Insights
Active Quantitative Equity (AQE)

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Active Quantitative Equity

Drawing Lessons from Downturns

The best explanation for which equity sectors outperformed in September can be found in a multi-dimensional view of each stock, including its valuation, quality, and sentiment indicators.

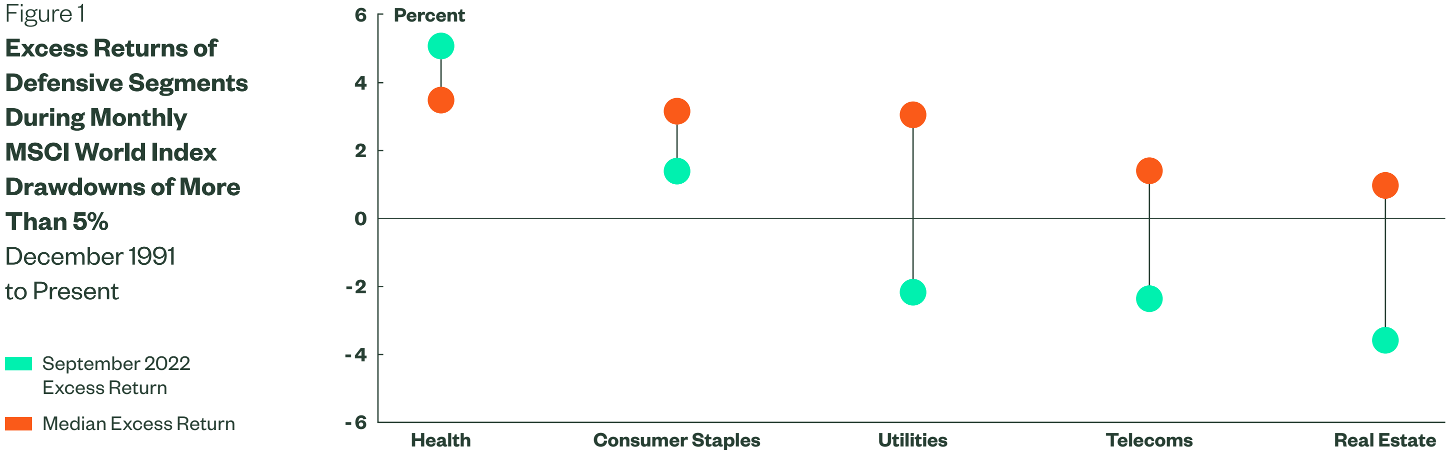
The Active Quantitative Equity (AQE) team has been closely examining the September equity drawdown to better understand what was "conventional" versus "unconventional" about it and how these findings inform the AQE team's process. September's decline of more than 9% was the eighth worst monthly return for the MSCI World Index in 30 years.

Historically, investors concerned about a market drawdown have looked to lower-risk, defensive segments like Real Estate, Utilities, Telecoms, Consumer Staples, and Health Care. And investors concerned about a market drawdown have also typically avoided higher-risk segments like Financials, Materials, Industrials, and Technology.

September Surprise

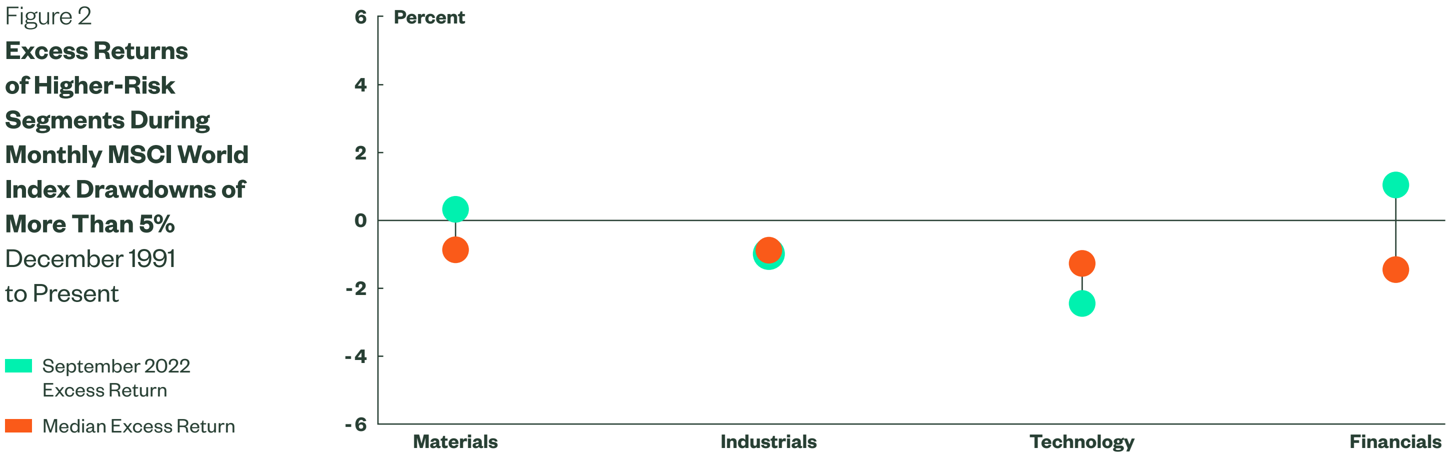
Over the last 30 years, when equity markets have experienced monthly declines of more than 5%, defensive segments have generally outperformed the broad market index. However, September was a decidedly different outcome. Health Care and Consumer Staples were great cushions for the overall market drawdown, but Utilities, Real Estate, and Telecoms all markedly underperformed. On the other hand, Materials and Financials — higher-risk segments that would typically underperform in a market drawdown — outperformed the market in September. See Figures 1 and 2.

Figure 1
Excess Returns of Defensive Segments During Monthly MSCI World Index Drawdowns of More Than 5%
December 1991 to Present



Source: MSCI and Bloomberg Finance L.P., as of September 30, 2022.

Figure 2
Excess Returns of Higher-Risk Segments During Monthly MSCI World Index Drawdowns of More Than 5%
December 1991 to Present



Source: MSCI and Bloomberg Finance L.P., as of September 30, 2022.

Also, if we look at risk attributes like volatility and beta (instead of segment), history would tell us that a monthly market return of -9% would on average be coupled with a spread return for lower-risk versus higher-risk quintiles of stocks of approximately +8.5% (using simple regression analysis). However, during September, the spread return for lower-risk versus higher-risk quintiles of stocks was only +3.5%.

What Was Different

Why didn't lower-risk stocks provide the expected payoff relative to higher-risk stocks in September? Interest rate sensitivity may be part of the answer. Financials should achieve better earnings when interest rates rise, and long-duration, debt-heavy industries like Utilities and Real Estate are negatively exposed to rising rates.

That said, we believe that a better explanation for which segments outperformed in September can be found in a multi-dimensional view of each stock, including its valuation, quality, and sentiment indicators. This means that, while AQE's overall preferences coming into September were generally aligned with lower-risk attributes, these additional considerations supported our continued favoring of Health Care and Consumer Staples, as well as our continued avoidance of Real Estate. Among higher-risk sectors, they also led us to favor Financials and avoid Technology.

The Bottom Line

In the June commentary, we remarked that AQE's preferred stocks across the developed equity market were "...in total, quite a bit less risky than the average stock." We also clarified that it didn't mean AQE only liked low-risk segments, or that all low-risk segments were attractive. And we used Energy (high risk but attractive) and Real Estate (low risk and unattractive) stocks to highlight this nuance. September market action supported the thinking in that discussion.

In sum, a difficult September has at least reminded us of the importance of assessing stocks on multiple dimensions, systematically, to help weather storms such as those created by unexpected market drawdowns and other volatile events.

Figure 3
Sector Preferences of AQE Stock Selection Model

Most Preferred
Least Preferred
Neutral

	Stronger in September	Neutral to Drawdown in September	Weaker in September
Typically Stronger in a Drawdown	Consumer Staples Health care		Real Estate Telecoms Utilities
Neutral to Drawdown		Energy Discretionaries	
Typically Weaker in a Drawdown	Materials Financials		Technology Industrials

Source: State Street Global Advisors as of September 30, 2022.