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The Old Faithful Portfolio

Old Faithful is the most famous geyser in Yellowstone National Park. It was so named because its spectacular water shows are extraordinarily reliable. Since its discovery in 1870, more than one million water discharges have occurred. They are highly predictable, occurring on average every ninety minutes and they can be predicted more precisely by checking the duration of the previous discharge – the longer the previous discharge, the longer the wait for the next one.

In the context of the stock market, we ask the question "Is it possible to build an Old Faithful portfolio, i.e., a portfolio that is reliable, especially during turbulent times?" The answer is that yes, one can make a reasonable attempt to do so although the stock market is too unpredictable to promise a guaranteed outcome.

To create a sample Old Faithful portfolio, we use a unique analytical tool High Pointe created to analyze the risk characteristics of stocks. This tool is called the Stock Evaluation Tool (SET). We start by using SET to examine the behavior of all stocks in the S&P 500 Index during times of increased risk. For this study, we measure risk by observing the VIX index. The index, colloquially known as the Fear Index, measures the 30-day expected volatility of the U.S. stock market derived from S&P 500 calls and put options.

An example of the efficacy of the VIX index can be seen in the events on February 2, 2018. The national employment report was released that morning and it rekindled inflation fears in the marketplace. As a result, the VIX index increased from 13.5 to 17.3 that day, an increase of 28% in one day. Nor surprisingly, the stock market tanked, closing down 2.2%. This inverse relationship between the VIX index and stock market performance is quite strong.

For this study, we examined the data for the last five years and selected the "worst" 100 days, i.e., days when fear as measured by the VIX index increased the most. The stock market declined on 91 of these 100 days and the average decline was 1.17%. We then examined the performance of all sectors and all individual stocks to see which sectors and stocks held their own and which ones did not. Our results are described on the next page.

In the table below, we show the data for each sector in declining order of resilience during the 100 days when VIX increased the most during the last five years.

Market and Sector Performance when Risk (VIX) Increases Significantly[1]

Economic Sector	Average Performance	Average Performance Relative to Market
S&P 500 Index	-1.17%	--
Utilities	-0.55%	+53%
Consumer Staples	-0.78%	+33%
Telecommunications	-0.87%	+26%
Health Care	-1.17%	0%
Consumer Discretionary	-1.18%	-1%
Industrials	-1.20%	- 2%
Information Technology	-1.30%	-11%
Energy	-1.31%	-11%
Materials	-1.31%	-12%
Financials	-1.44%	-23%

These data imply that if one wanted to create an Old Faithful portfolio for the primary purpose of protection when risk level increases, one way to do that would be to overweight Utilities, Consumer Staples and Telecommunications sectors.

Next, we extend this analysis to individual stocks. We use our analytical tool to identify individual stocks with defensive characteristics even in sectors that in aggregate are not defensive. In the table below labeled Defensive Stocks, we show selected stocks from each sector that performed relatively well during the 100 days when VIX increased the most. And, in the table on the next page labeled Volatile Stocks, we show selected stocks that performed relatively poorly during the same 100 days. We also comment briefly on each stock.

Selected Defensive Stocks[1]

Stock	Performance Relative to Mkt.	Reason for Defensiveness
McDonald's	+38%	Sells inexpensive food whose sales will hold up well if incomes decline
AutoZone	+32%	People keep cars longer during lean times thus needing more repairs
Dollar General	+29%	More customers will likely patronize dollar stores during difficult times
ONEOK	+13%	Energy company in stable natural gas transportation business
CBOE	+50%	Options exchange without the high leverage typical of financials
Allstate	+25%	Insurance co. with less balance sheet risk compared to other financials
Humana	+24%	Essential healthcare services
Baxter	+19%	Essential blood and other healthcare products
Waste Mgmt.	+33%	Waste hauling is an essential service with limited volatility
Lockheed	+28%	Long-term, locked defense contracts that are noncyclical
Paychex	+12%	Payroll provider with sticky customers and limited competition
Newmont	+41%	Biggest producer of gold, the traditional safe haven asset
AT&T	+28%	Stable cell phone business
Southern Co.	+76%	Stable electric utility with income guaranteed by regulators
Duke Energy	+75%	Stable electric utility with income guaranteed by regulators

[1] *The Defensive stocks listed in this table are **NOT** recommendations and they do not constitute a well-diversified portfolio. They are shown here only to illustrate the differences among stocks when VIX index level rises.*

Selected Volatile Stocks[1]

Stock	Relative Performance	Reason for Volatility
Borg Warner	-59%	Supplier of new car parts whose demand declines in lean times
Lennar	-29%	Homebuilder, a highly cyclical business
Newfield	-56%	Boom or bust energy exploration business
Devon Energy	-47%	Energy exploration business with success tied to volatile oil prices
AMG	-61%	Equity markets related business with fortunes tied to markets
E-Trade	-60%	Equity brokerage business with fortunes tied to markets
Nektar	-71%	Boom or bust biotech business
Vertex	-49%	Boom or bust biotech business
United Rentals	-67%	Construction equipment rental business that is cyclical
American Air	-56%	Airline business is cyclical and impacted by volatile oil prices
AMD	-70%	Semiconductors – a notoriously cyclical industry
Micron	-50%	Semiconductors – a notoriously cyclical industry
Freeport	-81%	Copper mining business that is cyclical
CenturyLink	-6%	Declining landline phone business and high debt on balance sheet
NRG Energy	-21%	A utility focusing on unregulated business where returns are not guaranteed

*[1] The Volatile stocks listed in this table are **NOT** recommendations and they do not constitute a well-diversified portfolio. They are shown here only to illustrate the differences among stocks when VIX index level rises.*

One look at the comments in the two tables above indicates a pattern that stocks of entrenched companies that sell essential goods and services and that operate in less cyclical businesses hold up well when risk increases, and vice versa. Perhaps more interesting is the fact that we can use our analytical tools to quantify the defensiveness of individual stocks by analyzing their behavior on days when the VIX index goes up. For most balanced investors, asset allocation will remain the most effective way to manage risk but the type of analytical ability described above can add an additional layer of risk control to equity portfolios.

One should be careful not to assume that the stocks labeled defensive are better that those labeled volatile. For one, this analysis was based only on days when the Fear index increased. There will be many days when the Fear index declines and it is quite likely that defensive stocks would underperform on those days. Also, valuation and other important risk factors are not accounted for in this analysis. A defensive stock that is too expensive would likely not be a good stock to buy.

Lately, our concerns regarding high debt levels all around and the removal of liquidity by central banks have been heightened. In light of these concerns, we have used the VIX analysis described above along with other tools at our disposal to modestly increase the defensiveness of our portfolios. We will continue to monitor developments and make additional adjustments as dictated by the changing environment.

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