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Markit Commentary

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Hedging for Brexit and 'black swans'

Investors concerned with limiting downside risk to unforeseen (and foreseen) market events can potentially enhance performance by avoiding stocks shown to fall during similar past events, and by picking stocks historically known for subsequent market bounces.

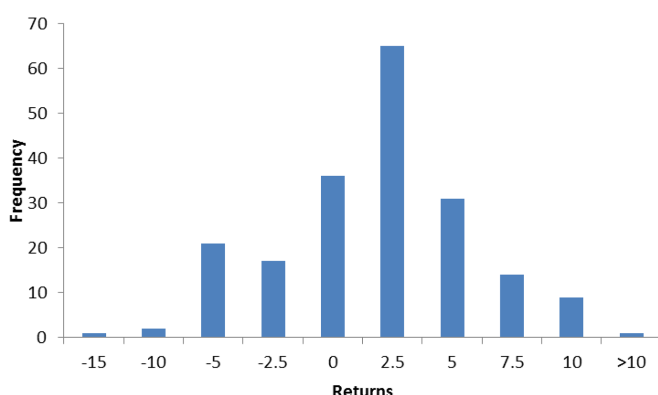
- Isolating and avoiding low ranked quality names creates inexpensive pseudo-hedges
- Volatility and valuation rankings enhance returns, both in avoidance and in stock selection
- Post market events, Deep Value factors lead returns as markets bounce back

Ahead of the UK's vote on continued membership to the European Union, expected to have a large impact on markets, Markit **Research Signals** has released a detailed report analysing how long investors can best position portfolios to outperform during and post major market moving events - whether anticipated or not.

Please contact us to get the full report.

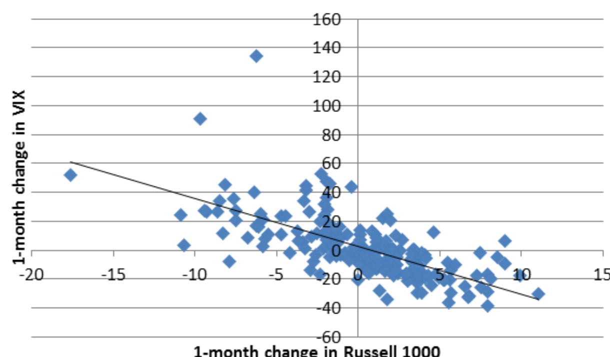
Unanticipated market downturns have historically occurred more frequently than expected and are associated with higher levels of volatility. However investors can avoid names that are expected to fall the most while also going long names expected to subsequently outperform.

Histogram of Russell 1000 1-month index returns, Jan 2000 – May 2016



One month price changes across the Russell 1000 from January 2000 to May 2016 show that large drawdowns (exceeding 2%) occur more than is actually expected by a normal distribution – with 47 occurrences during the time frame. Market sell offs are more frequent than anticipated and when markets do sell off, volatility levels increase, as shown by the relationship in the chart below where volatility decreases when markets rise.

Russell 1000 versus 1-month changes in the VIX, Jan 2000 – May 2016



These characteristics create incentives for investment managers to hedge downside risk but also create opportunities in subsequent periods, in the wake of a so-called '**black swan**' events, to position portfolios for enhanced returns.

US Total Cap factors with the weakest D10 excess returns during months when the Russell 1000 index losses exceeded -2%, Jan 2000 – May 2016

Factor	Group	D10 excess return (%)
1-Month Realized Stock Return Volatility	Liquidity, Risk & Size	-6.17
Distress Measure	Liquidity, Risk & Size	-6.04
At the Money Put Option Implied Volatility	Liquidity, Risk & Size	-5.82
Product of Beta and Sigma	Liquidity, Risk & Size	-5.80
TTM Core Earnings-to-Price	Deep Value	-5.73
60-Day Residual Risk	Liquidity, Risk & Size	-5.58
52-Week High	Price Momentum	-5.56
Stock Return Volatility	Liquidity, Risk & Size	-5.53
CV of Prior 90-Day Closing Prices	Price Momentum	-5.52
20-Day Volume Volatility to Price Volatility	Liquidity, Risk & Size	-5.50

Analysing the lowest ranked 10% of names in the US Total Cap universe (covering 98% of cumulative market cap), the weakest factor returns during market declines (of more than 2%) over the past 16 years is led by the highest risk names captured by 1-Month Realised Stock Return Volatility factor which unperformed consistently across 43 of the 47 'events' during the sample period. As seen in the table above – liquidity and risk measures clearly dominate the poor performers identified during a market decline.

Looking towards fundamentals that outline more traditional 'stock picking' factors, shows that the worst ranked companies according to TTM Core Earnings-to-Price factor have suffered the brunt of market down turns. This implies that companies overvalued on earnings multiples are expected to decline the most on average.

Post black swan

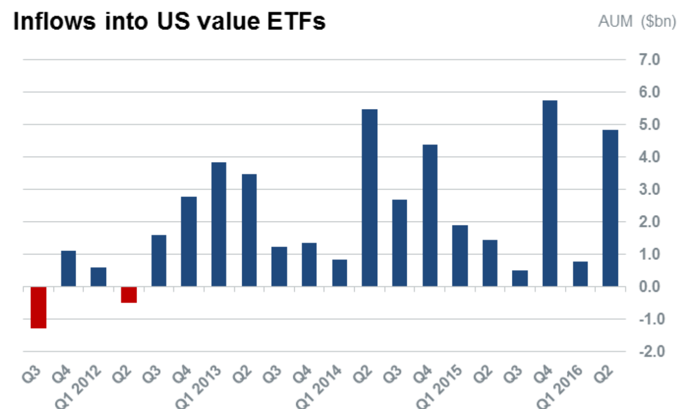
US Total Cap factors with the best 6-month D1 excess returns subsequent to months when the Russell 1000 index losses exceeded -2%, Jan 2000 – May 2016

Factor	Group	D1 excess return (%)
Leading 12 Month Sales Yield	Deep Value	6.80
Current Liabilities-to-Price	Liquidity, Risk & Size	6.62
TTM Core Earnings-to-Price	Deep Value	6.43
TTM Free Cash Flow-to-Price	Deep Value	6.41
TTM Growth Flow-to-Price	Deep Value	6.21
TTM Sales-to-Price	Deep Value	6.09
Time Weighted Earnings Yield	Deep Value	6.03
TTM Operating Cash Flow-to-Price	Deep Value	6.01
Forward Free Cash Flow-to-Price	Deep Value	5.77
Leading 12 Month Book Yield	Deep Value	5.50

While successfully avoiding names expected to fall the most in a market moving event, positioning for subsequent recoveries is perhaps more pragmatic. Across the 47 episodes identified, the top factor returns in the subsequent six months have been evaluated across the top 10% of companies' ranks across the factor library.

Companies ranking highly according to Deep Value factors are the clear outperformers in subsequent bounces post market declines, with the top factor being Leading 12 Month Sales Yield.

Perhaps pragmatic US investors, pre-empting a potential market moving event, might explain the $5.6bn of inflows into US value ETFs seen so far in 2016. The category has accumulated almost a net $43bn in the past five years with $106bn in current assets under management.



Source: Markit

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