.7%		9.6%	5.8%	3.8%
Next five-year return	11.3%	9.2%	2.1%		11.6%	12.9%	-1.3%
Next five-year alpha	3.8%	-3.6%	7.4%		2.6%	-2.4%	5.0%

Source: Robeco, 2023

During cyclical rallies, equity returns are usually high, averaging above 10% per annum. In this US sample, cyclical stocks delivered an average annual return of 16.1% over the past five-year period, while their defensive counterparts gained 12.5%, resulting in a return difference of 3.7%. Following a five-year period of strong performance for cyclical stocks, the subsequent five years usually favor defensive stocks, which achieve an average return of 11.3% compared to 9.2% for cyclical companies.

Moreover, the alpha – measuring risk-adjusted returns – stands at 3.8% for defensive stocks versus -3.6% for their cyclical peers. While defensive companies outperform in 51% of the five-year periods, they continue to perform well but tend to lag cyclical stocks. Overall, this environment is attractive for equity markets, in which defensive stocks tend to lag slightly (1.3%), whereas the alpha spread remains a healthy 5.0%. Similar outcomes for subsequent five-year returns are found when three-year and seven-year lookback periods are used.

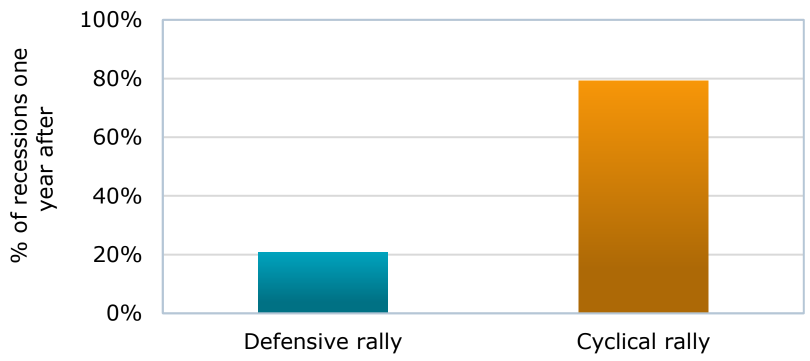
Recession risk

Following five-year strong returns from cyclical stocks, we find that equities have somewhat lower returns the next years. Thus the relative performance of low-risk equities might also be used as a market-timing indicator, although the five-year evaluation horizon may be too long for most investors.

“ Higher recession risk after cyclical rallies

Meanwhile, rallies of both sorts can also be linked to macroeconomic regimes. We therefore also looked at the recessions over this 90+ year period. The US economy was in recession 188 months, or 15.6 years (14% of the time). Interestingly, about 80% of these recessions occur in the year following a five-year cyclical rally, whereas recessions are much less likely after a defensive rally.

Figure 2 - Percentage of recessions one year after cyclical/defensive rallies over full sample period, January 1929-May 2023



Source: Robeco, 2023

Shorter sample and enhanced low volatility

To ensure robustness we also assess recent data for mean-reversion patterns. Additionally, we include the Conservative Equities strategy, Robeco's approach to defensive equity investing. This strategy, which incorporates factors such as volatility, net payout yield and price momentum to select the most attractive defensive stocks, is designed to be less sensitive to the defensive/cyclical cycle. The sample starts in January 2000, using data from 1995 to determine the prior five-year relative returns. The US Conservative Equities strategy series consists of real-life returns, both after transaction costs and before fees, backfilled with simulations prior to 2014.

Given this shorter sample only spans 23 years of data, we evaluate the subsequent one-year returns. The limited number of observations means that the results should be interpreted carefully. Table 3 presents the findings. Using this more recent and shorter sample, we observe that cyclical return rallies were more frequent. Indeed, cyclical rallies have occurred 54% in the 21st century versus 46% for defensive rallies.

Table 3 – Simulated performance of defensive and cyclical stocks, including Conservative Equities strategy, January 2000-May 2023

	Cyclical rally (54%)				Defensive rally (46%)		
	Defensive	Cyclical	Conservative		Defensive	Cyclical	Conservative
Past five-year return	11.1%	14.0%	11.5%		6.0%	3.8%	8.6%
Next one-year return	5.1%	-1.1%	5.6%		10.4%	15.9%	12.0%
Next one-year alpha	4.0%	-1.9%	5.0%		1.0%	-0.3%	3.0%

Source: Robeco, 2023

Again we find a clear overreaction pattern: defensive stocks tend to perform well (poorly) following a five-year rally in cyclical (defensive) stocks. The latter gain 5.1% the year after a cyclical rally, whereas the former fall by 1.1%, amounting to a return difference of more than 6%. In contrast, after a defensive stock rally, the companies in the latter group deliver an attractive return of 10.4%, but this lags the performance of their cyclical counterparts which advances 15.9%. When corrected for market risk, the alpha of defensive stocks is 4.0% and 1.0% in these two market environments respectively.

Interestingly, the return pattern of the Conservative Equities strategy is similar, with 5.0% alpha following defensive rallies and 3.0% alpha following cyclical ones. After a cyclical rally, the Conservative Equities strategy adds 1.0% alpha versus generic defensive equities and also outperforms cyclical stocks significantly. Thus, the impact of this five-year reversal pattern is partly mitigated, but still there.

Final remarks

In this brief note we confirm the earlier academic findings that the stock markets tend to overreact. The relative performance of cyclical stocks versus defensive ones reveals mean reversion over a five-year time frame; a pattern that remains robust as similar outcomes are found when different lookback periods are used.

However, benefiting from this insight in real-time poses challenges, requiring tactical allocation decisions based on a slow-moving signal. As an investor, few opportunities arise over time that allow such a decision to be made. This brings us to our previous research on 'strong hands', showing that many investors are plagued by inverse timing skills, often abandoning an asset, investment style, or stock at an inopportune moment. This tends to coincide with multiple years of weak relative performance, which subsequently reverts.

Considering the recent lag in performance of defensive stocks compared to cyclical ones over the past three to seven years, this offers an optimistic outlook for investors who have invested in defensive equities recently. At the same time, for investors wanting to take advantage of the attractive relative returns of defensive stocks following cyclical rallies, the current market backdrop presents a favorable entry point.

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