?Most investors are primarily oriented toward return, how much they can make and pay little attention to risk, how much they can lose.? *? Seth Klarman*

Imagine being in the shoes of an NFL head coach with a critical decision to make. Your team is up by five points with a minute left in the game. The opposing team?s offense is lining up on their 35 yard line and must drive 65 yards to score a touchdown and win. If your defense holds them to anything less, you will be dowsed in Gatorade with a victory in hand.

As the coach, you have three options to try to stop the team and secure a win.

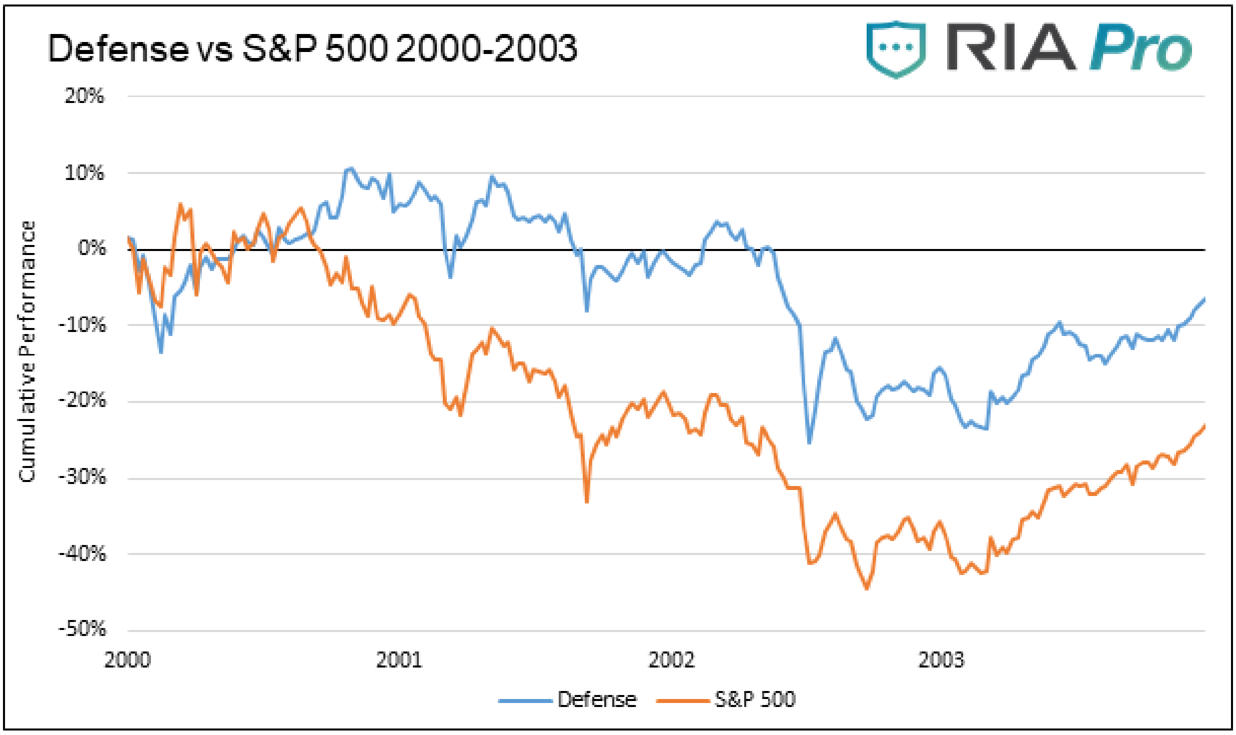
1. The easiest option is to select the first 11 defensive players you see and send them out on the field.
2. The second option, requiring a little more skill, is to choose the best 11 defensive players and put them on the field.
3. The final alternative, and the one providing you the best chance for a victory, is to choose from all of the 53 players on your team and craft the most formidable defense for the situation. Yes, this may mean the quarterback, punter, or even water boy heads out to battle.

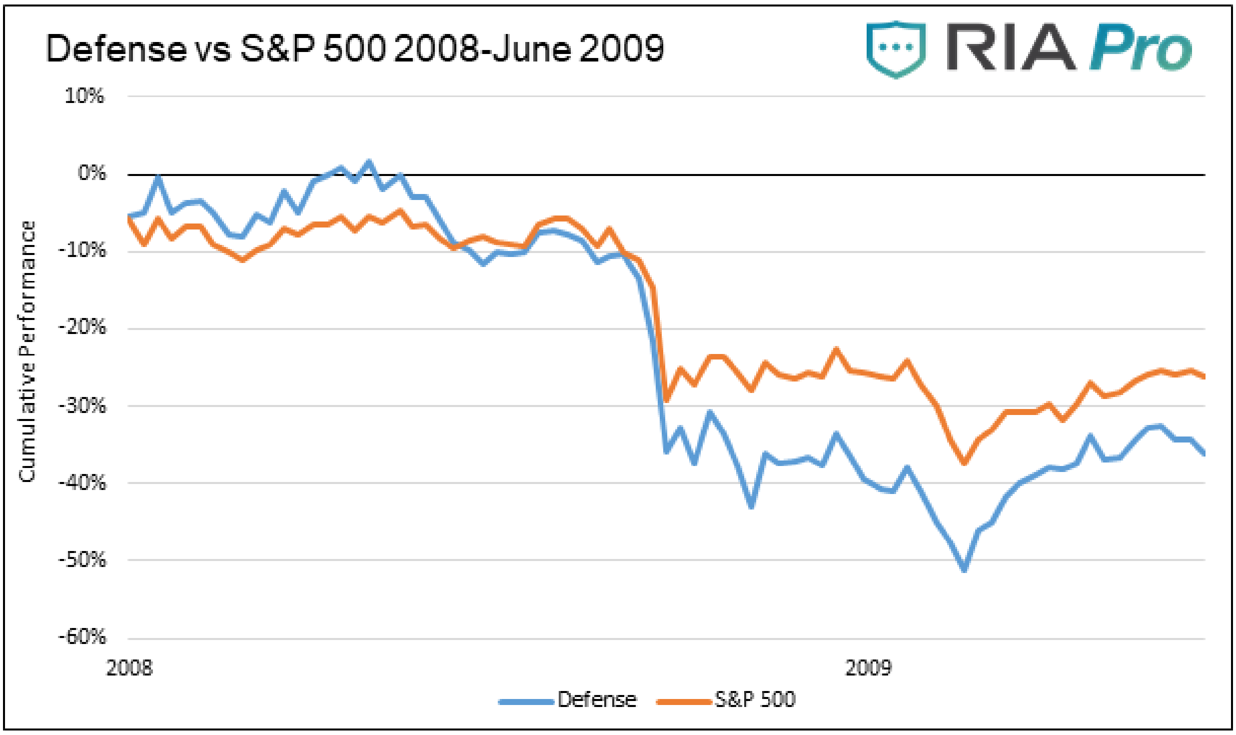
The three defensive personnel options are representative of similar choices that investors must face from time to time when bear markets take hold. Significant market declines defining bear markets are infrequent, but, minimizing losses during these trying periods is potentially the most important thing a portfolio manager can do to optimize longer term returns.

While fielding any defensive team is better than doing nothing, we hope you walk away from this article realizing that playing to win is not just about fielding a defense, it?s about putting the best defense to work for you.

Option 1

The first option in our NFL example is simply picking the first 11 defensive players you see on the sidelines. This is the most common approach that investors take when they decide to reduce risk. Such action typically translates to reallocating from riskier, higher-beta sectors into defensive, and lower-beta sectors. Like the coach?s first option, most investors assume the popular defensive sectors standing right in front of them will serve their purpose. These sectors tend to be utilities, healthcare, and consumer staples. In the past, buying these sectors during a downturn frequently limited losses and resulted in outperformance versus the broader market. Outperformance does not mean gains, just that the losses were not as bad as the broader market.





Certain sectors, like those mentioned, are classified as defensive because the companies underlying them produce cash flows that are not as sensitive to the economy. For instance, during a recession:

- Will consumers significantly curtail their electricity usage?
- Will people stop seeing doctors and neglect to take prescribed medicines?
- Will consumers start using newspaper instead of toilet paper?
- Will consumers stop using toothpaste and shaving cream?

The logic behind buying fundamentally stable companies is sound, however, it completely fails the most important investing rule - buying that which is cheap? As the saying goes, there are good companies and good stocks but they are not always the same ones.

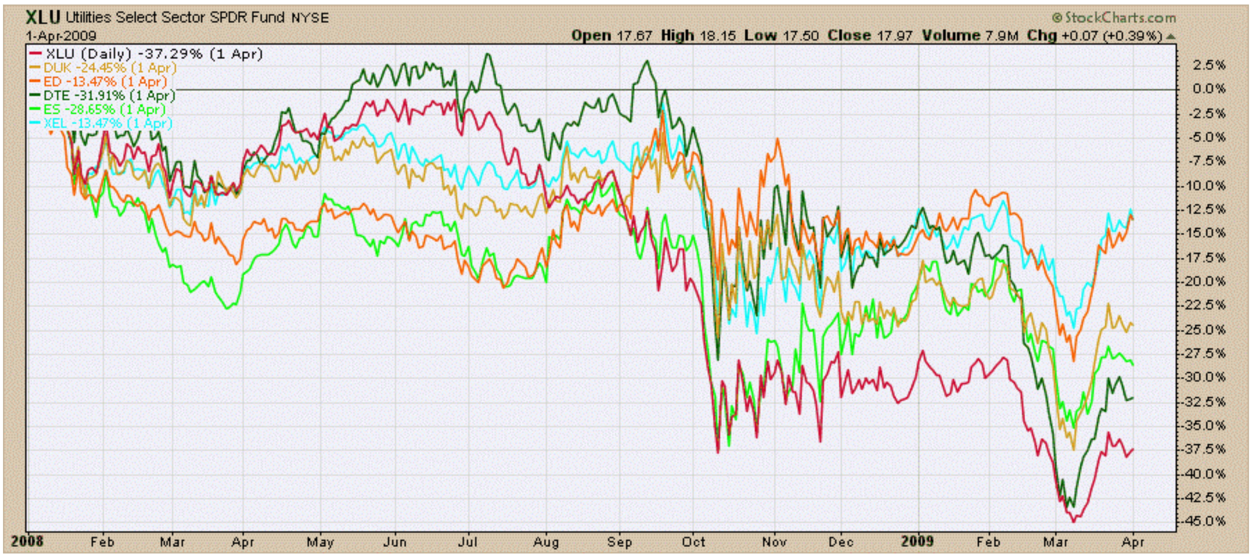
The charts below compare an index made of the utility, staples and healthcare sectors to the S&P 500 during the last two bear markets. In both cases the three-sector defensive stance minimized loses relative to the broader market.

Option 2

As noted in the first option, reallocating to a more defensive sector because of stable revenues may not provide you the results you were hoping for if the valuations of the sector are not cheap. Therefore, the equivalent to option two in our NFL example is to find the cheapest companies within the defensive sectors. Picking the best 11 defensive players is certainly better than picking the first 11 we see.

Buying companies in safer sectors and at valuations that are below average provide an additional cushion against losses. Again, we stress that this does not preclude the stocks that meet this criteria from declining, but it does tend to reduce the amount they can fall.

To show how such an approach worked during the 2008-2009 bear market, the graph below shows the five companies within the utility sector that were trading at a below average P/E ratio versus that of the prior four years. We caution here that P/E analysis is just one of many fundamental tools investors should use to assess a company?s value.



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The average loss of the five utility stocks was 22.32%. By selecting those specific stocks (DUK, ED, DTE, EX, XEL) instead of the entire sector (XLU ?red line), an investor would have beat the utility ETF by 14.97% and the S&P 500 by 22.44%.

In the consumer staples sector, we selected the four companies with the lowest relative P/E?s versus their respective averages. These stocks (SYY, PEP, WMT, and KMB) on average lost 16.73% but beat the consumer staples ETF (XLP) by 7.07%, and the S&P 500 by 28.03%. It is worth pointing out, however, that XLP outperformed two of the four stocks, albeit by a small margin.

In the healthcare sector we selected the four companies with the lowest relative P/E?s versus their respective averages. These stocks (AMGN, LLY, JNJ, and MDT) on average lost 21.57% but beat the healthcare ETF (XLV) by 8.53%, and the S&P 500 by 23.19%. The outperformance would have been greater, but MDT declined by nearly 40% or about 10% more than the ETF.

Below is a summarized version of the results discussed above.

Price Return January 2008 - March 2009	
Option 1 XLU	-37.29%
Option 2 DUK, ED, DTE, EX, XEL	-22.32%
Option 1 XLP	-23.80%
Option 2 SYP, PEP, WMT, KMB	-16.73%
Option 1 XLV	-30.10%
Option 2 AMGN, LLY, JNJ, MDT	-21.57%
Option 1 Portfolio of ETFs	-30.40%
Option 2 Portfolio of sub-components	-20.21%
S&P 500	-44.76%

As shown above, option 1, a portfolio of the three defensive ETF?s outperformed the S&P 500 by nearly 15%. Option 2, a portfolio of the thirteen individual stocks within the three defensive sectors with the lowest valuations would have beat the portfolio of sector ETF?s by 10% and the S&P 500 by almost 25%.

Hindsight is 20/20, so we bring current the same calculations we did for the 2008/09 bear market. The analysis below provides clues as to what might outperform if the next bear market were to occur in the not too distant future. The tables below show the largest companies within each sector and each companies Z-score based on the current valuation versus their respective 20 year historical average. We color-coded the Z-scores to highlight rich and cheap valuations (a negative Z-score (green) denotes a valuation that is historically cheap).

Utility Sector (XLU)				
	Weight	Current P/E	Average	Z Score
NEE	12.05	23.18	14.93	2.13
DUK	8.67	18.45	15.84	0.90
D	7.33	18.35	16.32	0.62
SO	6.88	14.21	15.75	-1.03
EXC	6.36	14.97	13.89	0.34
AEP	5.35	19.10	14.13	1.83
SRE	4.37	20.76	14.32	1.39
PEG	3.79	17.86	13.48	1.35
XEL	3.70	21.24	14.19	1.46
ED	3.40	18.51	14.97	1.51
WEC	3.18	21.26	16.54	1.14
PPL	3.06	12.59	13.32	-0.25
ES	3.04	20.77	17.04	0.99
DTE	2.92	17.98	14.48	1.13
WAVG		18.77	15.03	1.00

The companies above represent 75% of the utility sector by market capitalization. The sector, as represented by these stocks is moderately expensive with a P/E ratio trading at a high premium to its long term average. Within the sector, however, Southern Corp. (SO) and PPL Corporation (PPL) are trading at valuations that are historically cheap compared to their averages.

Staples Sector (XLP)				
	Weight	Current P/E	Average	Z Score
PG	14.76	22.24	21.04	0.26
KO	11.46	24.59	26.11	-0.17
PEP	9.62	22.29	22.97	-0.09
WMT	8.26	20.18	22.22	-0.22
MDLZ	4.79	18.98	18.70	0.07
COST	4.54	32.62	26.15	1.35
PM	4.31	16.77	17.42	-0.18
MO	4.17	13.88	14.09	-0.05
CL	3.97	21.32	24.20	-0.49
WBA	3.94	13.66	25.54	-1.00
KMB	2.81	17.53	17.48	0.02
EL	2.35	30.29	27.14	0.48
SYY	2.20	21.20	22.09	-0.16
KHC	2.05	14.32	21.85	-1.54
WAVG		21.39	22.21	-0.04

The companies above represent 79% of the staples sector by market capitalization. The sector, as represented by these stocks, trades at a below average P/E. Within the sector, Walgreens (WBA) and Kraft Heinz (KHC) stand out as they are trading well below their long term P/E?s. Keep in mind KHC is under SEC investigation for accounting irregularities.

Health Care Sector (XLV)				
	Weight	Current P/E	Average	Z Score
JNJ	10.40	18.48	19.93	-0.25
UNH	7.27	23.10	20.36	0.39
PFE	7.08	15.51	21.18	-0.41
MRK	5.86	18.54	18.14	0.06
ABT	3.79	26.35	19.70	1.21
MDT	3.53	19.58	24.89	-0.42
ABBV	3.48	12.59	15.02	-0.96
AMGN	3.27	15.00	23.81	-0.58
LLY	2.89	22.09	20.88	0.13
TMO	2.57	23.41	20.88	0.37
GILD	2.47	11.21	5.94	0.10
CVS	2.40	11.76	19.40	-1.10
BMY	2.30	14.37	21.30	-0.91
ANTM	2.05	19.65	13.55	1.54
WAVG		18.42	19.48	-0.08

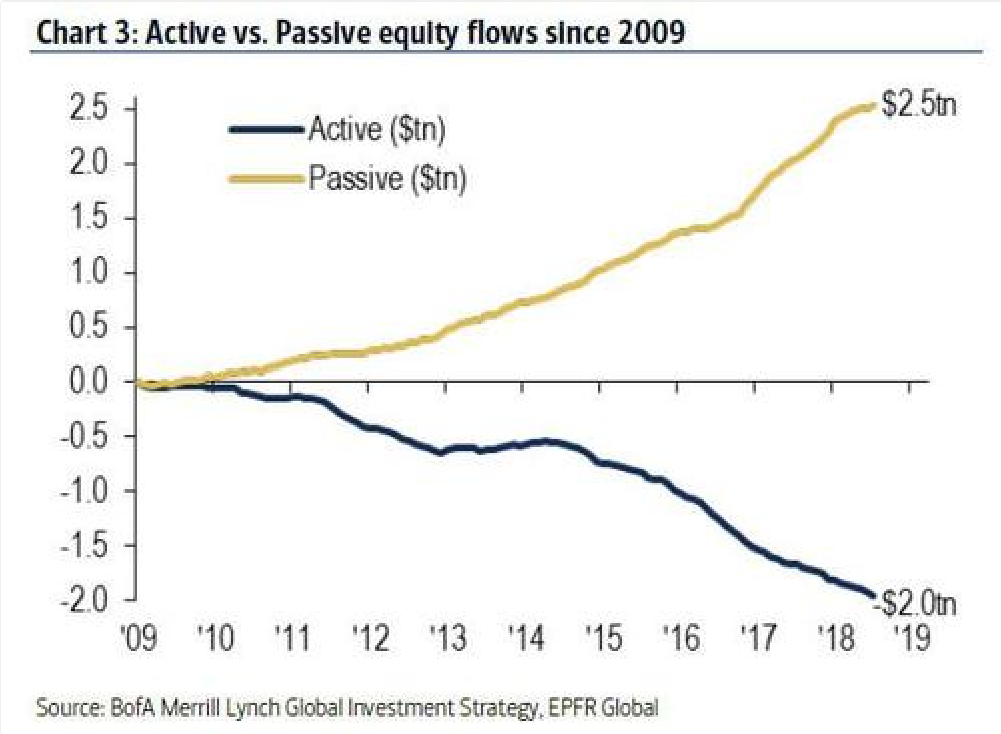
The companies above represent 59% of the healthcare sector by market capitalization. The sector, as represented by these stocks is fairly priced with a below average P/E. Within the sector, CVS (CVS), AbbVie (ABBV), and Bristol-Myers Squibb (BMY) stand out as they are trading well below their long term P/E?s.

Option 3

The third option in our NFL example is to choose the best 11 players from the entire roster. Instead of focusing on utilities, staples and health care or the most valuable stocks within those sectors, we must broaden our horizon to all sectors and stocks.

This third option is more important today than it ever has been. The rapid growth of passive investment strategies and ETFs, along with the decline in the popularity of active strategies, has homogenized the markets and its underlying securities. By this, we refer to behavior in which investors are buying indexes and sectors without regard for the valuation of the underlying stocks. As a result of such price/value insensitivity, stocks included in popular indexes rise and fall together based on market conditions and not the traits of each individual company.

The graph below highlights the divergence between passive and active equity flows since 2009.



The bottom line: Stocks well represented in passive ETFs have risen with the market and in most cases now trade at above average valuations.

The problem: When investors reduce risk and sell passive strategies, most stocks, some of which are defensive in nature, will go along for the ride.

The solution: Look for value amongst stocks that are not well represented in ETFs or popular indexes.

Option three is the solution to the dilemma that the impulse of passive investing has put upon many of the traditionally safer sectors. Option three involves looking for companies that are not on the radar of most investors. The following traits are ones that we deem important in finding companies that may provide the best defense in a coming bear market:

- Value- Stocks trading at cheap valuations using multiple valuation metrics
- ETF Participation- Little to no ownership by passively managed ETFs and mutual funds
- Ownership- Companies in which management holds a large percentage of the company. Think ?skin in the game.?
- Fundamentals- Companies with solid revenue and earnings trends along with manageable amounts of leverage and cash flows that easily satisfy debt expenses.
- Business Sector- Firms that are in businesses that can better withstand the ill effects of a recession.

In part two of this article, we will provide a scan for companies that fit this bill. The list will not be extensive, because cheap is a trait that is incredibly hard to find these days. The list will also likely cover companies with which you are unfamiliar. Stay tuned.

Summary

Three years ago, in our first article published on Real Investment Advice, we wrote about the value of playing defense. To wit: ?*Growing wealth through investing typically occurs over a long time* *horizon that includes many bullish and bearish market cycles.* ***While making the most out of bull markets is important, it is equally important to avoid letting the inevitable bear markets reverse your progress.?***

In today?s environment, where the passive investing craze has changed the landscape of defensive investing, the lesson quoted above holds more meaning. We are concerned that various defensive postures, as described in options 1 and 2, that have served investors well in the past will do a poor job in the coming bear market.

The value of buying value stocks preached by investment greats, like Seth Klarman, Warren Buffett, Benjamin Graham and David Dodd to name a few, is falling on deaf ears. Like Odysseus, we urge you to ignore the passive siren song of the market, put wax in your ears and tie yourself to the mast. When it?s time to play defense, take a fresh approach and seek stocks that are truly cheap, not those companies and sectors that the market believes are defensive.