BlackRock.

# Defensive Investing

## A credit investor's defensive approach to equity investing

**Heightened macroeconomic uncertainty and more frequent market drawdowns have forced many investors to try to build defensiveness into their allocations.**

**Consistently analyzing equities from a debt investor's perspective may help identify opportunities to generate a defensive return stream.**

***Defensive Alpha*—an alternative source of potential return that takes advantage of dispersion and the behavioral bias to underappreciate debt risk—may help deliver diversifying, positive returns when markets sell off.**


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We feel many investors are aware of how the growth in leverage over recent decades has created embedded risks for the credit markets. But many are unaware of the dramatic implications that this increased leverage likely bears for the equity markets.

In this paper, we will discuss why elevated leverage levels make understanding a company's debt profile all the more important for defensive equity security selection.

We believe an investor can benefit from a strategy that looks across the capital structure to consistently evaluate information from both debt and equity markets.

Finally, we introduce an alternative form of diversification* and potential return called Defensive Alpha, and discuss the key structural underpinnings that help support its defensive return profile.

# Elevated corporate debt levels and market stress

In recent decades, the US economy remained in an extended period of low interest rates and economic expansion, accompanied by strong investor demand for corporate credit in a global search for higher yields. This resulted in increasing levels of corporate leverage as companies looked to benefit from low rates to fund their growth. This trend is illustrated by leverage ratios in the US Investment Grade debt universe shown in Figure 1. The leverage ratio of companies steadily increased for years leading up to the COVID-19 pandemic.

Now, the macroeconomic environment has shifted. Persistent high inflation has led to a rapid cycle of interest rate increases. As long as inflation uncertainty continues, policymakers are expected to prioritize restoring price stability over preserving economic growth. Central banks are much less likely to intervene and provide a backstop to the economy and financial markets in the event of a growth shock. As a result, economic downturns and headwinds to company performance may be more frequent and persistent than in recent decades.

While markets have typically de-levered following economic slowdowns, corporate debt loads remain well above historical averages after several years of expansion. Currently, about 67% of issuance is from companies with leverage ratios over 2.0x, versus about 47% in 2005. Our expectation is that elevated leverage may act as a magnifying force to make a company's debt profile an incredibly important source of information for potential asset returns during periods of economic and market turmoil.

# Companies are exposed to debt and equity risk... But do investors pay consistent attention to both?

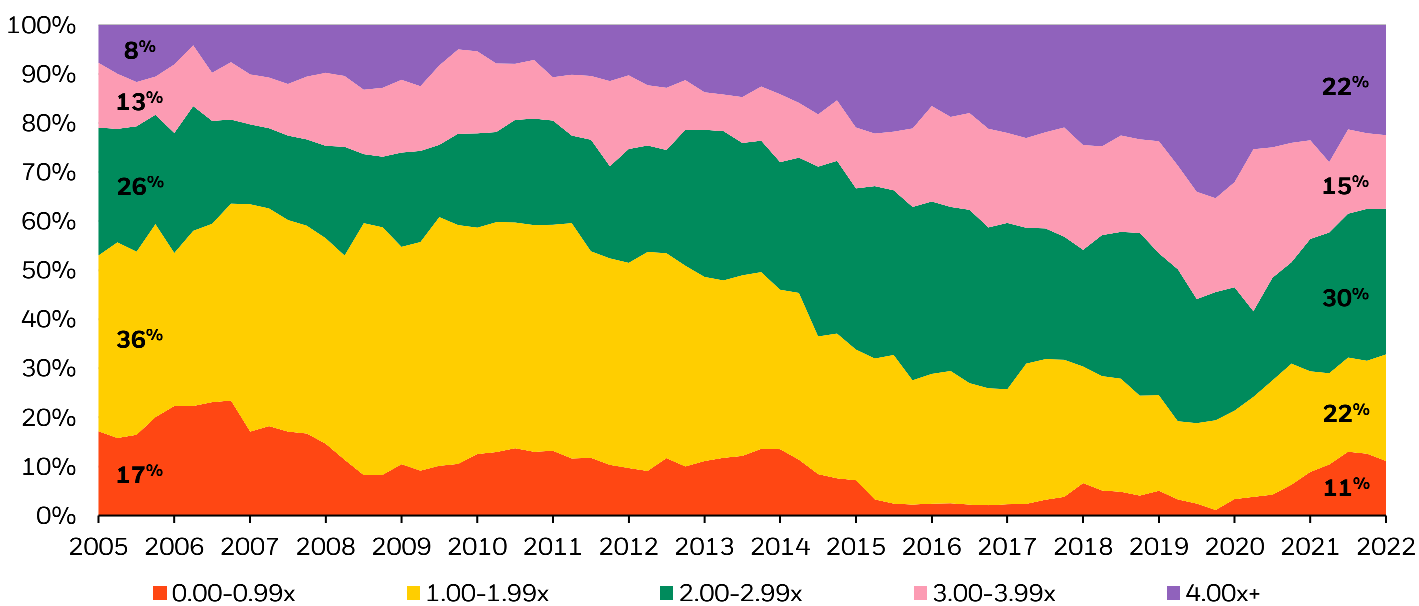
In light of this elevated leverage, one interesting output of our research has been a realization that equity investors do not consistently value debt information in their analysis.

For companies that are reliant on both the equity markets and the debt markets for funding, it is critical to pay attention to both, as moves in one asset class can have a dramatic impact on the other. Surprisingly, we have found that equity investors do not pay sufficient attention to credit markets outside of periods of credit stress. We find this to be a behavioral mistake.

One reason for this inconsistent attention could be the segmentation that has existed within the asset manager community between equity and bond funds. Even though bonds and equities are issued by the same companies, the investor bases looking at these securities have often been separated into distinct groups by asset class.

Most asset management companies have separate equity groups and credit groups. Institutional clients often have separate teams that conduct due diligence on fixed income and equity products. Even sell-side research is published by separate teams based on asset class. As a result, equity investors tend to inconsistently evaluate the debt-related information of the companies they cover.

**Figure 1: A world of elevated leverage may require greater equity investor attention**
% of U.S. investment grade debt in each gross leverage bucket




Source: BlackRock, Morgan Stanley, as of 31 December 2022.

# The opportunity for cross-asset class insights

Why the disconnect? While there are several possible reasons, we believe this divergence in focus across the two asset classes is largely driven by the different outcomes that each investor type seeks to achieve (see Figure 2).

Equities have a more symmetric payoff profile with meaningful upside potential. Thus, most equity professionals are incentivized to focus on the upside. Because equities represent a growth option on a firm's business operations, equity investors tend to focus more on income statements, earnings growth, product rollouts, and long-term growth prospects when analyzing a company.

Credit investors, on the other hand, tend to care less about growth and more about how that growth will be funded. Notably, the structure of debt securities is such that investors face the prospect of little upside potential and significantly more downside risk. Thus, debt investors are incentivized to focus on the downside, leading to more attention paid to balance sheets, default probabilities, and cash flows.

These behavioral silos act like invisible boundaries between the markets that inhibit the efficient and consistent transfer of information. As a result, we believe that equity and credit analysts tend to focus more heavily on information specific to their respective market. Due to this segmentation, we find that equity market information gets priced into the equity markets quickly, and credit information also gets priced into the credit markets quickly—but both sets of information are not quickly priced into a single asset class efficiently.

In our experience, the cross-market mispricing of information can be more persistent due to the natural segmentation of market participants.

# Why and *when* debt matters most

Logically, credit-based insights matter because debt levels increase a company's chances of default. But this long-term concern can become a more immediate and pressing issue during recessions or in times of market stress.

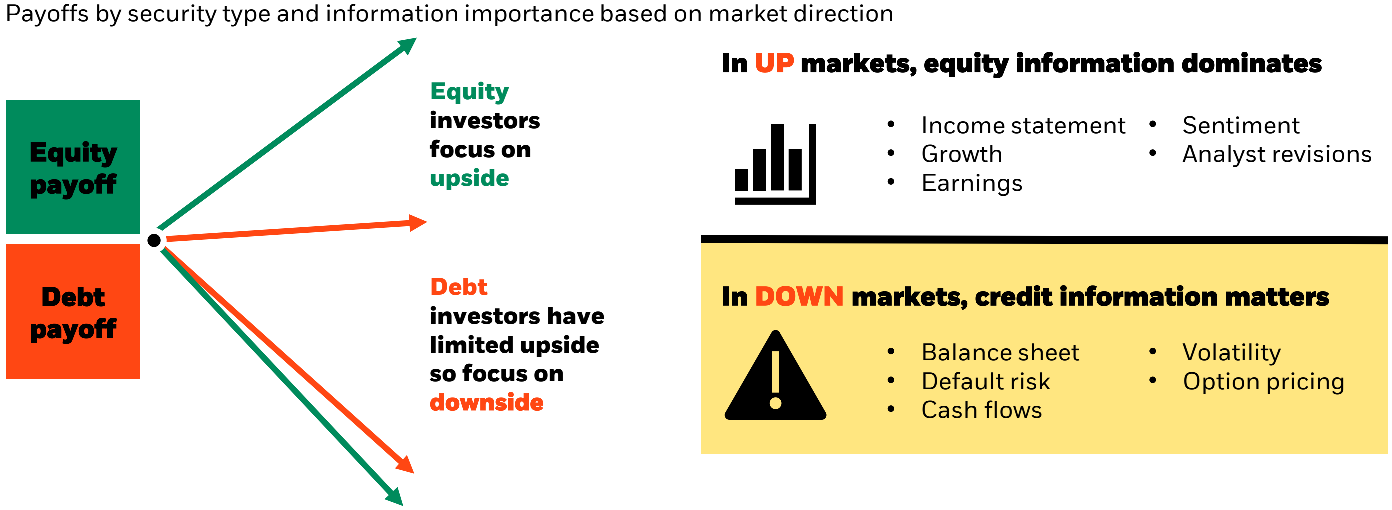
Companies that had the ability to access debt and equity capital markets to fund operations in strong economic times may find that their funding spigot gets turned off in recessionary periods.

This can result in increased equity volatility as high debt loads lead investors to question future profitability or even debt sustainability. In such a case, we find that for equity valuations, equity-related metrics take a back seat to credit-related metrics.

Looking back to Figure 2, we find that market direction can play a major role in shifting the focus of market participants, resulting in the repricing of equity assets as the once overlooked credit-related information is accounted for.

In the following section we review how we aim to exploit the market bias to misprice debt risk in order to produce a defensive return stream during market sell-offs.

**Figure 2: Payoffs can drive focus, but market direction can shift the importance of information**
Payoffs by security type and information importance based on market direction




Source: BlackRock. Based on the views and opinions of the Systematic Fixed Income group, as of May 2023. Charts are for illustrative purposes only and are not meant to depict past or future results.

# An alternative approach to defensive investing

In the following section we review an alternative approach to defensive investing that taps into market dispersion—not market direction—as a source of potential return. Dispersion is the difference in returns across a universe of companies. High dispersion implies a wide difference between winners and losers, while low dispersion implies a narrow difference between winners and losers. One effective way to take advantage of dispersion is through market neutral long/short strategies that go long companies who may become winners and go short companies that may become losers.

In our approach to defensive equity investing, we seek to generate returns in a long/short framework based on the dispersion of companies that are highly levered. We call this source of return **Defensive Alpha**. The persistence and effectiveness of Defensive Alpha is rooted in market structure and the behavioral disconnect between equity and debt investors we outlined earlier.

## Structural drivers of Defensive Alpha

The three key forces that underlie Defensive Alpha's potential to be an effective defensive source of return are:

1. **Dispersion may rise when markets fall**
2. **Leverage may increase market dispersion**
3. **Equity returns may be more dependent on debt metrics during drawdowns**

### Dispersion may rise when markets fall

First, as Figure 3 highlights, an important feature about dispersion among equities (yellow line) is that it has historically been highest when markets fall and are most volatile (green area). As you can see, dispersion of companies in the S&P 500 largely follows the level of overall market volatility, as measured by the CBOE VIX Index. As equity volatility ramped up, so did dispersion.

### Leverage may increase market dispersion

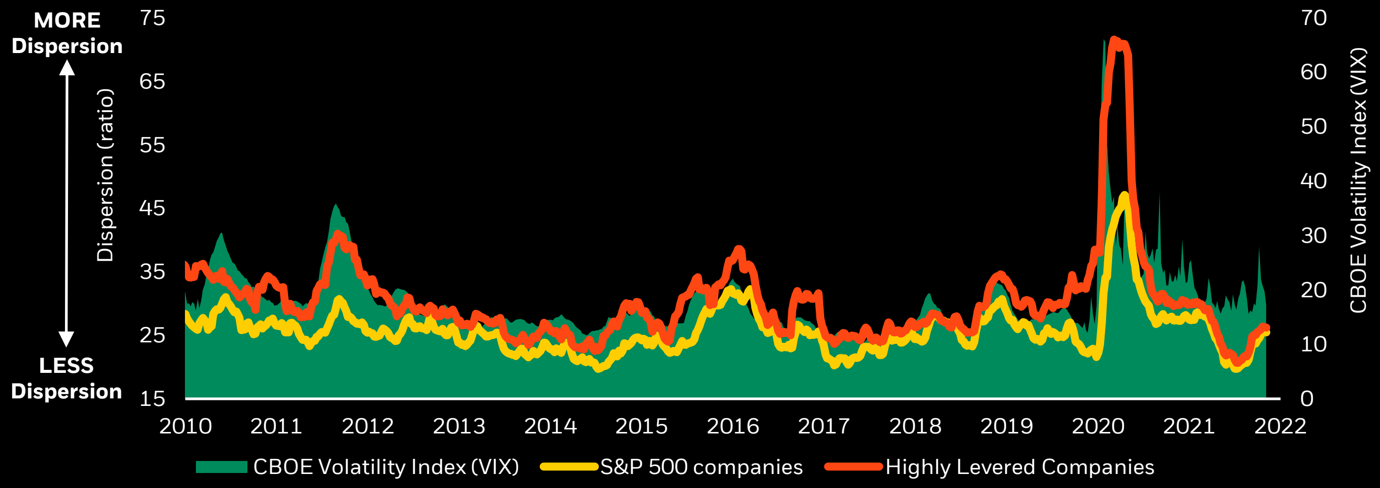
Second, leverage on the balance sheet may amplify a company's stock return—both up and down. The orange line in Figure 3 highlights this very important attribute about the interaction of dispersion and leverage. It shows that over a long time period, a universe of levered companies, or those with debt on the balance sheet, tend to have higher levels of dispersion versus a standard universe like the S&P 500. Put simply, leverage amplifies dispersion.

### Equity returns may be more dependent on debt metrics during drawdowns

Finally, this higher level of dispersion among levered companies can become even more heightened when markets are volatile, as demonstrated by the spikes in the orange line during past market shocks. As we stated earlier, this is because equity-related metrics dominate valuations in normal times. In bad markets, credit-related metrics dominate, increasing dispersion of levered companies as the information is realized. We find that the more stressed the market, the more important credit-metrics become.

This regime dependence of information acts as structural support for generating our Defensive Alpha return stream as it focuses on a universe of companies with debt. Thus, in normal times Defensive Alpha can be an incremental source of return, but may spring into action when markets are declining—the very time you need defensiveness most.

**Figure 3: Dispersion levels are elevated during volatility, especially among levered companies**
Market volatility and return dispersion of S&P 500 vs. highly levered companies




Source: BlackRock, CBOE, S&P, Bloomberg, as of 31 December 2022. "Highly levered companies" represented by the top decile of companies in the Russell 1000 Index based on their level of leverage. **Index performance does not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Past performance is not a reliable indicator of current or future results and should not be the sole factor of consideration when selecting a product or strategy.**

## Putting it all together

As systematic investors, we strive to deliver specific outcomes to investors by targeting explicit return sources. By separating sources of returns into directional (beta and factors) and idiosyncratic (alpha) components, we can engineer highly customizable return streams to seek specific risk, return, and diversification properties.

Defensive Alpha, and its potential to take advantage of dispersion to produce positive idiosyncratic returns when equity markets sell-off, is just one of the differentiated return streams we seek to target in our strategies.

In an environment of more frequent downturns and heighted market volatility, we believe Defensive Alpha offers an alternative source of diversification and return that can help investors build more resilient portfolios.

## Conclusion

The overall elevated levels of leverage in the market make understanding a company's debt profile important for not only investing in debt, but also critical for equity security selection. Market silos between investors have tended to result in inconsistent attention being applied to debt information in equity markets.

As a result, we believe an investor can benefit from these current debt and equity dynamics by employing a strategy that looks across the capital structure to consistently evaluate information from both markets.

Furthermore, taking advantage of dispersion among highly levered companies may help produce a defensive return stream during market downturns—the very time when investors need it most.

**Investing involves risk, including possible loss of principal.**

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