OakBrook Investments

Research Note
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The Benefits of Out Performing in Down Markets

During the stock market's strong rise in January, many aggressive investors were able to out perform the market while defensive investors lagged. As the stock market declined in February, fortunes were reversed as defensive investors enjoyed the best returns. Clearly from month to month, the style of investment that is best depends on the state of the market. The question is, does either style have an advantage in the long run? The answer is yes! Due to the power of compounding, defensive investors who out perform in flat to down markets will out perform over the long run.

To illustrate, we have constructed a simple example using S&P 500 returns of 4.18% in January and –3.11% in February. Consider two managers, both of whom out perform the market by 0.80% in one month and under perform by 0.50% in the other. The aggressive manager out performs in January and under performs in February, resulting in a total return of 1.19%. The defensive manager under performs in January but then out performs in February. Due to the power of compounding, total return for the defensive manager is 0.09% higher after two months even though both managers have the same amount of out performance and under performance in the individual months.

	January Return	February Return	Overall Return
S&P 500	4.18%	-3.11%	0.94%
Defensive Manager	3.68%	-2.31%	1.28%
Aggressive Manager	4.98%	-3.61%	1.19%

Now a tenth of a percent may not seem like much but over time it can really add up. Over the full year, it could translate into an extra 0.60% for the defensive manager. Over a ten year period, it could translate into an advantage of more than 10%.* In addition to higher returns over the long run, the defensive approach also provides the benefit of a smoother return pattern, making it a little easier for the average investor to sleep at night.

With the clear advantages of a defensive style, how does one identify a defensive manager? One way is to look at the "beta" of the manager's portfolio. Beta is a measure of the portfolio's sensitivity to changes in the level of the market. A beta less than one means that a manager's style tends to dampen swings in the market, reducing both the market's dips and its highs. A beta greater than one means that the manager's style tends to accentuate market swings. Defensive managers have betas less than one. OakBrook's Large Cap Growth Strategy has a beta less than 0.85.

* - It should be pointed out that the size of the defensive manager's advantage does depend on a number of factors including the average level of return on the market, the amount by which each manager out performs and under performs, and the difference in return between the market's strong and weak periods. The results presented here do NOT depend on the market experiencing a negative return. The defensive manager's advantage is even larger if we substitute 8% and 1%, respectively, for the S&P 500 returns of 4.18% and –3.11% which were used in the example. What is critical to the result is that the defensive manager out performs when S&P 500 returns are below average, while the aggressive manager out performs when S&P 500 returns are above average.