Diversifying + Defensive Equity Approaches:

Aiming for attractive outcomes while managing risk

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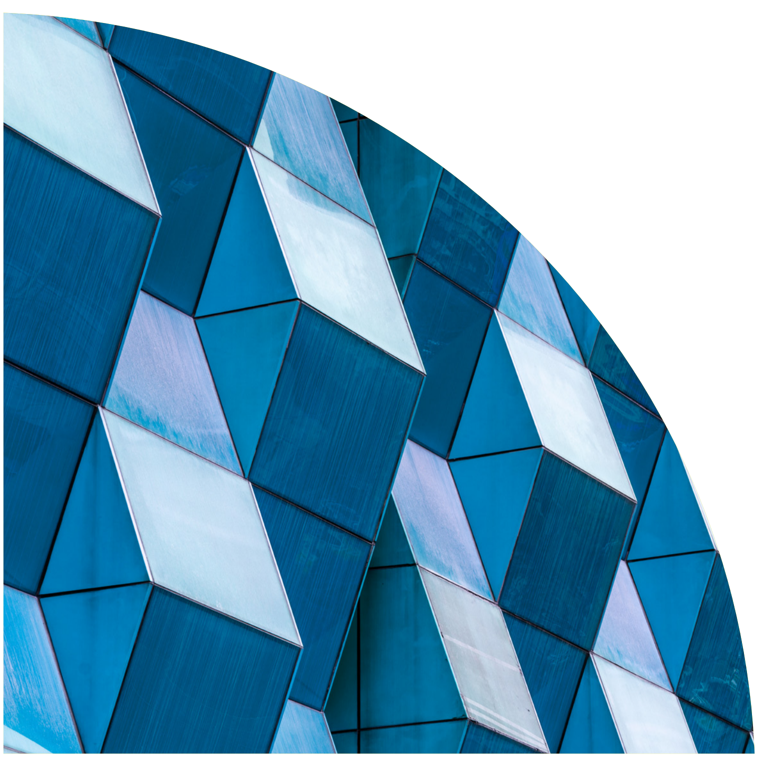
While there seems to be consensus around a U.S. recession, it's worthwhile to differentiate between a *profits* recession and an *economic* recession. In recent quarters, we've seen a series of earnings declines across different companies and industries—for example, in the U.S. financials and communication sectors—providing strong evidence that a profits recession has already started. However, what's key for us to monitor now is when earnings start to rebound, as equity markets often stage a profits recovery before the economy starts recovering. Considering that many industries have already experienced a profits recession, it's possible we'll see market multiples and credit spreads pointing toward recovery before the reality of an economic recession sinks in.

While inflation has trended down, the path to lower inflation may not be a straight line. Finding a balance between taming inflation and maintaining economic growth is always hard and leaves plenty of room for surprises. With this in mind, we see higher potential for downside risk in equity markets with possible upside surprises.



What potential areas of opportunity do you see for investors in the near term?

In an environment where we experience some form of recession while inflation stays higher for longer, we believe a more cautious and defensive positioning is warranted. Depending on different preferences and portfolio characteristics, investors may wish to consider approaches that we use to adjust equity exposures to be more defensive:

Looking for income?

We believe an enhanced equity income approach could fit well in this environment given its dual focus on income and total return. The income approach we use strongly emphasizes stable and sustainable businesses that can support their dividend policy. Those types of businesses have proven more resilient during recessionary environments. As we witnessed in 2023's first quarter and many other periods in history, a dampened economic outlook might not always translate into a disappointing equity market. Should there be any market upside, we think a total-return focus may allow investors to retain higher upside capture.

Concerned over higher stock and bond correlations going forward?

We feel that diversifying these exposures is more important than ever. A long/short equity approach offers the potential to provide equity-like returns with lower volatility and, importantly, preserve capital during market downturns. Over the long term, we've seen high-risk segments of the market frequently underperform their low-risk counterparts. High-risk stocks tend to fall farther during market downturns. This trend, called volatility drag, means they have a harder job to regain lost ground, and it's led to underperformance of high-risk stocks over the long term. We witnessed this most recently in 2022, when high-risk stocks underperformed low-risk stocks by 26%. By shorting high-risk stocks, losses may be mitigated during down markets while retaining attractive upside potential.

Seeking more explicit risk management strategies?

One approach is to use options, which may provide more certainty on the hedging outcome but also can be costly. Another possibility is to consider a more flexible and futures-based dynamic risk-hedging approach. Its goal is to provide protection based on a consistent, systematic assessment of the market. A dynamic risk-hedging approach is activated only when deemed necessary, which may help preserve capital at a more affordable cost. This type of approach does not offer guaranteed protection but may provide a meaningful cushion during market downturns.

With possible downside risk on the horizon, a combination of diversifying and defensive equity approaches can be an attractive way to potentially improve the probability of achieving positive outcomes.

For further information

We want to help clients build for successful outcomes, defend portfolios against uncertainty, and create long-term financial well-being. To learn more, investment professionals can contact us.

Contact details

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- For retail clients, contact your financial advisor.
- To reach our intermediary sales professionals, contact your dedicated regional director, or call us at **1-866-701-2575**.
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FOR SUSTAINABLE INVESTING

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