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A Drawdown Comparison to the Global Financial Crisis

While the uncertainty feels similar, the current shock is somewhat different from a factor perspective.

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I have heard many comparisons between the current crisis and the global financial crisis (GFC). To me, this shock feels similar in terms of uncertainty, but somewhat different from a factor perspective. We compared the first two months of the GFC and the four weeks ended March 13; these two periods equated to about a -25% market decline. Several high-level observations stood out:

1. Key takeaway: The worst-performing factor was clearly solvency risk, followed by value. We think the market has been engaging most on companies that might not pass the "going concern" test in the face of the first real growth shock we've seen since the GFC, and that these companies are seeing a massive increase to their discount rates. Our definition of solvency looks at the relative distance to a default (similar to the model used by credit-rating agencies), identifying distress at the individual company level by considering the interaction between capital structure and stock-price volatility. For capital structure, we look at leverage on the balance sheet and add back fixed-cost structures such as lease obligations, pensions, etc.
2. This isn't just a reaction to leverage. Looking across our factor returns, there is a direct correlation between a factor's exposure to solvency risk and excess return. Leverage is much less explanatory. Overall, the market is pricing high solvency risk nearly three times more than high leverage.
3. Unlike the first hit of the GFC (September and October of 2008), this time around there is not as much on the other side from a style perspective to cushion the blow (e.g., low volatility and profit stability factors are ahead, but not by much).
4. Up to now, the weakness in value factors has far outstripped the gains in defensive and quality factors. During the GFC, this was more balanced.
5. Dividend yield has not protected like it did in 2008, largely because the highest yielders are in energy and financials, which have higher exposure to solvency risk.

Given continued high uncertainty, we are being thoughtful about factor exposures, solvency risk, and stock-specific risk, and when in doubt, we are taking the defensive side.

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