Man

Views From the Floor

Buy That Dip?

04 May – 10 May, 2022

Time to read: 4 minutes

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Global stock markets slid on a year-on-year basis in April. This has been a relatively unusual occurrence over the past 10 years, a boom decade for equities – so much so that an entire generation of investors has been trained to reflexively buy the dip. But does this strategy work when an index has declined for a full year?

To answer that question, we analysed seven equity indices over a 35-year period, screening for years when the year-on-year return has been negative. We then analysed the forward returns of the index up to 12 months from that date (Figure 1).

The results show that the future returns have been remarkably strong. The S&P 500, NASDAQ, Russell 2000, Euro STOXX 50, STOXX Europe 600, FTSE 100 and FTSE 250 indices posted positive returns across all time periods. There was also a marked tendency for an index to post stronger returns if it had greater exposure to riskier stocks: small-cap indices outperformed their larger counterparts, and tech-heavy indices in the US such as the NASDAQ posted some of the best returns across the sample.

Figure 1. Index 12-Month Forward Returns After a Year-on-Year Fall – 1987-2022

Index	YoY	1m fwd	3m fwd	6m fwd	9m fwd	12m fwd
S&P 500	-14%	1%	1%	3%	5%	9%
NASDAQ	-23%	1%	2%	6%	10%	15%
Russell 2000	-13%	1%	4%	8%	13%	17%
EURO STOXX 50	-16%	1%	1%	3%	4%	6%
STOXX Europe 600	-14%	1%	1%	3%	5%	8%
FTSE 100	-12%	1%	1%	3%	4%	6%
FTSE 250	-12%	1%	3%	6%	10%	14%

Source: Bloomberg, Man GLG; as of 3 May 2022.

However, our analysis has two major limitations. First, it does not quantify the alpha in this strategy, so one would ideally want to compare those returns to regular average expected returns when holding the index. Second, some of those returns can be directly attributed to the monetary policy response from the Federal Reserve. In 2015, 2018 and 2020, the Fed either postponed or reversed rate hikes, as well as unleashing quantitative easing and other forms of unorthodox monetary policy, somewhat artificially boosting the returns in our sample. This is an important factor to be aware of: in the current inflationary environment, it can be argued that the Fed’s ability to support equity markets by cutting rates is distinctly limited.

To strip out this latter effect, we then ran the same test over a longer time period, with results going back to 1960 (Figure 2). Splitting the results by time period, 12-month forward returns for the S&P 500 averaged 11% during the 1960s, 6% during the recessionary 1970s and 12% after 1980. Even without the Fed firing the big guns of stimulus, returns in the 12 months after a year-on-year downturn were positive.

Fed or no Fed, there seems to be every reason for investors to buy the dip.

Figure 2. S&P 500 Index 12-Month Forward Returns After a Year-on-Year Fall - 1960-2022

	1m	3m	6m	9m	12m
1960s	0.7%	2.9%	5.4%	7.6%	10.7%
1970s	0.3%	0.6%	1.7%	3.9%	6.2%
After 1980	0.6%	2.0%	4.0%	7.2%	11.8%
Total across all dates	0.5%	1.8%	3.6%	6.3%	10.0%

Source: Bloomberg, Man GLG; as of 3 May 2022.

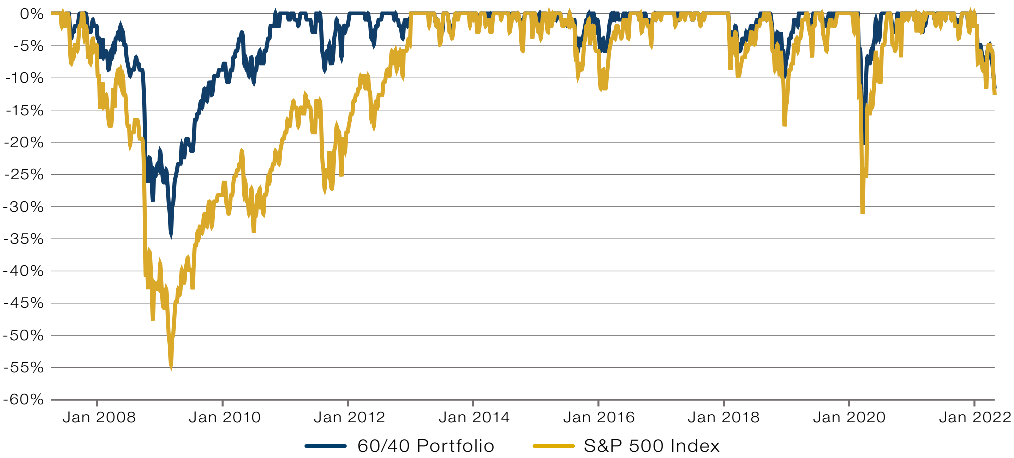
What to Do When Diversification Doesn't Work

The 60/40 portfolio – 60% allocated to equities and 40% to bonds – has always relied upon diversification to enhance its returns and protect against selloffs. The logic is that bonds and equities are negatively correlated, with one asset class performing when the other does not, thus protecting the portfolio during trouble. This correlation is a fairly recent phenomenon – indeed, we first identified **in 2017** that it is only since 1998 that the stock/bond correlation has been negative.

The problem is that in times of high and rising inflation, the positive stock/bond correlation tends to re-assert itself. While previously the 60/40 portfolio provided a measure of protection in a selloff – with the Global Financial Crisis in 2008 and Corona Crash in 2020 being notable examples – in 2022 this has not worked (Figure 3). A 60/40 portfolio outperformed the S&P 500 index by a maximum of 21 percentage points in 2008-9, but there has been no similar outperformance in 2022. In fact, with performance roughly level: bonds are no longer providing the diversification benefit they have been doing since 1998.

What, then, is the solution? Given the positive stock/bond correlation during an inflationary environment, we would argue that **explicit pro-inflationary** strategies are where investors should turn. These include allocations to alternative strategies such as commodities, Momentum equities and – most importantly – all-asset trend.

Figure 3. 60/40 Portfolio Versus S&P 500 Index – Maximum Drawdown



Source: Bloomberg, Man GLG; as of 3 May 2022.

Note: 60/40 portfolio represented by the BMA6040 Index.

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MKT004433/ST/GL/W