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ETF Securities Asset Allocation Research

How to hedge against uncertainty

Summary

- Gold and precious metals remain the best assets to face market uncertainty, as demonstrated in the past with the global financial crisis and again recently with the UK decision to leave EU.
- Continued low inflation, slowing manufacturing production and a return to recession are scenarios that should be considered in investor's next allocation decision.
- Stocks with resilient revenues should be favoured to protect the portfolio against downside risk during periods of slowing manufacturing production.
- An allocation into small cap during periods of rising global leading indicator improves the return of a standard portfolio of 40% bonds and 60% equities by 35%.

With the Fed less likely to hike rates, the upcoming US presidential election, UK leaving EU, the ECB adding more stimulus to support EU economies and China struggling to meet growth expectation, 2016 has been so far a challenging year for investors. News and rumours are dictating market movements across the board. Asset classes are moving in tandem as challenges reshape the world. In such a volatile environment, short term tactical trades are favoured with investors forced to review their allocation strategies more often than intended.

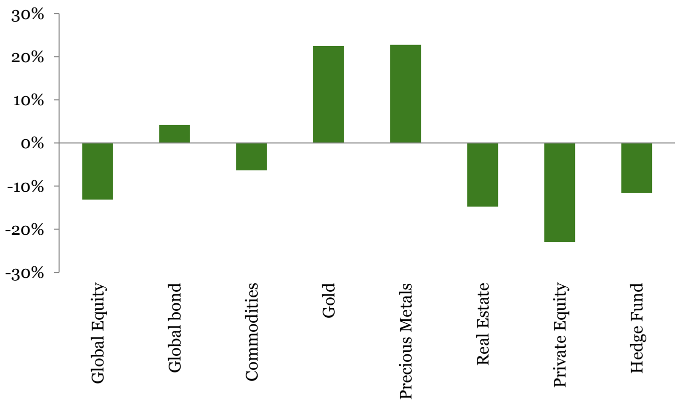
In this note, we show the best and worst performing assets under different scenarios based on manufacturing production, inflation and leading indicators. We also look at how to use these assets in a portfolio as a hedge or to outperform.

Gold and precious metals – the best assets to face uncertainty

Contrary to evidence from electoral polls, the shocking EU Referendum result for the UK to exit the Union sent financial markets into a panic. Investors need to be able to hedge their portfolio against shocks where assets across the board are sold off aggressively due to unexpected events.

We looked at how each asset class performed six months following three recent financial crises: the global financial crisis, the Arab Spring and the Chinese market closure.

Returns 6 months post recent crisis[1]



Source: ETF Securities, Bloomberg

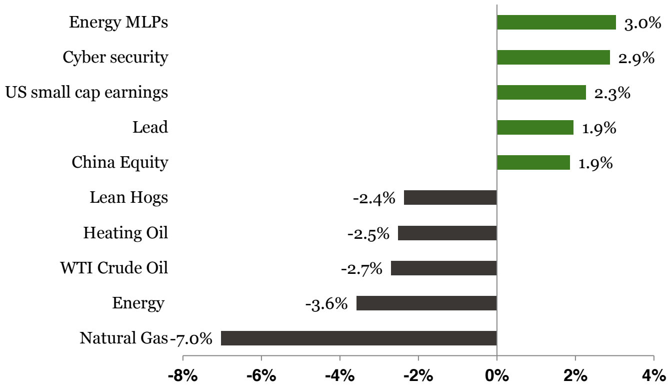
[1]Average returns over the 6 months following the financial crisis on the 11th of September 2008, the Arab Spring on the 25th of Jan 2016.

The above chart shows that gold and precious metals remain the best assets to hold in a portfolio during periods of high market uncertainty. After each market shock, gold returned 21%, 22% and 24% (non-annualised), while a precious metals basket returned 15%, 30% and 23%. Bonds also tend to perform well during these periods.

Stocks with resilient earnings – a protection from the downside

The future of the UK and the EU is adding to global financial market uncertainty, which could in turn impact economic growth. Which assets stand out in periods of slowing growth?

Performance during slowing manufacturing production



Source: ETF Securities, Bloomberg

The above chart shows the best and worst performing assets during periods of slowing global manufacturing production. The returns represent the average monthly returns of assets during the months where global manufacturing indicators were at the lowest over the past ten years.

Stocks with resilient revenues such as energy MLPs, Cybersecurity or small caps tend to perform best because of the nature of their businesses. Clients of midstream MLPs tend to sign contracts over the long term while demand for niche businesses such as cybersecurity tend to be inelastic to price and non-cyclical.

Combining inflation and growth indicators

In this section, we are analysing assets performance under four different economic scenarios that combine global inflation and growth.

As summarised in the below table, we observed that during periods of slowing growth, energy MLPs and cybersecurity perform well regardless of inflation.

China and EM stocks, as well as robotics are ranked among the top ten performers during low inflation periods regardless of global growth, while EM bonds are ranked sixth in a high inflation and slowing growth environment.

Agricultural commodities are more concentrated in the bottom right of the table where inflation is high and growth is rising.

Metals with industrial applications benefit most from a rising growth environment regardless of the inflation dynamics, while gold performs best in high inflation periods alongside slowing growth.

Top 10	Slowing growth		Rising growth	
Low inflation	China A Equity	2.9%	Lead	3.3%
	US small cap earnings	2.6%	China A Equity	3.1%
	Energy MLPs	2.3%	China Equity	2.7%
	Lead	2.3%	US small cap earnings	2.6%
	China Equity	2.1%	Cotton	2.4%
	Cyber security	1.7%	Palladium	2.3%
	Zinc	1.5%	Robotics	2.3%
	EM Equity	1.4%	EM Equity	2.3%
	Robotics	1.4%	Tin	2.2%
	US small cap	1.3%	Agribusiness	2.2%
High inflation	Energy MLPs	1.9%	Silver	2.4%
	Cyber security	1.8%	PM Basket	2.1%
	Soybean Meal	1.5%	Corn	1.9%
	US small cap earnings	1.5%	Soybean Meal	1.9%
	G10 FX Multi Strategy	1.0%	Lead	1.7%
	EM bonds	0.9%	Soybeans	1.7%
	Gold	0.9%	Precious Metals	1.5%
	Precious Metals	0.8%	Tin	1.5%
	US Low Vol	0.8%	Agribusiness	1.5%
	Global Corp bonds	0.7%	Grains	1.5%

Top 10 performers based on average monthly returns under four scenarios: 1. Slowing growth and low inflation, 2. Rising growth and low inflation, 3. Slowing growth and high inflation and 4. Rising growth and high inflation. An in-house global manufacturing PMI indicator is used as a proxy for rising/slowing growth and an in-house global inflation indicator as a proxy for high/low inflation. Monthly returns are in local currencies from May 2006 to May 2016. Sources: ETF Securities, Bloomberg

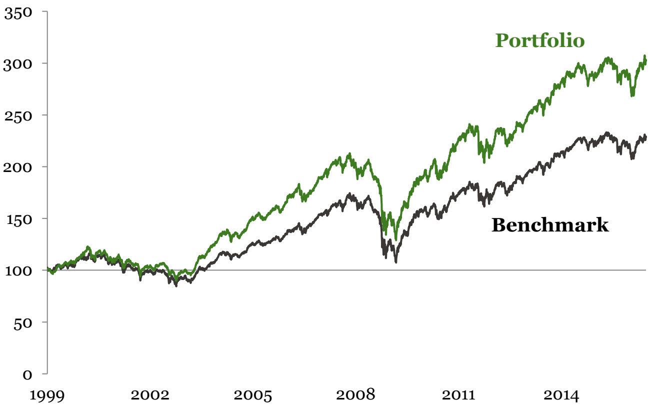
Looking at the table, it is interesting to note that US small cap stocks are ranked among the top ten performers in three out of the four scenarios, the exception being in growing manufacturing production and high inflation environment.

The case for small caps

Based on the previous scenario analysis, we have devised a relative trade strategy between small caps and large caps and analysed the impact on the portfolio's risk/return profile.

In our analysis, we use a portfolio of 60% global large caps and 40% global bonds as our benchmark and we use an in-house global leading indicator as a trade signal. When the global leading indicator is rising, signalling an economic expansion, the portfolio allocates the 60% equity component into small caps. When the global leading indicator is declining, signalling a slowdown in economic growth, the portfolio re-allocates the equity component into large caps at 60%.

Portfolio outperforms benchmark by 35%
Daily data from January 01, 1999 to June 22, 2016



Source: ETF Securities, Bloomberg

The above chart shows that the relative trade portfolio with small caps replacing large caps during expansionary periods outperformed the benchmark by 35% over a period of 17 years, posting an information ratio of 0.6.

	Portfolio	Benchmark	Small cap	Large cap	Bonds
Volatility	8.6%	**6.6%**	16.0%	16.3%	4.1%
Annual returns	7.2%	**5.0%**	8.3%	4.1%	4.9%
Max drawdown	-30%	**-27%**	-61%	-58%	-7%
Max recovery	2.5	**2.0**	2.7	2.8	1.1
Beta	1.19	**1.00**	2.10	2.29	0.14
Correlation to benchmark	0.92	**1.00**	0.87	0.93	0.23
Tracking error	3.6%	**0.0%**	10.7%	10.4%	7.0%
Sharpe ratio	0.58	**0.42**	0.38	0.12	0.66
Information ratio	0.59		0.30	-0.08	-0.01

*Based on daily data in USD from January 01, 1999 to June 23, 2016. Volatility and returns are annualised. Max drawdown defines as the maximum loss from a peak to a trough based on a portfolio past performance. Max recovery is the length of time in number of years to recover from the trough to previous peak. Risk free rate equals to 2.2% (Cash – a simulated combination of the IMF UK Deposit Rate and the Libor 1Yr cash yield). Source: ETF Securities, Bloomberg

The relative trade portfolio strategy also enhances the Sharpe ratio from 0.42 with the benchmark to 0.58.

Important Information

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