DUPONT CAPITAL

FOOD FOR THOUGHT · GLOBAL EQUITIES

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For the Risks, They are-a Changin'

The order is rapidly fadin'
And the first one now
Will later be last
For the times they are a-changin'
(Bob Dylan)

It's not often we look to Bob Dylan for equity market insights, but one can't help but wonder if the times or at the least the risks we are facing are a-changin'?

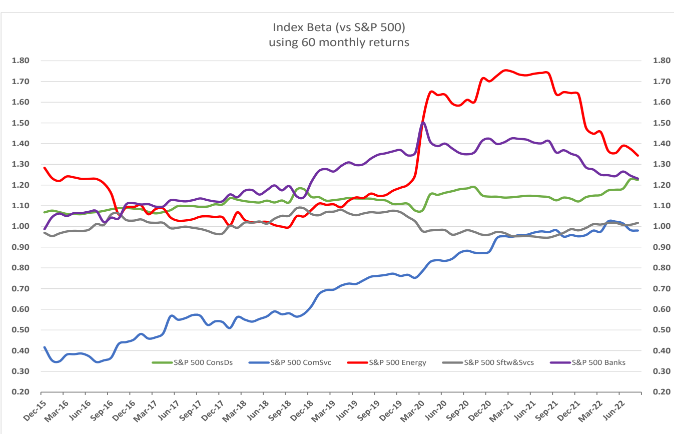
One of the reasons we ask ourselves the question is that over the last couple of months, we noticed two trends in the risk profiles of some of our portfolios:

- A growing divergence between the Ex-post and Ex-Ante Tracking Error (with the ex-post tracking errors being higher than the ex-ante numbers). (1)
- Upward pressure in the market beta of the portfolios, despite high quality and defensive exposure

While everybody is aware of the leadership gyrations and extra-ordinary volatility in the equity market, fundamental investors and traditional quant models alike generally assume risk profiles of companies and sectors to be relatively stable.

Chart 1 below shows the beta versus the S&P 500 of the following sectors/industries: Energy, Banks, Software, Consumer Discretionary and Communication Services. We use the latter 3 as proxies for Mega-Cap growth (given the influence of Microsoft, Google, Meta, Amazon, Tesla, Netflix … on these sectors). We use the former 2 as proxies for old economy value cyclicals.

Chart 1



Source: Bloomberg, S&P, DCM

The degree and speed of the change in market leadership and performance differentials over the last 12 to 18 months resulted in a dramatic change in the market beta of these sectors, significantly reducing energy and banks' relative risk, while increasing the risk of the mega cap growth sectors (making them at least more market sensitive). In essence, the most important observation is the narrowing of the differentials overtime (especially between Communication Services and Energy). It is also interesting to note that the relative risk of the mega-cap growth industries already started creeping up in 2016.

This change is throwing risk models and portfolio construction considerations an interesting curve ball. To illustrate this, we calculated the beta of 2 theoretical industry portfolios. Portfolio 1 has an equal 20% weight in Consumer Discretionary, Communication Services, Software, Banks and Energy. This portfolio has a more cyclical value tilt given the relatively high combined weight in the latter 2.

Portfolio 2 has a 25% weight in Consumer Discretionary, Communication Services and Software and 12,5% in both Banks and Energy. We view this as a more Mega Cap Growth tilted portfolio.

The charts on the following page show the dramatic change in the market beta of these 2 portfolios over time. While energy and banks are considered fundamentally more risky and volatile, the more cyclical portfolio 1 has become less market sensitive over the last 12 months, while the higher quality and growthier portfolio 2 has seen its' beta remain stable. When we calculate the risk (beta) over a shorter time period (as seen on chart 3) the market beta of portfolio 1 has now actually dropped below that of portfolio 2. Most traditional risk models like Barra generally use longer time horizons to calculate market sensitivity, while other risk models, like Blackrock's Aladdin, use shorter estimates (2 Year).

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Chart 2

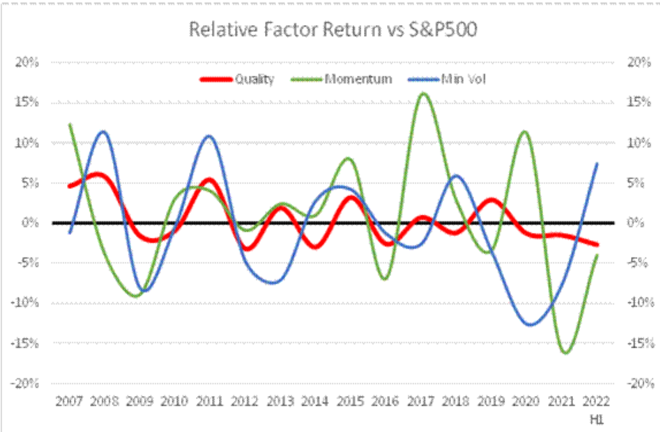
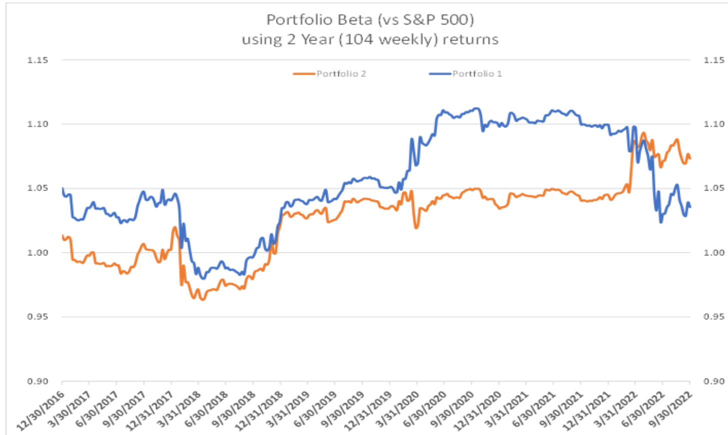


Chart 3



Source: Bloomberg, S&P, DCM

Putting these observations in a broader and longer-term portfolio context.

- Risk and market sensitivity are relative concepts that are market dependent and as such they will vary over time and extreme market contexts, like the one we are experiencing today, will impact these relative measurements to a greater extent versus history.
- We expect relative performance differentials to narrow if and when inflation numbers cool down, geopolitical tensions ease and there is better line of sight on Fed policy and interest rates. Sector/Industry betas should ultimately retrace some of the recent trends (but without going back to previous high/low levels).
- Using too narrow relative risk bands in these circumstances can introduce some level of unwanted short-termism and higher turnover.
- Overly broad risk margins, on the other hand, can lead to wide performance and volatility swings, that not every investor or asset owner is willing to stomach.
- There is a science in calculating and measuring different risk metrics, but there is an art in interpreting and using them.

(1) The Ex-ante tracking error is the estimated risk relative to the benchmark, while the ex-post tracking error shows the realized risk/divergence of the portfolio versus its' benchmark.

DuPont Capital Management is an SEC registered investment advisor based in Wilmington, Delaware. Since the firm's establishment in 1993, we've had a long history of developing global investment opportunities in both traditional and alternative strategies across equity, fixed income and alternative investments. Our investment team structure gives us the ability to be flexible and adapt to changing market conditions. DuPont Capital's focus is delivering consistent investment management results for our clients. Our history of institutional asset management is rooted back to 1942 when our former parent company, DuPont, established a pension plan for its employees. Corteva Inc. succeeded DuPont as sponsor of the DuPont Pension Plan in 2019. DuPont Capital is a wholly owned subsidiary of Corteva and continues to manage the legacy DuPont Pension Plan.

DuPont Capital's President and CEO, Valerie Sill believes in education and diversity of experience as represented in our investment teams which are comprised of PhDs, engineers, medical doctors, and scientists. We believe their global expertise creates a portfolio implementation edge that benefits our clients.

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Important Disclosures: