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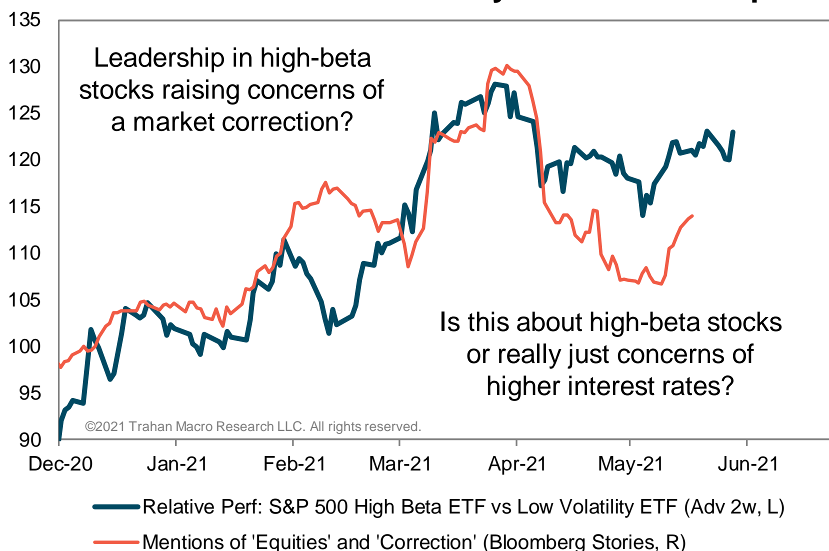
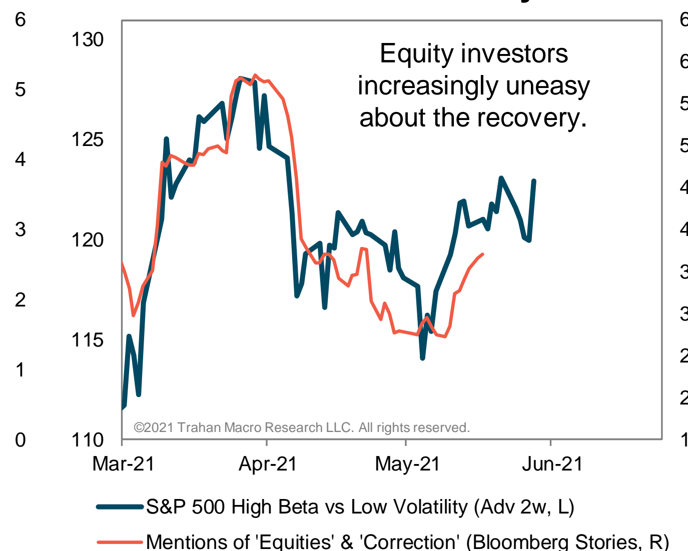
Managing Risk In An Unusually Polarized Equity Market

There are a lot of repeatable patterns observed in the equity market. The most important one in our framework is the relationship between stocks and the economy. That particular pattern is about as stable as it gets. Indeed, the S&P 500 has been in the official Leading Economic Index (LEI) since it was first created in 1937. Now a number of indicators have been added/deleted from the LEI in the course of the Conference Board's periodic review of their popular Index, but the equity market is one that has stood the test of time. While stocks and the economy exhibit a stable relationship, it is nonetheless important to acknowledge that every business cycle has peculiarities that are unique to it. The current one is no exception. The amount of stimulus is mind-numbing and the inflationary dynamic at play is certainly different from recent memory.





While the economic recovery has several aspects that are unique or different, it is the very composition of the S&P 500 as well as the lofty valuations of some of its larger stocks that have our attention. We have simply never seen the market cap of the S&P 500 skewed toward Growth to this extent before. More importantly perhaps, the make-up of this Growth segment is largely comprised of Long-Duration stocks that happen to be VERY sensitive to changes in interest rates. The S&P 500 has "loved" a recovery in the economy since 1937 but now appears allergic to signs of inflation and the potential for higher rates that this recovery might bring.

The valuation gap between Growth and Value has created a very polarized dynamic for equity leadership. It's almost like an ON and OFF switch where there is no middle ground. We continue to have a strong preference for all things cyclical but in this week's report we discuss strategies for managing risk amidst volatile rotations in leadership. We believe that this will be a key tool later in 2021 when PMIs start to come off their highs, but it might be appealing for those investors looking to minimize leadership risk immediately. Best, Francois

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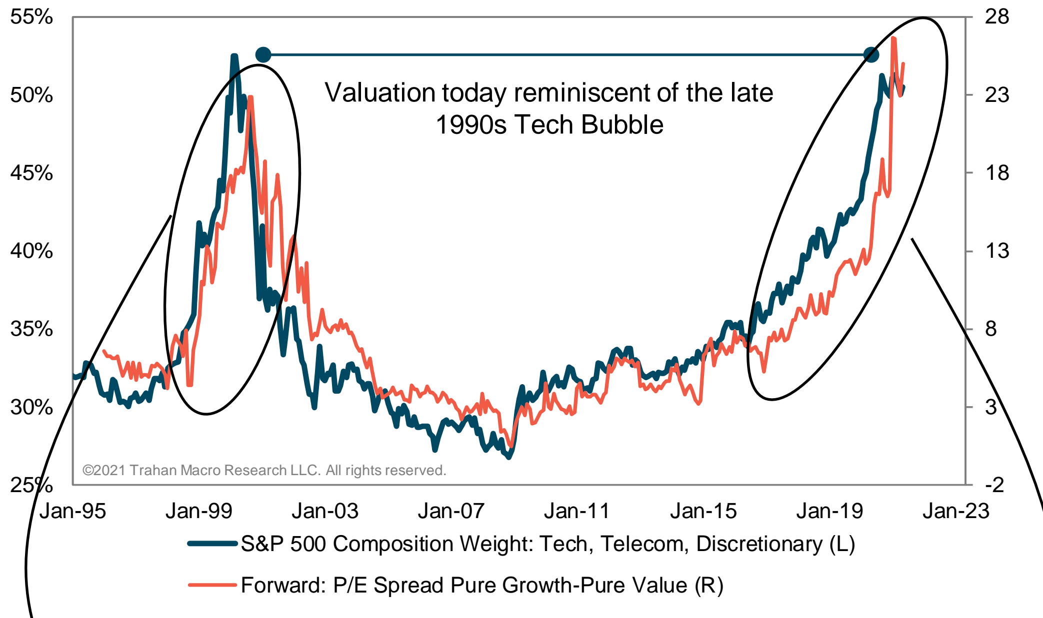
This Recovery Is No Longer "The Tide That Lifts All Boats"

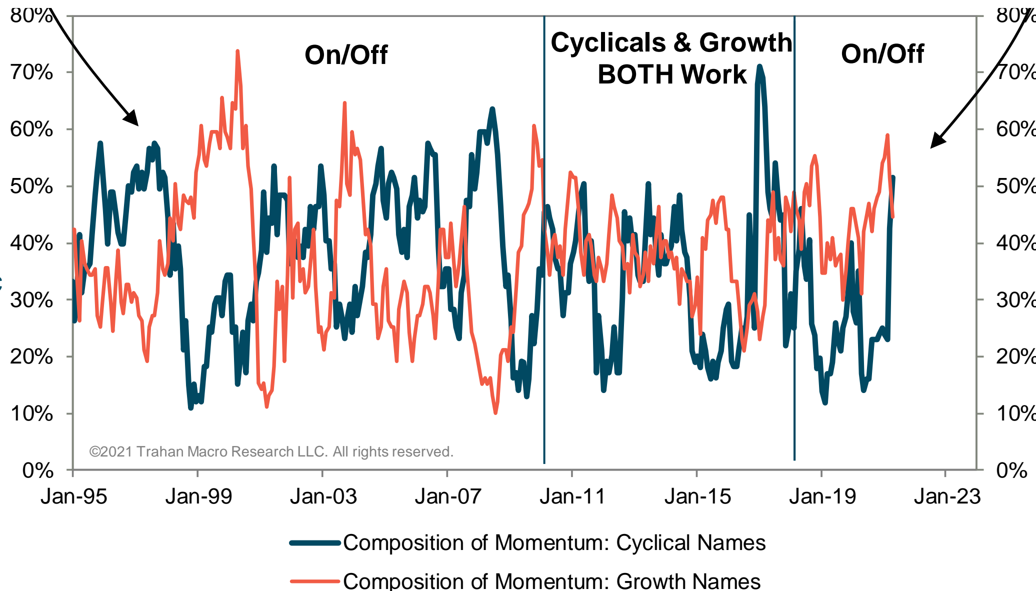
There is little doubt that the economy is gaining strength as the U.S. appears to be quickly transitioning into a post-pandemic recovery. Unfortunately for equity investors this has not been an easy backdrop to manage money. What we have seen this year is a see-saw between leadership of Growth/Stability and Value/Cyclicality, and with the latter has come downward pressure on the S&P 500 Index as a whole. One of the reasons for this behavior is the unusually high proportion of Growth stocks in the Index, which currently exhibits a historically high valuation spread relative to Value.

Valuation is once again playing a disproportionate role in equity markets.



Valuation also mattered greatly during the Tech bubble of the 1990s and throughout its unwind in the 2000s.

The large valuation disparity between Value & Growth has altered the leadership dynamic in the S&P 500.

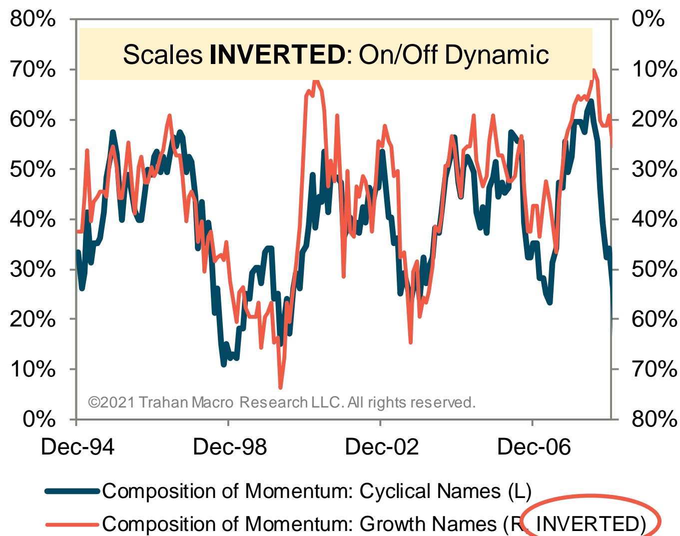


Leadership has become polarized in U.S. equities. This is similar to the dynamic seen before the GFC.

We have seen this pattern before. At times when the valuation spread between Value and Growth has been very wide, typically only one of the style trades was favored. Said differently, when the valuation spread is at extremes, equity leadership acts as an "On/Off" switch for the Index. In the late 1990s up until the Financial Crisis we saw this dynamic at work. In the decade following the crisis, however, things normalized and both Cyclicals and Growth were able to lead the S&P 500 higher at various times.

Valuation Plays A Disproportionate Role In Markets When At Extremes

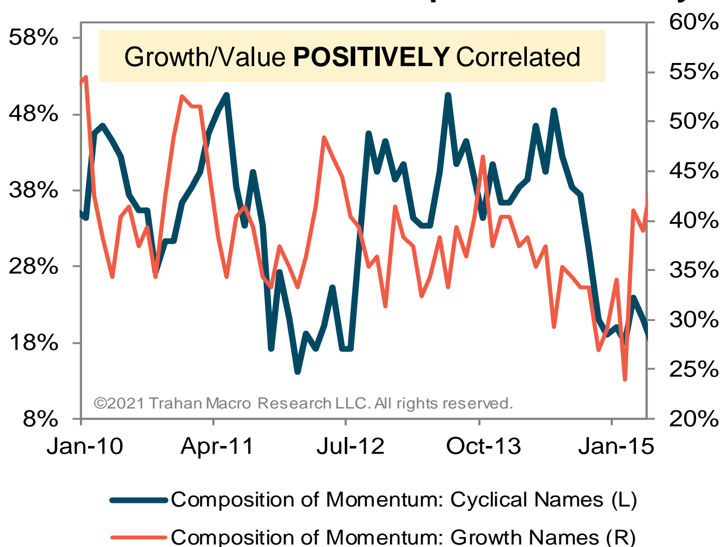
An On / Off Switch Between Growth & Value



Valuation Disparity: (Mid-1990s – GFC) A Tale Of Two Markets

The original On/Off market dynamic occurred in the late 1990s as the Tech bubble roared and lasted all the way through its unwind in the 2000s. The key feature of this dynamic, as illustrated on the chart, is that the two segments were inversely correlated (right scale is inverted). When cyclicality picked up, Growth lost steam, and vice versa. It is the perfect example of a polarized dynamic in leadership where a portfolio, if skewed toward one theme or the other, is either hot or cold.

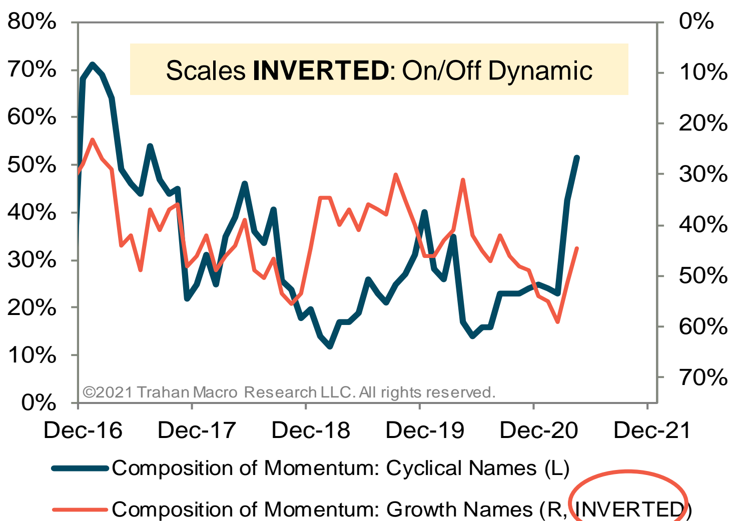
Growth & Value Can Go Up Simultaneously



Valuation Gap Narrow: (Post-GFC – 2015) QE Is The Tide That Lifts All Boats

Leadership/rotations were different in the wake of the Global Financial Crisis. While Cyclicals exhibited more volatility than Growth stocks, their respective momentum was mostly positively correlated. In other words, they often worked simultaneously. This was the case until roughly 2016, so clearly ZIRP and QE played a role here. Money seemed to be the tide that lifted all boats simultaneously. Alpha became about degrees of performance rather than directional.

On / Off Switch Between Growth & Value

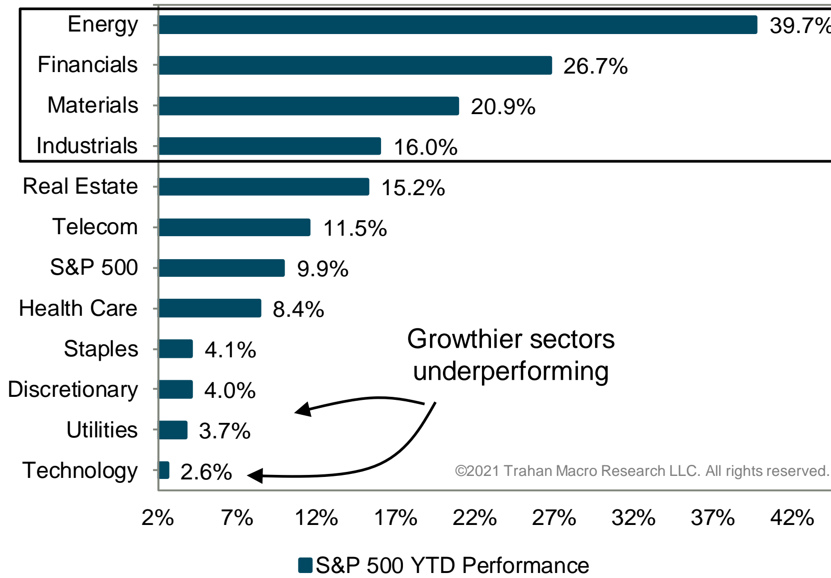


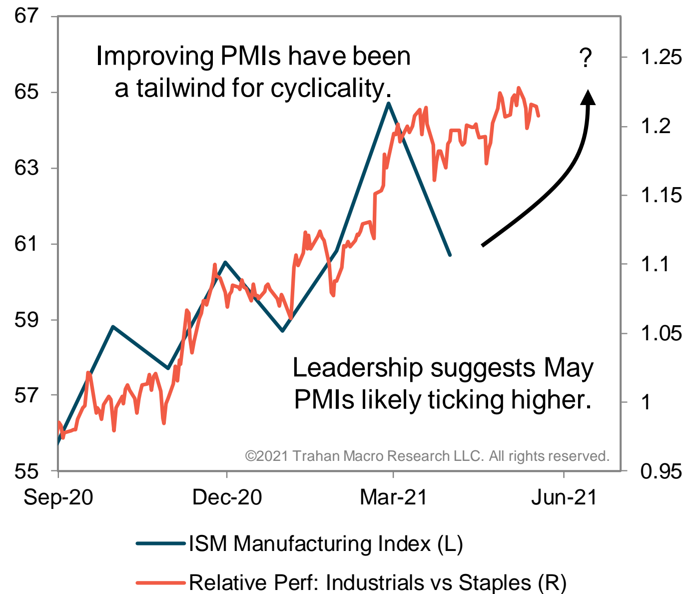
Valuation Disparity: (2017 - ?) A Tale Of Two Markets Revisited

The end of ZIRP saw the re-appearance of the inverted relationship in performance between Growth and Value. This is illustrated on the chart by plotting the series using inverted scales. While monetary policy clearly had a role to play, the commonality between the late 1990s and today is the large valuation gap that exists between the Growth and Value universe. Certainly, a change in leadership will be magnified when valuation is so significantly different, as is the case today.

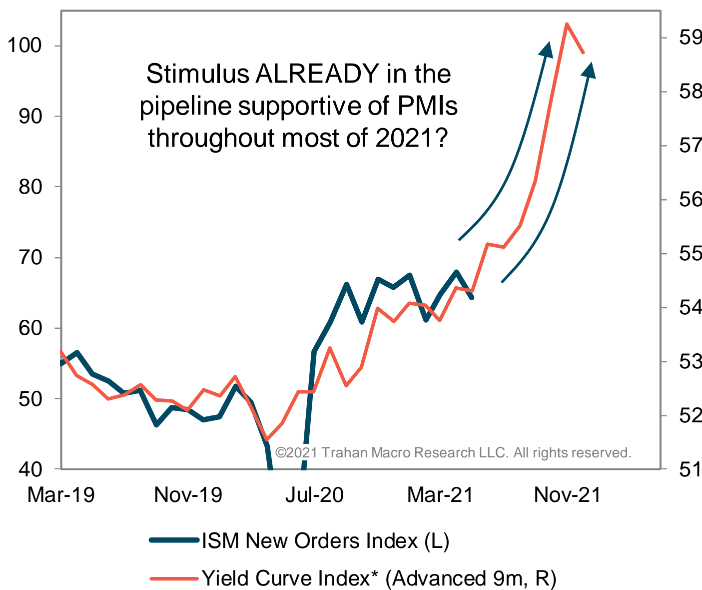
Polarized Performance Generally A Source Of Anxiety For Investors

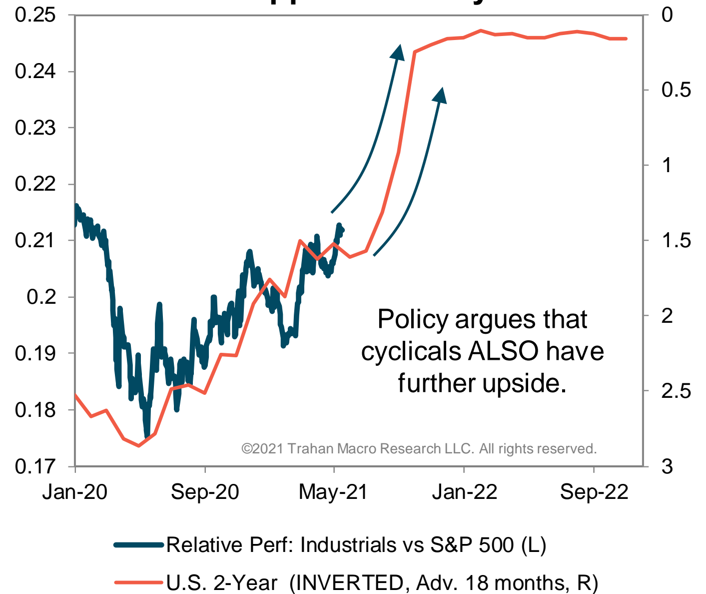
Without a doubt there are segments of the S&P 500 Index that have been roaring year to date. The top four sectors are all Cyclicals—Energy, Financials, Materials, and Industrials. Improving data is clearly supporting these segments over their Growth counterparts which linger at the bottom of the roster. This is causing many investors a lot of angst as the largest, most popular stocks that have outperformed in recent history are now getting punished on news of a strengthening economic recovery. It feels counterintuitive in many respects but as we've seen, this can happen when valuations are at extremes.





Our framework tells us that this dynamic is most likely set to continue for the foreseeable future. Last year's stimulus is still working its way through the economic pipeline and likely to remain supportive of PMIs throughout most of 2021. Interest rates also argue for more upside for Cyclicals in 2021. Whether this translates into further downside for Growth remains to be seen, but if history is a guide, we may well be in for several quarters of polarized performance and pressure on the S&P 500 Index as a whole.





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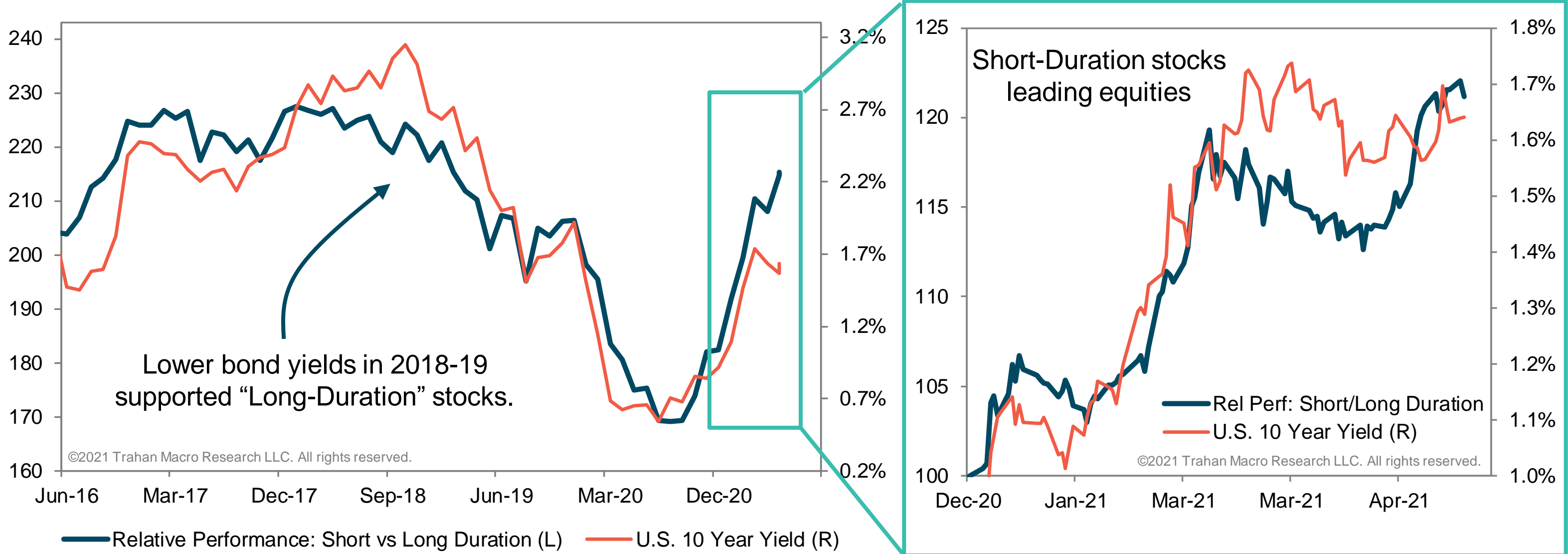
Higher Rates Weighing On ONE Segment: Long Duration Stocks

As we've covered at length in recent weeks, the beneficiaries of better data, and by the same token higher rates, have been "Short-Duration" stocks. Short-Duration stocks typically do not respond to higher interest rates as violently as Long-Duration stocks, which has given this segment more of a tailwind in the current backdrop. If we expect rates to continue to rise throughout the year, and we do, then we believe that Short-Duration stocks are a better bet than the more sensitive Long-Duration names.



Digging into the composition of the Short-Duration bucket shows that it is comprised of about 61% of Pure Value names and only 2% of Pure Growth. This helps to explain why the performance of Short-Duration stocks and Value/Cyclicality leadership are in sync. Meanwhile, Pure Growth is much more represented in the Long-Duration bucket and thus more "sensitive" to higher rates.

Still, there were a few surprises at the sector level. The top three sectors represented in the Short-Duration group are Financials (Cyclical), Health Care (Defensive) and Consumer Discretionary (Growth). The Financials representation is to be expected, but HC and Discretionary are a bit of a surprise. In a backdrop like we have today it's difficult to generalize and maintaining exposure at either extreme of the duration spectrum can produce some challenging periods.

Short Duration More Exposed To Value And Vice Versa

Style	Short Duration	Long Duration	S&P 500
Pure Value	61%	11%	20%
Pure Growth	2%	27%	14%

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Sectors Are Over & Underrepresented In Duration

Sectors	Short Duration	Long Duration	S&P 500
Financials	23%	4%	14%
Health Care	14%	9%	13%
Discretionary	13%	17%	13%
Industrials	10%	4%	16%
Telecom	11%	2%	5%
Materials	9%	4%	6%
Technology	5%	17%	16%
Real Estate	4%	6%	6%
Staples	4%	5%	7%
Energy	7%	3%	5%
Utilities	0%	27%	6%

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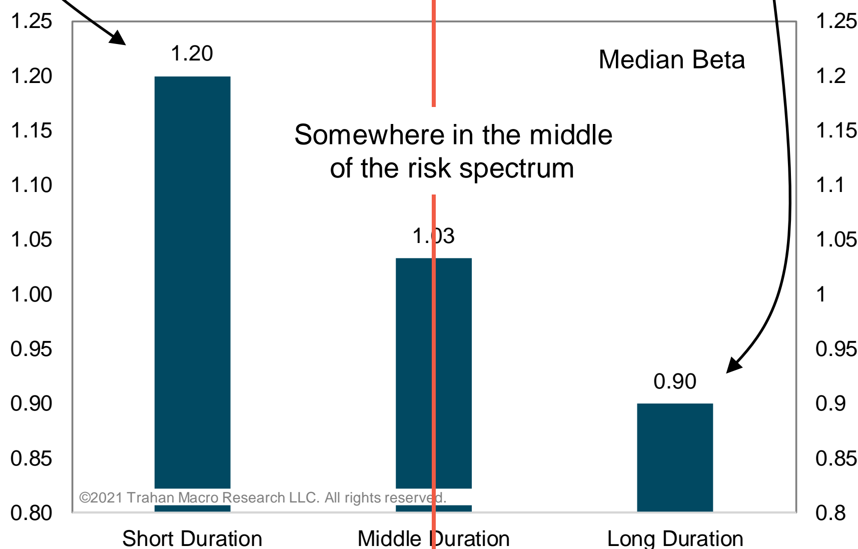
Emphasizing Middle-Duration Stocks Should Lower Tail Risk

In an ideal world, one would hold Cyclicality/Value until the PMIs topped out and rotate into Stability/Growth on the exact day that investor appetite for all things economic-sensitive fades. In the real world, it does not work like this, however. The lofty valuation gap between Long- and Short-Duration stocks has magnified the volatility of rotations increasing the risk of shifting too early or too late into the next market leader. One simple strategy for minimizing volatility is to cut out the tails altogether. This can be simply done by limiting your investment universe to the Middle-Duration stocks in the S&P 500.

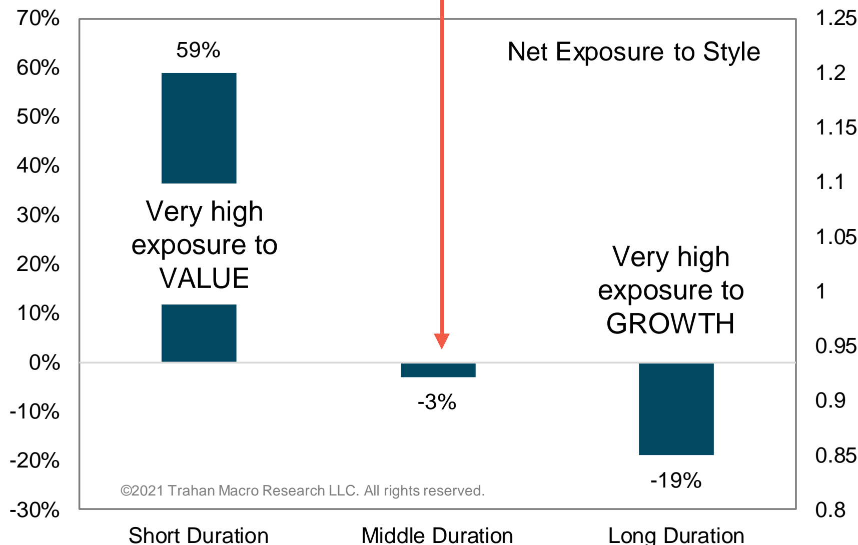
Sensitivity Of Duration Portfolio To Rates/Business Cycle

Unsurprisingly, the Middle-Duration universe exhibits a near market beta.



The average beta of 1.03 shows how effective this strategy can be for minimizing volatility in a portfolio.

The Middle-Duration universe is close to being style neutral.



The Middle-Duration universe is almost perfectly style- and beta-neutral.

*Middle-Duration Stocks: Average of Quintiles 2, 3 and 4 in Equity Duration Screen

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The Composition OF The Middle-Duration Universe In A Nutshell

Removing the tails of Equity Duration from the investible universe will have a big impact on two sectors: Financials which is mostly comprised of Short-Duration stocks, and Utilities which is largely made up of Long-Duration stocks. Beyond those two sectors, the screen will remove stocks from the tails of every other sector. As such, sectors with the highest number of stocks will have a greater representation in the universe. Indeed, Industrials, Technology and Health Care are the three sectors with the larger constituency of Middle-Duration stocks (one Cyclical, one Growth, and one Defensive).

Middle Duration – Sector Breakdown

Percentage of Constituents by Count		
Sectors	**Mid Duration**	**S&P 500**
Industrials	21%	16%
Technology	18%	16%
Health Care	14%	13%
Discretionary	12%	13%
Staples	8%	7%
Real Estate	7%	6%
Materials	5%	6%
Financials	5%	14%
Energy	5%	5%
Telecom	4%	5%
Utilities	1%	6%

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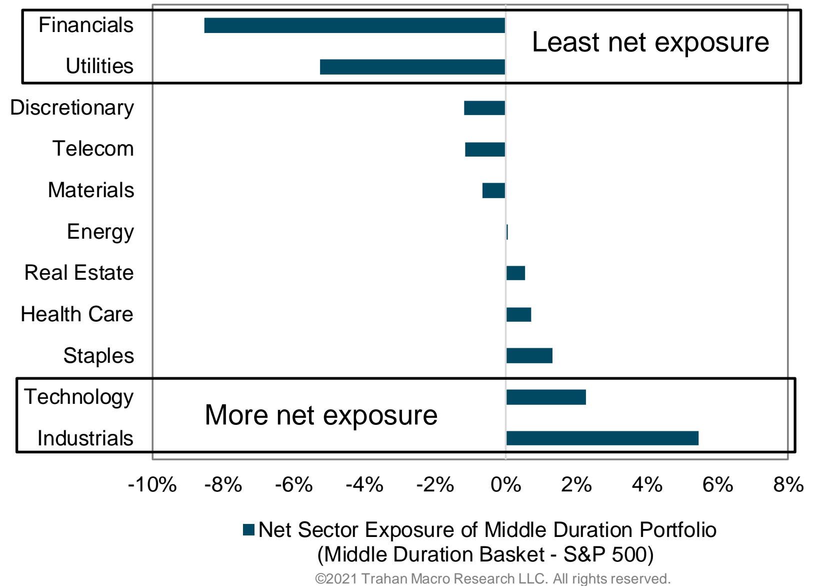
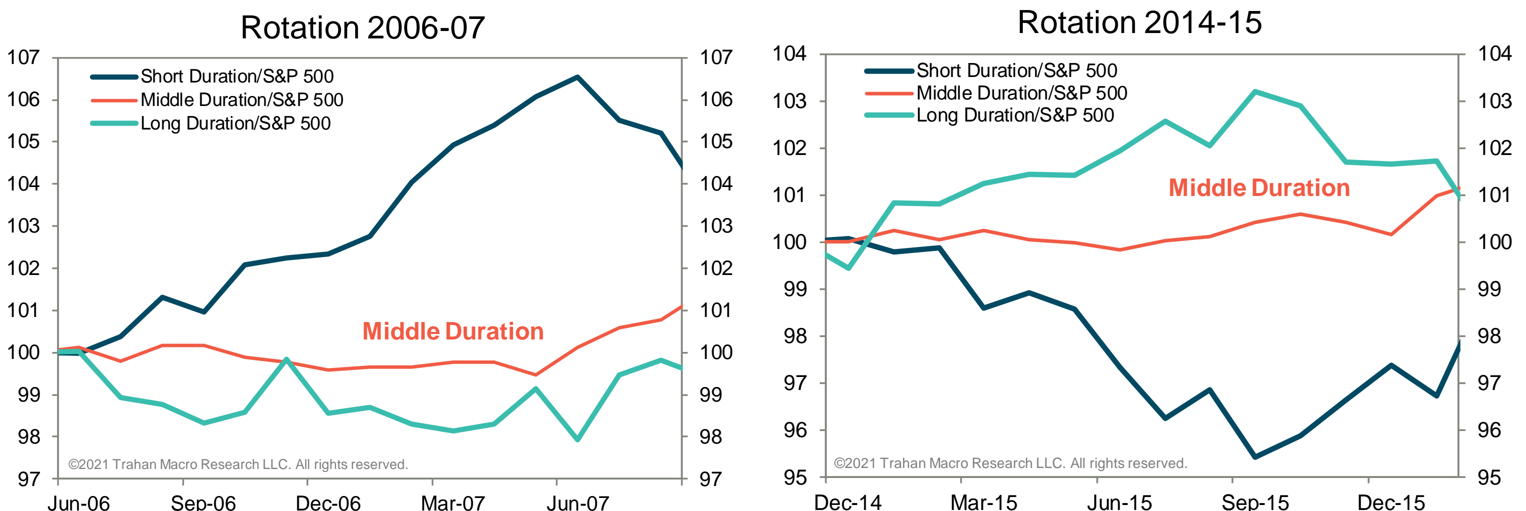
Less Net Exposure To Rate-Sensitive Sectors



In summary, the characteristics highlighted on page 6 showed that the Middle-Duration universe has an average beta of near 1 as well as being mostly style neutral. In that vein, it should not be a surprise to see that the Middle-Duration universe has exhibited very little volatility around past peaks in the business cycle (using the ISM as a proxy). In today's context, every investor concerned about an imminent peak in the ISM or the possibility of a Fed tightening cycle can use this simple screen as a starting point for stock picking, one that reduces the influence of "some" external forces. This universe essentially resets the bar, picking the right stocks from here should result in alpha in portfolios.

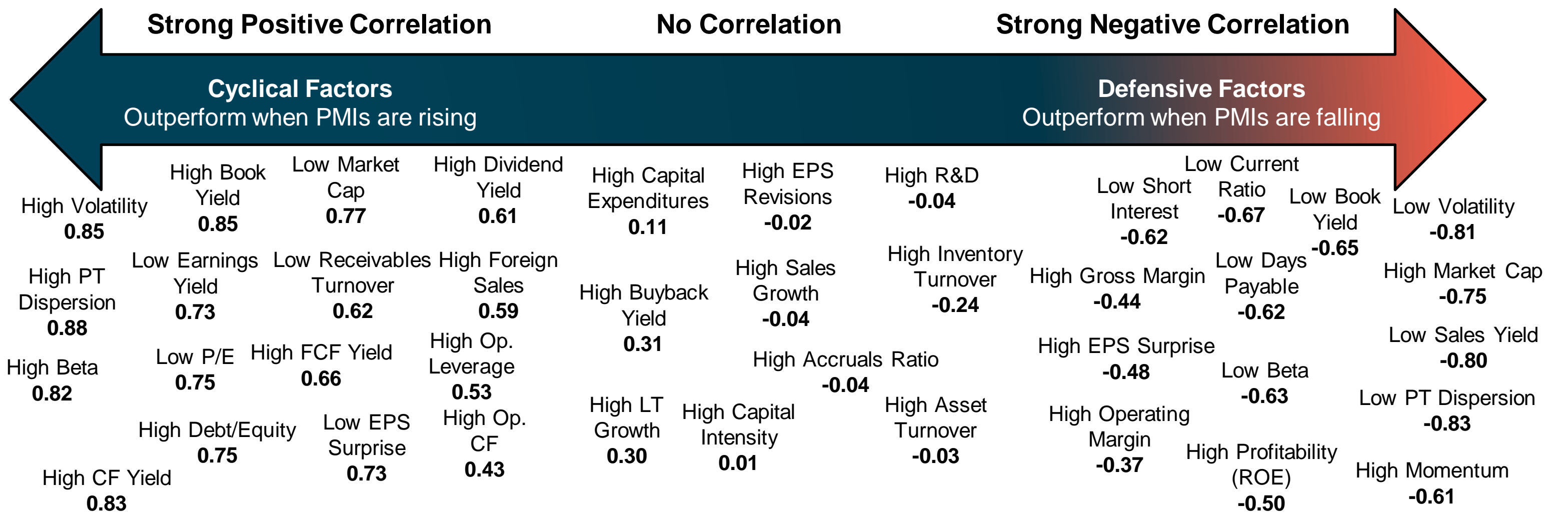
Middle-Duration Stocks Provided Investors With Less Volatility In Past Economic Transitions

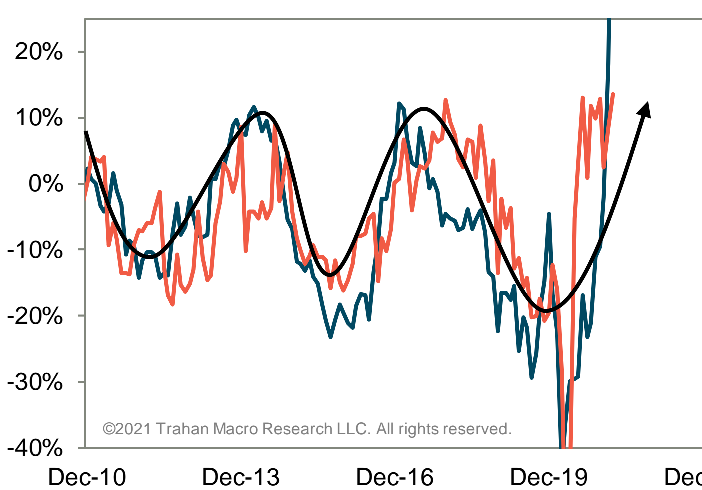


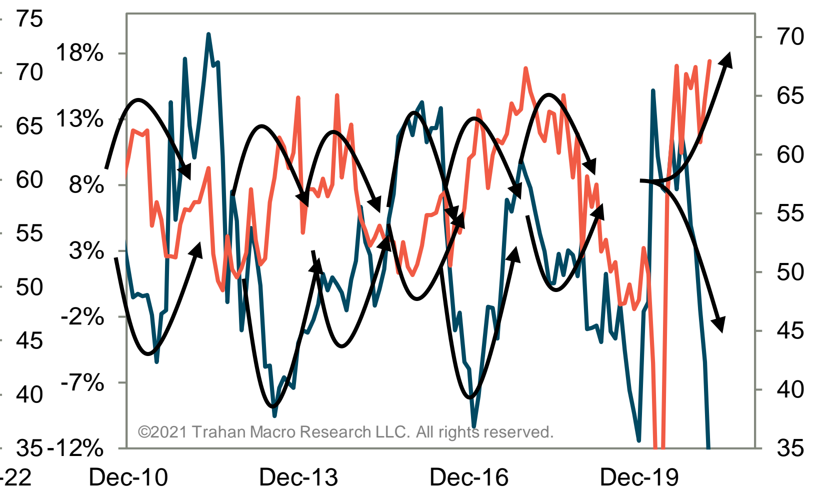
Middle-Duration Universe Will Reduce Volatility, Not Generate Alpha!

Emphasizing the Middle-Duration universe will reduce overall business cycle risk from portfolios. As we showed on the prior page, the universe tends to market perform around past peaks in PMIs. It won't help much, however, if one uses cyclical or counter-cyclical factors to pick stocks within that universe. While the average beta of Middle-Duration is near 1, it is nonetheless an average, and some stocks will have more economic sensitivity than others. In essence, we would advise investors use factors that exhibit low correlations to the business cycle like Buybacks or Inventory Turnover in the diagram below.

Correlation Of Stock Factors To The Business Cycle



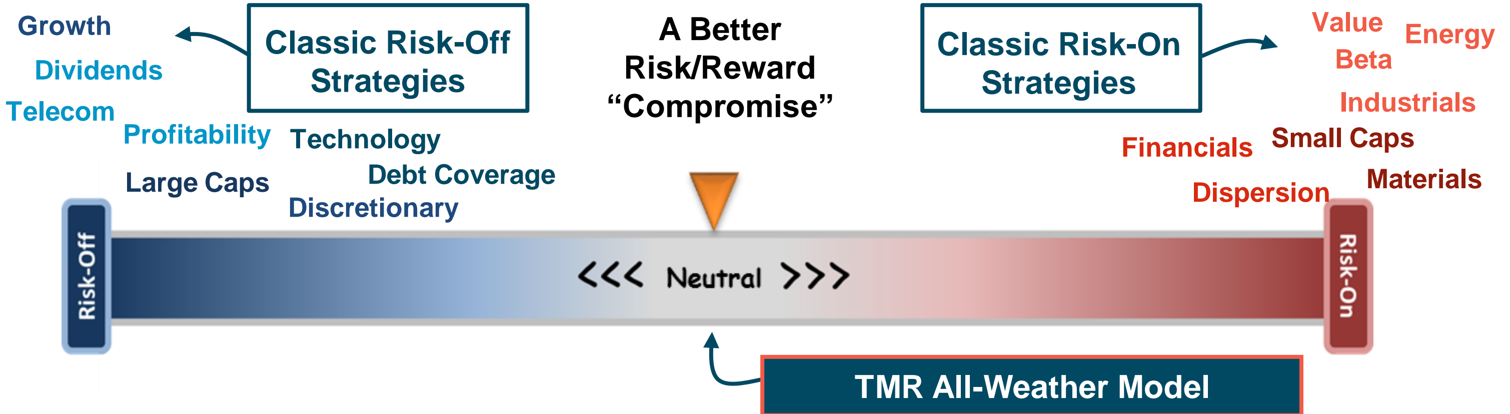




Eliminating the tails of economic sensitivity by removing Long-Duration and Short-Duration stocks from one's investible universe will go a long way toward reducing volatility in portfolios. Still, utilizing economic-sensitive factors would essentially negate the benefits of focusing on this universe. The ideal strategy from here, if the goal is to minimize the effects of rotation risk, would be to use a solid stock-picking model that is itself devoid of economic influences—just good time-tested factors that are not overly sensitive to the business cycle one way or the other.

TMR All-Weather Portfolio: Stock Picking For All Economic Scenarios

We already have a roadmap for reducing portfolio volatility around market leadership rotations—stick to middle-duration stocks and avoid economically-sensitive factors. In order to generate alpha, however, we need to add in a time-tested stock-picking model that also avoids getting whipsawed by these rotations. Classic Risk-Off strategies favor Stability and Growth characteristics like Profitability and Large Caps and sectors such as Tech and Discretionary. On the opposite side of the coin, Cyclicality and Value plays like Financials, High Beta, and Small Caps tend to do best in Risk-On backdrops. The current environment calls for somewhat of a Risk/Reward compromise between these two bookends.



The current polarized investment backdrop presents some rather unique challenges for investors, and to many it may seem risky to go all in on either side of the debate. Our TMR All-Weather Portfolio Model is a great solution for times like these. The All-Weather Portfolio looks to straddle the investment themes that work at the extremes. The All-Weather Portfolio blends both cyclical and defensive themes to find stocks that rank attractively in both. Additionally, we remove the highly cyclical categories of risk and sentiment that typically trade like a light switch … either on or off (i.e., high or low).

What's In The All-Weather Portfolio?

The All-Weather Portfolio Focuses On All Of The Core Categories Of Stock Selection …

… While Avoiding The Themes Most Leveraged To Changing Economic Prospects

Rather Than Changing Themes … Focus On The Best Of Both

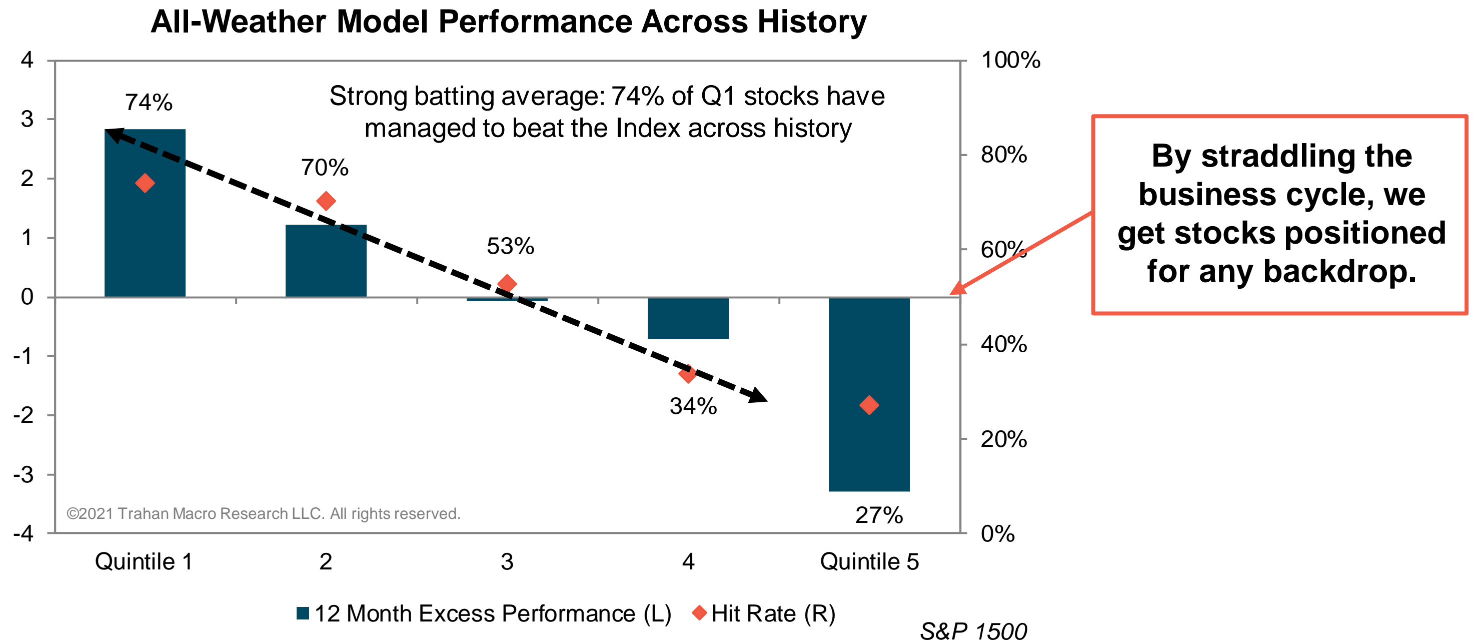
"TMR All-Weather Portfolio"

	Risk-On Themes	NEUTRAL	Risk-Off Themes
Valuation	Equity Valuation		Firm Valuation
~~Risk~~	~~Aggressive~~		~~Defensive~~
~~Sentiment~~	~~Contrarian~~		~~Consensus~~
Management	Shareholder Return		Governance
Operating Efficiency	Turnover		Coverage
Profitability	Growth		Stable Profitability

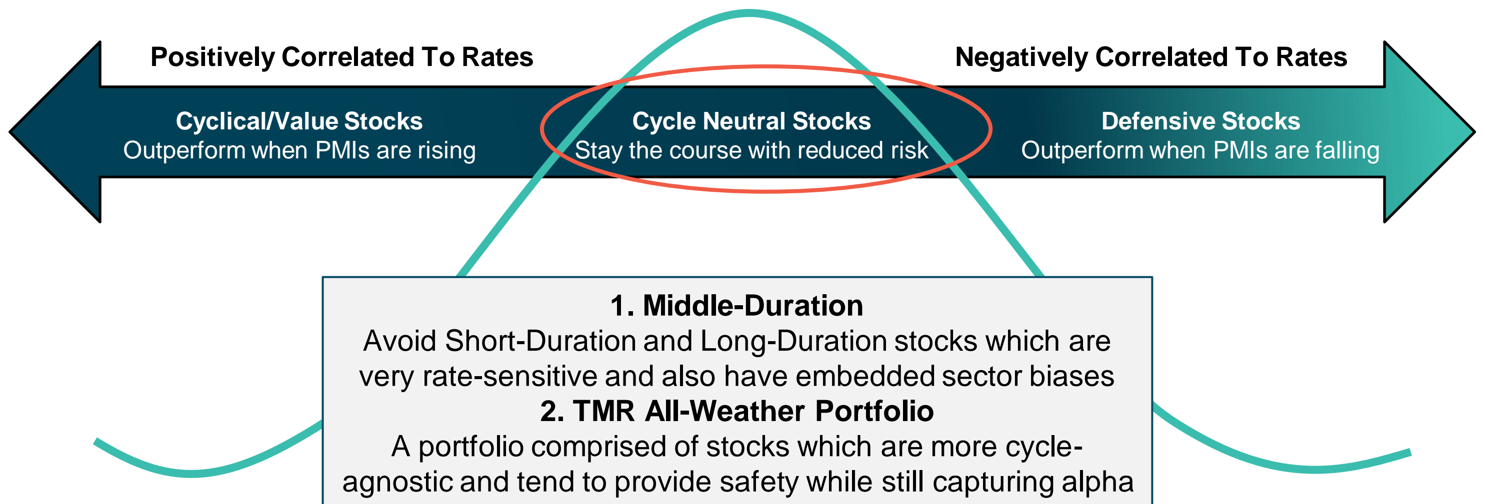
** Earnings quality is a constant across themes*

Straddle The Middle Of The Risk Spectrum For Reduced Beta Exposure

The All-Weather Portfolio is business cycle agnostic and performs well in almost every type of investment backdrop. The chart below shows the consistency of outperformance for the stocks that rank well in the model, and the underperformance of those that do not. This is a great tool for investors who do not want to commit to either the Growth/Stability or the Value/Cyclicality trade.



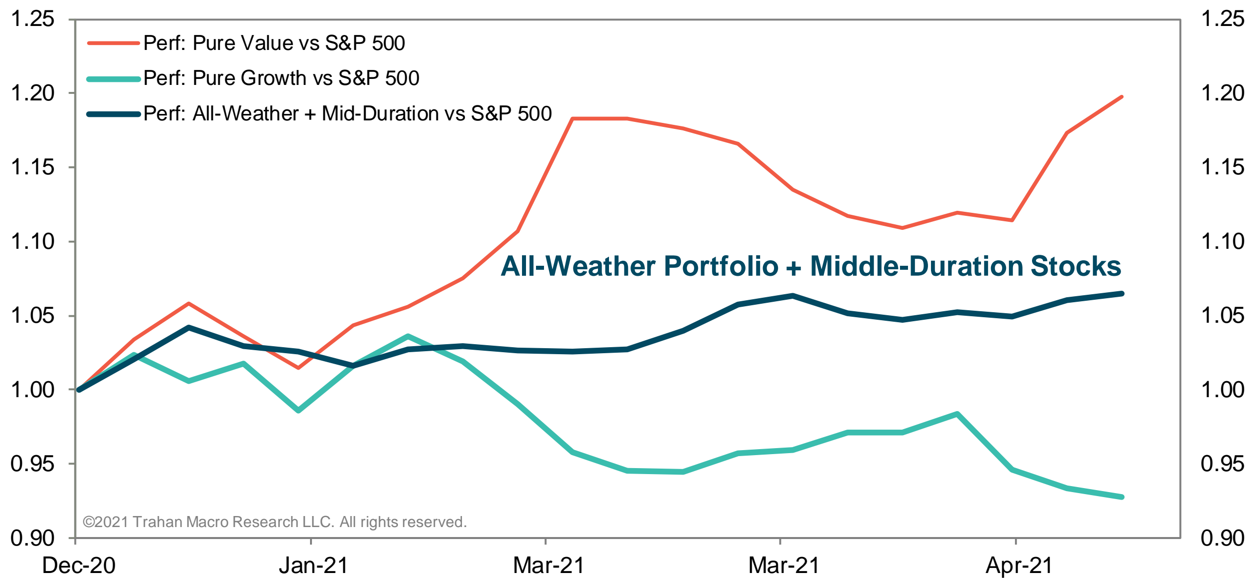
In order to weather (pun intended) the uneven market backdrop, we are highlighting the stocks that rank well in our business cycle-agnostic All-Weather Portfolio AND also are not on the extremes of the equity duration spectrum. By focusing on these middle-duration stocks we avoid most of the sector biases that are embedded in the Short- and Long-Duration buckets and we also diminish sensitivity to rising rates. Meanwhile, the Cycle Neutral Stocks that rank well in the All-Weather Portfolio Model allow investors to maintain some portfolio safety by avoiding "rotation risk" while still capturing alpha.



TMR All-Weather Portfolio (AWP) With Emphasis On Middle-Duration

Using the All-Weather model on the Middle-Duration universe of the S&P 500 is a simple way to dampen rotation risk. In 2021 this portfolio has managed to generate about 600 basis points of alpha. To be sure, this is not as compelling as the returns seen in Pure Value stocks which are up over 2000 basis points, but we view it as a lot of alpha considering it almost eliminates the risk of a sudden rotation from one style preference to another. The full excel version of the screen is available for clients of the firm. Note that all screens are accessible on TrahanMacroResearch.com for a while longer.

AWP Combined With Middle-Duration Has Been A Profitable Strategy This Year



The screen below shows just a handful of the stocks that rank well in the All-Weather Portfolio and have middle-duration. Please email us at quant@trahanmacroresearch.com for the full screen.

These are the stocks that are most likely to still generate alpha while limiting "rotational risk" in the S&P 500 as of 5/19/21 according to our All-Weather Model. For additional S&P Index screens please email us at Quant@TrahanMacroResearch.com

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Universe: S&P 500

Ticker	Name	All Weather Rank	Equity Duration	Price	Market Value	Sector
WMB	Williams Companies, Inc.	1	6	25.38	30,830.7	Energy
LDOS	Leidos Holdings, Inc.	1	5	103.45	14,629.9	Industrials
LMT	Lockheed Martin Corporation	1	7	387.77	107,774.5	Industrials
CDW	CDW Corp.	1	6	168.53	23,628.5	Information Technology
COST	Costco Wholesale Corporation	1	6	379.53	167,954.8	Consumer Staples
REGN	Regeneron Pharmaceuticals, Inc.	1	5	517.17	55,101.3	Health Care
WEC	WEC Energy Group Inc	1	6	95.84	30,231.2	Utilities
NEE	NextEra Energy, Inc.	1	5	72.63	142,459.7	Utilities
MLM	Martin Marietta Materials, Inc.	1	6	374.47	23,355.3	Materials
SWK	Stanley Black & Decker, Inc.	1	4	216.10	34,899.0	Industrials

For monthly model updates:
Email quant@trahanmacroresearch.com or visit trahanmacroresearch.com/screens