EQUITIES

Understanding Defensive Equity

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AQR White Paper

“Defensive equity,” “low beta,” “minimum variance” and “low volatility” all describe investment strategies that generally seek to overweight safe securities and underweight risky securities (relative to capitalization-weighted benchmarks).

They are all based on historical evidence that investors have not received extra compensation for holding risky securities relative to safe securities. In fact, the average return of high-beta stocks has been about the same as the average return of low-beta stocks. This phenomenon is known as the “low-risk anomaly,” and it is what enables “defensive equity” portfolios to deliver long-run returns similar to traditional benchmarks, at a significantly lower volatility.

The strategy has received increasing attention over the past few years for a variety of reasons. First, backtests have empirically shown that such strategies have delivered higher risk-adjusted performance than traditional benchmarks. Second, after the severe global market decline in 2008 and the subsequent turmoil in European financial markets, many investors are actively seeking to avoid severe losses in periods of financial distress. Third, because of increased volatility in equity markets, investors have sought to reduce their concentration in equity risk as well as the risk of their overall portfolios.

This paper analyzes the intuition behind defensive equity. We review the empirical evidence, analyze construction and performance of defensive equity portfolios, and discuss the possible explanations for its outperformance. Finally, we discuss the role defensive equities can play in investors’ overall portfolios.

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