Portfolio defense in market stress

Apr 11, 2023 | **Carolyn Barnette**

Key takeaways

- With continued volatility in the forecast, this is a good time to consider reducing portfolio risk.
- Shifting some exposure from stocks into bonds or diversifying alternatives can provide a significant risk reduction, although it limits upside capture in a market recovery.
- Increasing the quality of your bonds and/or using defensive strategies in your stocks can have a meaningful impact on portfolio risk as well.
- When choosing a defensive equity strategy, be mindful that there are various types designed for different outcomes.

March was madness in the markets. Amid the Federal Reserve's ongoing inflation battle, the failure of two U.S. regional banks sparked chaos across financial systems. Investors immediately ratcheted up scrutiny of banks near and far, and additional stress emerged in banks abroad.

Though the Fed and the European Central Bank raised rates as anticipated, the upset in the banking sector stoked uncertainty as to whether major central banks will stick to their game plan of keeping interest rates high as long as it takes to quell inflation. Volatility spiked in rates markets, and we expect to see more ups and downs in equity markets, too.

Reduce risk ahead of volatility

With continued volatility in the forecast, it's a good time to consider reducing portfolio risk, especially in allocations that have historically been more volatile. Sub-investment grade bonds, smaller cap stocks, and the extreme tails of growth and value securities (i.e., deep value and unprofitable growth) are all good funding sources if you've been holding on to these higher-risk parts of the market.

The more nervous you are, the bigger the move you may want to make. The most significant risk reduction can be achieved by shifting some exposure away from stocks and into lower volatility assets like high quality bonds or diversifying alternatives. While this move has a greater impact on risk reduction, it also has a greater impact on your portfolio's ability to participate in a rebound.

Markets are notoriously difficult to time, so be careful not to step too far away from strategic asset allocations or you risk missing a market rebound. Balance your conviction in the move with its potential impact on the portfolio. For context, our target allocation model portfolios, which maintain equity allocations within bands of +/-5%, recently moved to a -1% underweight in stocks vs. bonds.

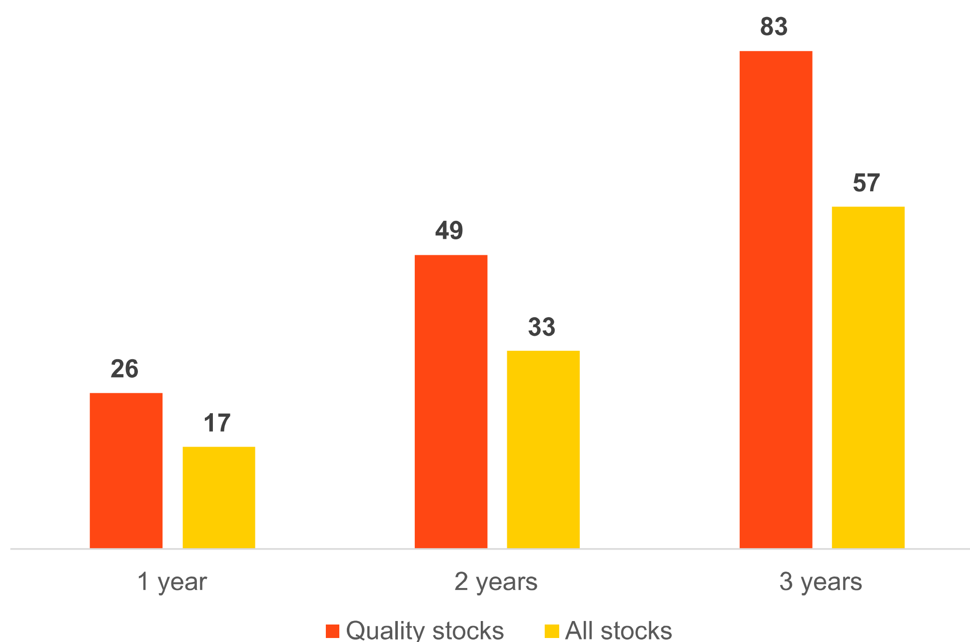
But you don't necessarily have to adjust your asset allocation to lower your risk. You may be able to get enough risk reduction by making changes within your bonds or stocks.

Increasing the quality of your bonds can go a long way toward decreasing portfolio risk. We tactically prefer short-duration Treasuries and investment grade-rated securities.

There are a variety of ways to reduce risk within equities. In the current environment, we prefer quality companies with strong balance sheets, consistent cash flows and low leverage given their historical outperformance of the broader stock universe following Fed rate hiking cycles.

Quality stocks have tended to outperform after Fed hiking cycles

Average cumulative returns (%) after Fed hiking cycles end, 1984-2019



Source: BlackRock Fundamental Equities, with data from the Board of Governors of the Federal Reserve System and Bloomberg, March 2023. All equities represented by the Russell 1000 Index. "Quality" is defined as the top quintile of stocks ranked in the Russell 1000 Index using a proprietary research screen that assesses companies on 13 "quality" metrics. Returns are calculated from the month when the Fed stops raising rates for six hiking cycles from 1984 to 2019.

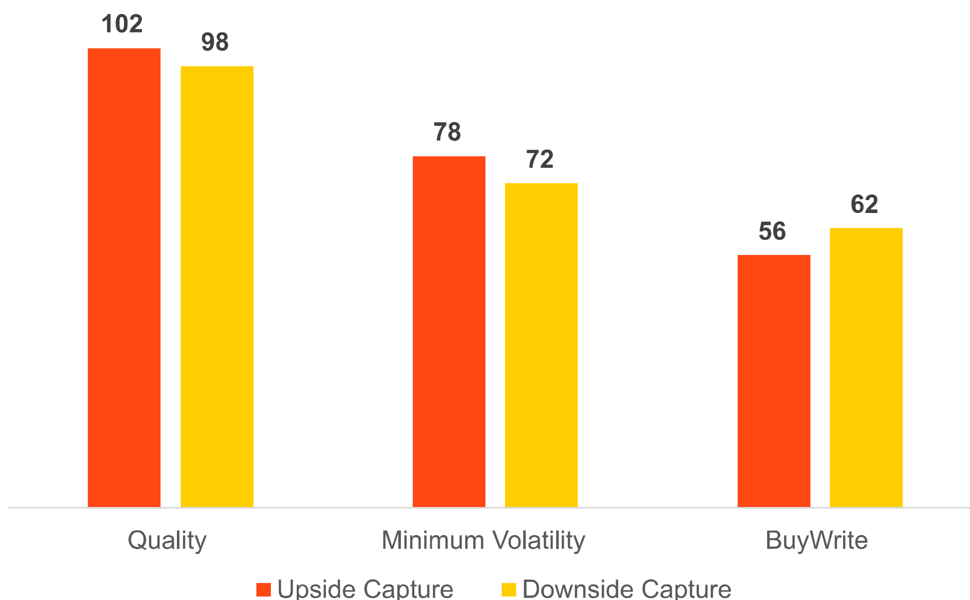
Choose equity strategies that align with your goals

There are different types of defensive equity strategies, so it's important to understand the outcomes they are designed to deliver. Defensive strategies are likely to behave in different ways, most notably in how they balance downside capture with upside participation, so make sure to choose the one that is most aligned with your market views and portfolio objectives. The ball is in your court!

	Best fit if…	Why?
Quality strategies	You're hoping to soften the sting of volatility but still be positioned for an upward-trending market.	Companies with strong balance sheets, high cash flows, and low leverage tend to weather volatility better. These may allow you to capture more upside potential than other defensive strategies, while still giving you some protection on the downside.
Minimum volatility strategies	You're very worried about volatility and want more downside protection.	Minimum volatility strategies are explicitly optimized to minimize volatility while reasonably resembling the market. The downside capture is likely the lowest of the three, but you'll be giving up some upside capture as well.
Covered call strategies	You anticipate moderate volatility and like the idea of locking in extra income.	Covered call strategies can provide a downside buffer through the extra income generated by writing calls. Consider these strategies if you don't think markets will swing meaningfully upward and cause your short call to lose money, and you also don't expect a huge downside correction.

Upside/Downside Capture Ratios of various defensive equity strategies

Based on 10 years of return history versus the S&P 500 Index.



Source: Morningstar Direct as of 2/28/23. Indexes include MSCI USA Quality, MSCI USA Minimum Volatility and CBOE S&P 500 BuyWrite BXM.

As you look for a strategy that suits your needs, keep in mind that 'value' and 'defensive' are not synonymous. While there are certainly defensive value strategies, there are also value strategies that are anything but defensive.

Defense wins championships

Markets aren't offering a lot of slam-dunk return opportunities right now, but that doesn't mean you can't deliver value to your clients. In fact, it's times like these that clients need you most. Reducing risk in your bonds, your stocks, or your broader asset allocation ahead of market volatility can help you keep clients on track toward their long-term financial goals.

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Carolyn Barnette, CFA, CFP, Director, is Head of Market and Portfolio Insights for BlackRock's U.S. Wealth Advisory business. She and her team focus on putting markets into context for financial advisors, tying the best of BlackRock insights into actionable portfolio implications.

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