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Investor Complacency and the Case for Defensive Equities

- Investor complacency increasing risk for equity markets.
- The case for defensive equities especially during more volatile market conditions.

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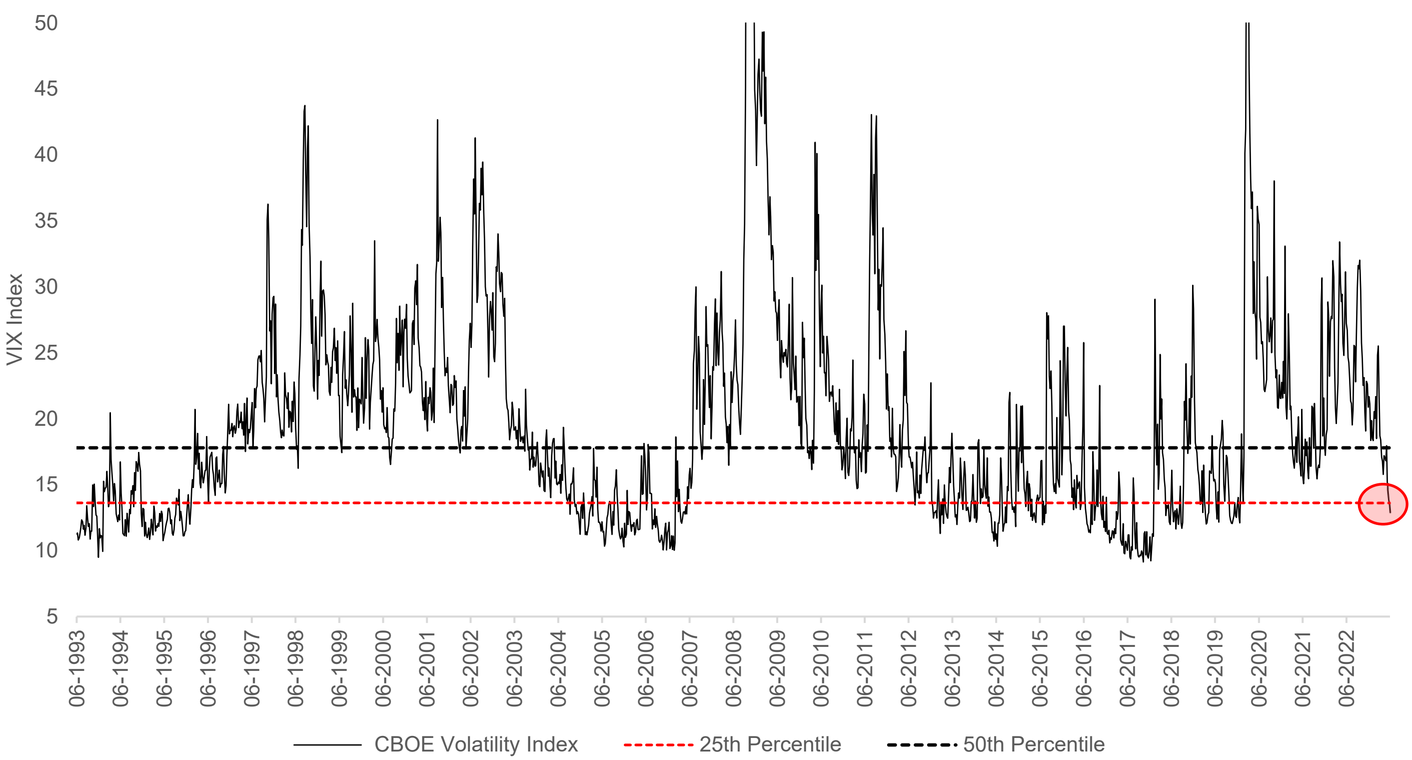
Investor Complacency Increases Risk for Equities

On the 22 June 2023, the CBOE Volatility Index (VIX) hit a low of 12.9, down -40% from the start of the year when it was trading at 21.7.[1] The VIX is a measure of investors expectation of volatility based on S&P 500 Index options. It is a commonly accepted measure of investor fear (or in this case lack of fear). The recent decline may be suggesting investor complacency. This is important because equity markets are more vulnerable to shocks when they are not expected. Figure 1 below highlights the recent fall in the VIX. At these low levels the VIX now sits below the 25th percentile.

The possible complacency has coincided with exuberant equity markets in 2023 which has taken valuations back into the expensive zone. The price-to-earnings ratio for the MSCI World Index has moved from 14.9 to 16.9 in 2023.[2] A move from the 50th percentile to the 85th percentile based on valuation levels of the last 20 years. At the same time the earnings trend has been subdued at only +1%[3], leading economic indicators continue to point lower, and the risks of a global economic slowdown or recession remain ever present.

Figure 1: VIX Hits Low of 12.9 Suggesting Possible Investor Complacency

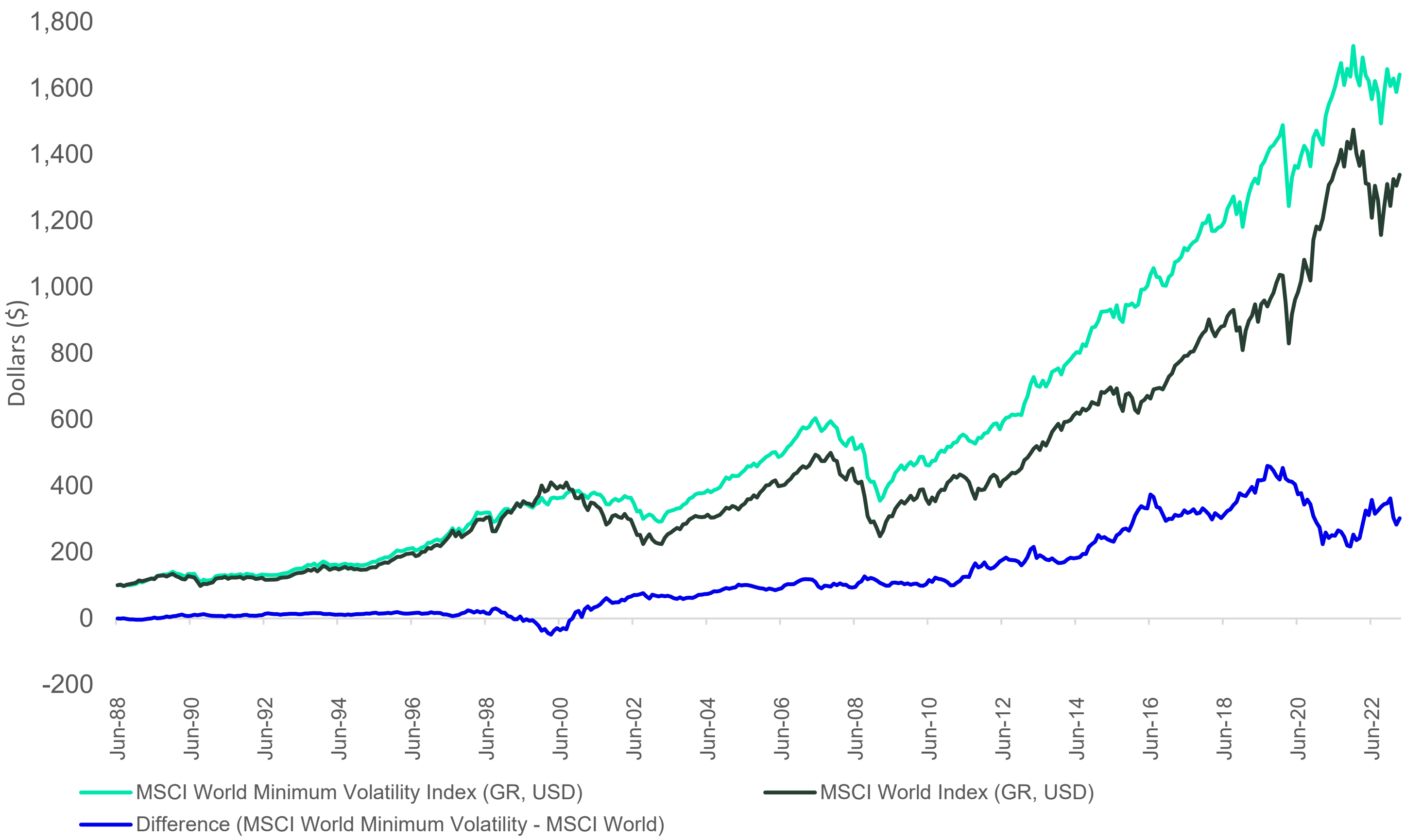


Source: Source: FactSet, State Street Global Advisors. CBOE Volatility Index for last 20 years from 25 June 1993 to 22 June 2023. Both the 50th percentile and 25th percentile are shown.

The Case for Defensive Equities Especially During More Volatile Markets

Minimum volatility investment strategies are designed to produce portfolios that are less sensitive to equity market volatility. Mostly they will tilt towards companies that are less volatile (lower beta) and often less cyclical. It is common to find larger allocations to consumer staples, healthcare and utilities in minimum volatility portfolios. Consumer staples, healthcare and utilities are often considered defensive sectors as their earnings tend to be less sensitive to economic cycles. They are also often considered “boring” due to their stability. Figure 2 below highlights the longer term outperformance of the MSCI World Minimum Volatility Index (Min Vol Index) compared to the MSCI World Index (World Index). Boring isn’t so boring when markets become more volatile.

Figure 2: Growth of $100 - MSCI World Index vs. MSCI World Minimum Volatility Index

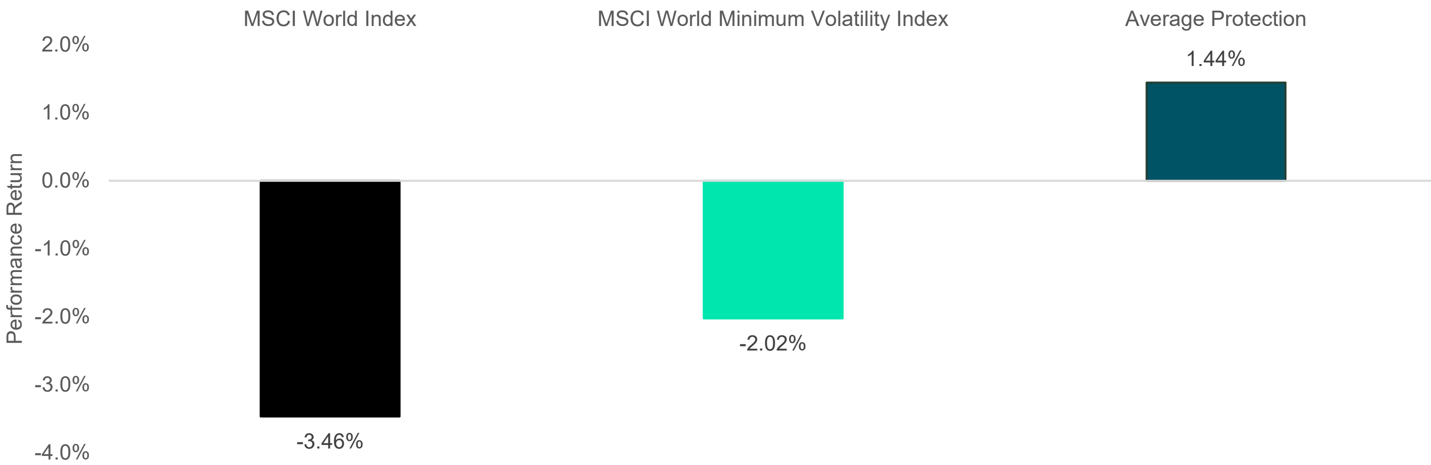


Source: FactSet, State Street Global Advisors. MSCI World Minimum Volatility Index and MSCI World Index are based upon the World Standard (Large+Mid Cap). Both are compared over the period 30 June 1988 to 31 March 2023. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable. All the index performance results referred to are provided exclusively for comparison purposes only. It should not be assumed that they represent the performance of any particular investment.

The blue line shows the difference in performance. When markets are more speculative, as they were in the lead up to the tech bubble bursting in 2000 and again during the 2019/2020 period, the more defensive strategies underperformed. During more volatile periods, lower volatility strategies have tended to outperform.

Figure 3a) and 3b) provide a perspective on the historical outperformance of the Min Vol Index during down months. Over the full sample period from 30 June 1988 to 31 March 2023, we had 417 monthly returns of which 152 were negative months. Figure 3a) shows the more defensive returns achieved by the Min Vol Index. The average negative monthly return for the World Index was -3.46% and the average corresponding negative monthly return for the Min Vol Index was a more muted -2.02%. A difference of +1.44%.

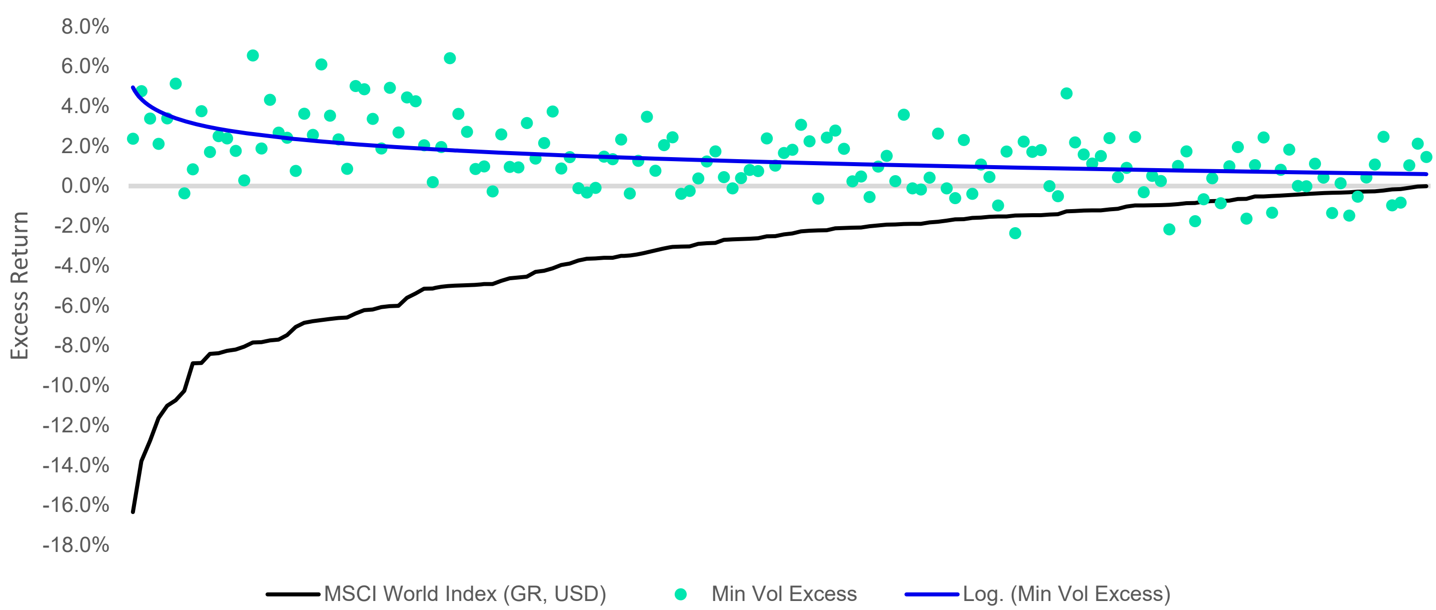
Figure 3a: Average Returns in Down Months for MSCI World and Minimum Volatility Indices



Source: FactSet, State Street Global Advisors. MSCI World Minimum Volatility Index and MSCI World Index are based upon the World Standard (Large+Mid Cap). Both are compared over the period 30 June 1988 to 31 March 2023. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable. All the index performance results referred to are provided exclusively for comparison purposes only. It should not be assumed that they represent the performance of any particular investment.

Figure 3b) provides a more detailed picture on the excess return for each of the 152 down months. We have sorted the months from most negative (-16%) to least negative (black line). The dots show the actual excess return for the down months and the blue line highlights the relationship between excess return and lower market returns. The more negative the World Index returns, the greater the Min Vol Index outperformance.

Figure 3b: Relationship Between Down Months for MSCI World Index and Excess Return for MSCI Minimum Volatility Index



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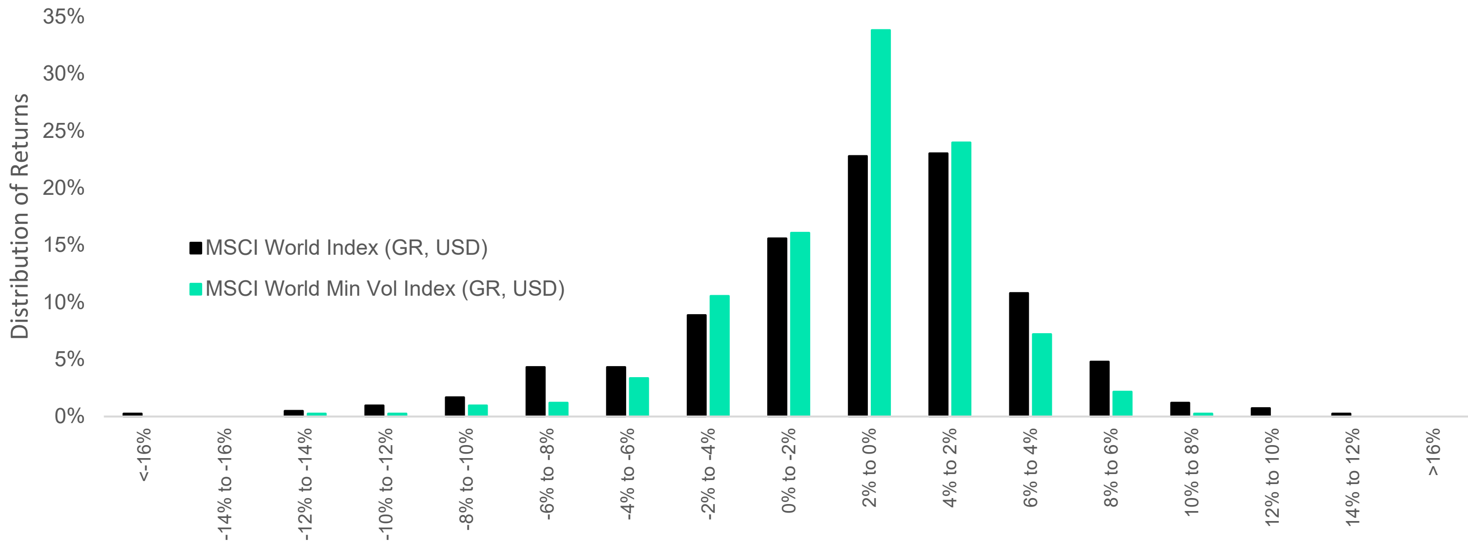
The MSCI World Minimum Volatility Index Tends to be More Consistent

Figure 4 highlights the full distribution of returns of the World Index compared to the Min Vol Index. It shows a more consistent profile with fewer negative observations (more positive return) and fewer outliers.

Figure 4: Distribution of Returns of the MSCI World Index vs. MSCI World Minimum Volatility Index



Source: FactSet, State Street Global Advisors. MSCI World Minimum Volatility Index and MSCI World Index are based upon the World Standard (Large+Mid Cap). Both are compared over the period 30 June 1988 to 31 March 2023. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable. All the index performance results referred to are provided exclusively for comparison purposes only. It should not be assumed that they represent the performance of any particular investment.

The Bottom Line

Equity markets have rallied in 2023 taking the market to more expensive valuations. With continued economic uncertainty, and now investor complacency, the equity market is more vulnerable. Strategies that focus on reducing volatility have much to offer during negative equity periods and over the longer term.

Footnotes

[1] Source: FactSet.
[2] Source: FactSet. Price-to-earnings ratio for the MSCI World Index calculated at 30 December 2022 and 16 June 2023.
[3] Source: FactSet. Based on the % change YTD for earnings per share estimates for the next 12 months for the MSCI World Index.

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