WHAT IS YOUR PORTFOLIO'S BUSINESS CONTINUITY PLAN?

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In a world where a virus originating from a single city can shut down the world economy at a moment's notice, investors can not afford to sit back and wait for the catastrophe to happen. While hoping for the best, investors need to prepare for the worst at all times and make sure that they have a plan to build their wealth onward.

By definition, black swan events[1] can only be truly recognized and defined after they have happened. However, in the same way that all companies have Business Continuity Plans in place, all investors should build their portfolios to be able to sustain the worst and weather any oncoming storms.

A balanced approach could help manage risks in the markets. It means recognising the risks and building resilience in the portfolio to achieve a better risk-adjusted outcome over time. This is why we have dedicated a section on our website to our defensive assets framework that highlights some principles that could be used to build more robust portfolios, i.e. focusing on assets that can balance defensiveness in drawdowns and growth in bull markets.

Focusing on equity investments, our framework has highlighted the strength of quality stocks as a potential way to grow wealth over the long term thanks to their proven business models while weathering any temporary storm thanks to their financial strength.

Historically, investing in Quality stocks has provided protection in all serious crises

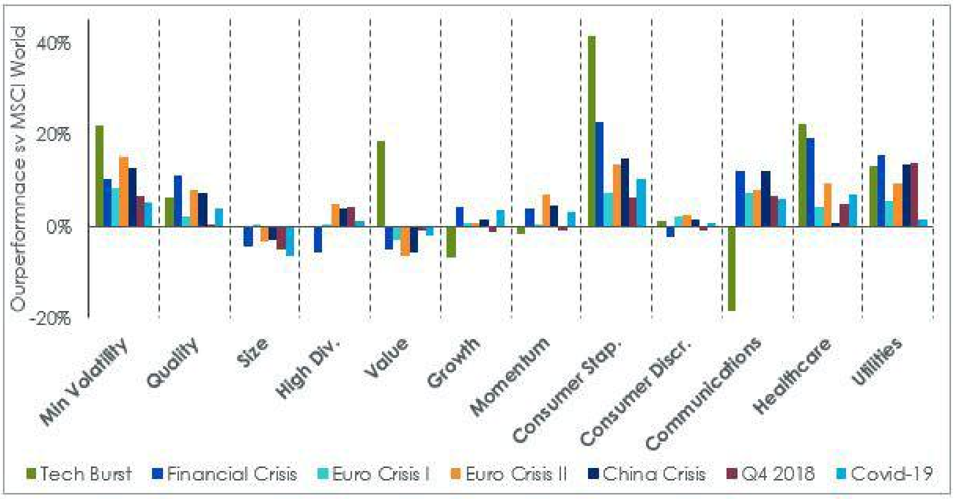
In Figure1, we look at the performance of different equity baskets or strategies including the one considered defensives in the main crises of this century. It is clear from the get-go that only 5 strategies have delivered some outperformance in all crises:

- Min Volatility
- Quality
- Consumer Staples
- Health Care

- Utilities

All the other strategies have failed to cushion the losses in at least one of those crises. If investors want to protect their portfolios against drawdowns, investing in one or more of these 5 strategies can help.

Figure 1: Outperformance vs MSCI World in periods of equity drawdowns



Source: WisdomTree, Bloomberg. In USD. Up to June 2020, MSCI World Communications is proxied by MSCI World Telecommunications.See below for more details on the indices used in the figure.

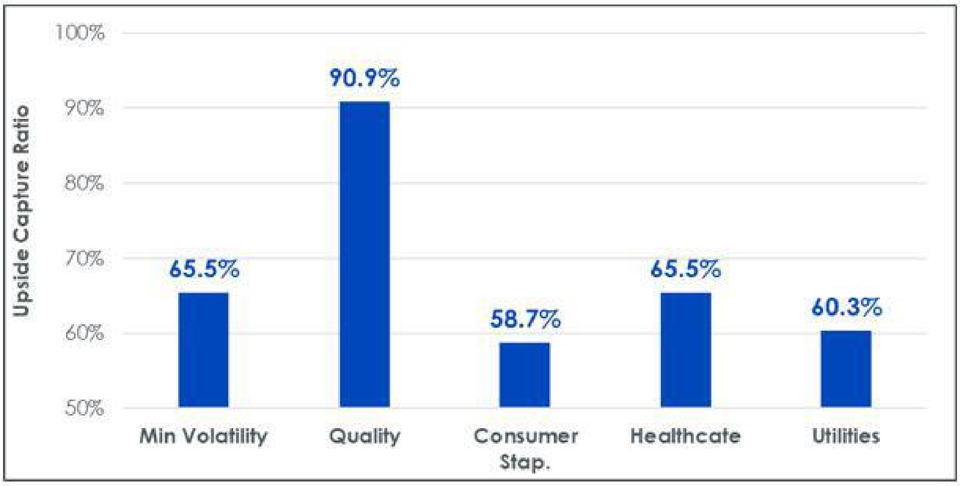
Historical performance is not an indication of future performance and any investments may go down in value.

However, most equity drawdowns are severe and are triggered by unpredictable events, so called black swan events. As investors, we need to acknowledge our limitation and accept that when the time comes it is likely that we won't see the drawdown coming and that we won't be able to properly assess the ramifications in the real world and in the financial world. So, investors have to consider the possibility that they should stay invested in defensive assets for long periods of time in preparation for possible shocks. The opportunity cost of doing so, however, can be significant and varies a lot from one strategy to another.

Quality stocks have historically captured most of the upside in the market

The upside capture ratio is the percentage of market gain captured by a strategy when markets go up. If the upside capture of a strategy is 60%, then when the market goes up by 10%, that strategy would only go up by 6%.
Focusing on the 5 equity strategies that performed the best in equity drawdowns, Quality draws a sharp contrast with the other 4 strategies. While Min Volatility or Utilities capture, on average, 60% of the upside in the market, Quality captures 91% of it. This means that Quality manages to sit both as one of the most defensive equity strategies available with reduced drawdowns in the 7 most severe crises in the last 20 years and as one of the most apt to capture market upside, with an upside capture ratio close to 100%.

Figure 2: Upside Capture Ratio of 5 equity strategies



Source: WisdomTree, Bloomberg. Period July 2000 to June 2020. Calculations are based on monthly returns in USD.
You cannot invest directly in an index. Above numbers include backtested data.

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This is a good combination for prolonged periods of uncertainty when a bear market rally or a deep drawdown are equally likely and it is, therefore, an ideal candidate for a strategic, core investment in equities. By investing in Quality, investors are creating a Busines Continuity Plan for their portfolio ensuring that the portfolio can participate in any upside while defending their wealth against any unexpected downturn.If you want to know more about our approach to quality, see here.

However, investing in quality is easier said than done. Identifying a quality stock is tricky and the list of potential descriptors is long with 7 different families of descriptors: Profitability, Earnings Stability, Accounting Quality, Capital Structure, Investment, Payout/Dilution and Corporate Governance. It is worth noting though that academics have shown that Profitability descriptors could capture most of the quality premium and unlock its all-weaterh characteristics.

In a second half of 2020, awashed with uncertainty, such a balanced approach could prove useful.

Definitions

the Tech Bubble (4 September 2000 to 12 March 2003)
the Financial Crisis (16 July 2007 to 9 March 2009)
the Euro Crisis I (15 April 2010 to 5 July 2010
the Euro Crisis II (2 May 2011 to 4 October 2011)
the China Crisis (15 April 2015 to 11 February 2016)
Q4 2018 (21 September 2018 to 27 December 2018)
Covid-19 (12 February 2020 to 23 March 2020)

Global equities are proxied by the MSCI World net TR Index. **Min Vol** is proxied by MSCI World Min Volatility net total return index. **Quality** is proxied by MSCI World Quality Sector Neutral net total return index. **High Dividend** is proxied by MSCI World High Dividend net total return index. **Value** is proxied by MSCI World Enhanced Value net total return index. **Momentum** net total return index. **Consumer Staples** is proxied by MSCI World Consumer Staples net total return index. **Consumer Discretionary** is proxied by MSCI World Consumer Discretionary net total return index. **Health Care** is proxied by MSCI World HealthCare net total return index. **Communication** is proxied by MSCI World

Communications net total return index. **Utilities** is proxied by MSCI World Utilities net total return index.

[1] A black swan is an unpredictable event that is beyond what is normally expected of a situation and has potentially severe consequences

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