HOW DEFENSIVE ARE UTILITIES?

Conventional wisdom tells us that utility companies act as ‘defensive’ investments during market downturns. The logic behind this makes sense – utilities are regulated monopolies with steady dividends and guaranteed rates of return. Additionally, power is a relatively inelastic good, so utilities rarely suffer from steep drops in demand.

Last year certainly made the defensive case for utilities. The utility sector was up 0.5% in 2018, while the S&P 500 was down 6.2%. This was an impressive outperformance, especially given many of the sector’s challenges (rising yields, tax reform, CA fires, etc.). But, what if the recent market pullback represented the beginning of a true bear market instead of just a healthy correction? To get an idea of the utilities' real defensiveness, we went back and looked at their relative performance during the Dot Com Bubble and Global Financial Crisis (GFC).

Table 1 shows the length and price declines of the S&P during the two previous downturns. Tables 2 & 3 show the performance of the five largest regulated utilities during those periods.

Table 1: Length and Price of S&P Declines

<table>
<thead>
<tr>
<th></th>
<th>Dot Com Bubble</th>
<th>Global Financial Crisis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Length (Days)</td>
<td>929</td>
<td>517</td>
</tr>
<tr>
<td>S&amp;P Decline</td>
<td>-49.15%</td>
<td>-56.78%</td>
</tr>
</tbody>
</table>

Source: Factset, RIM

Tables 2 & 3: Utility Returns

### Utility Total Return In 2000-2002 Bear Market

<table>
<thead>
<tr>
<th>Peak</th>
<th>Days After S&amp;P Peak</th>
<th>Trough</th>
<th>Days After (Before)</th>
<th>Length (Days)</th>
<th>Price Change (Peak Trough)</th>
<th>Price Change During S&amp;P Bear Mkt</th>
</tr>
</thead>
<tbody>
<tr>
<td>NextEra</td>
<td>26-Dec-2000</td>
<td>277</td>
<td>23-Jul-2002</td>
<td>(78)</td>
<td>574</td>
<td>-36.14%</td>
</tr>
<tr>
<td>Duke</td>
<td>26-Apr-2001</td>
<td>398</td>
<td>9-Oct-2002</td>
<td>0</td>
<td>531</td>
<td>-63.49%</td>
</tr>
<tr>
<td>Southern*</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>131.57%</td>
</tr>
<tr>
<td>Dominion</td>
<td>28-Jun-2002</td>
<td>826</td>
<td>9-Oct-2002</td>
<td>0</td>
<td>103</td>
<td>-44.23%</td>
</tr>
<tr>
<td>Exelon</td>
<td>27-Dec-2000</td>
<td>278</td>
<td>26-Oct-2001</td>
<td>(78)</td>
<td>303</td>
<td>-40.76%</td>
</tr>
</tbody>
</table>

*Southern troughed on March 10, 2000 and appreciated throughout the bear market.

### Utility Total Return In 2007-2009 Bear Market

<table>
<thead>
<tr>
<th>Peak</th>
<th>Days After S&amp;P Peak</th>
<th>Trough</th>
<th>Days After (Before)</th>
<th>Length (Days)</th>
<th>Price Change (Peak Trough)</th>
<th>Price Change During S&amp;P Bear Mkt</th>
</tr>
</thead>
<tbody>
<tr>
<td>NextEra</td>
<td>5-Dec-2007</td>
<td>57</td>
<td>10-Oct-2008</td>
<td>(150)</td>
<td>310</td>
<td>-47.81%</td>
</tr>
<tr>
<td>Duke</td>
<td>13-Dec-2007</td>
<td>65</td>
<td>9-Mar-2009</td>
<td>0</td>
<td>452</td>
<td>-38.88%</td>
</tr>
<tr>
<td>Southern*</td>
<td>18-Sep-2008</td>
<td>345</td>
<td>9-Mar-2009</td>
<td>0</td>
<td>172</td>
<td>-30.43%</td>
</tr>
<tr>
<td>Dominion</td>
<td>5-Dec-2007</td>
<td>57</td>
<td>9-Mar-2009</td>
<td>0</td>
<td>460</td>
<td>-41.33%</td>
</tr>
<tr>
<td>Exelon</td>
<td>10-Jul-2008</td>
<td>275</td>
<td>11-Mar-2009</td>
<td>2</td>
<td>244</td>
<td>-55.02%</td>
</tr>
</tbody>
</table>

Source: Factset, RIM
What do these charts tell us?

The first takeaway from the data is that utility stocks peaked much later than the S&P, particularly during the Dot Com Bubble. In that period, Dominion peaked nearly two and half years after the S&P, and Southern Company had large, positive returns throughout that bear market. The peak to trough periods for utility stocks were much shorter than the S&P’s bear market length.

Secondly, every utility stock outperformed over the course of the S&P’s decline and only Duke Energy had a sharper peak to trough decline (-63.9% vs. -49.15% during Dot Com Bubble). That’s not to say that utilities avoided major peak to trough declines during these bear markets. On an absolute basis, they often experienced 40%+ declines in total return. But, clearly a basket of these 5 utility stocks would have strongly outperformed the overall market over the course of the Dot Com Bubble and GFC.

Other Considerations

Before we rush to buy utilities, there are other factors that must be considered. Most importantly, we must evaluate these stocks in the context of their valuations and the interest rate environment.

Valuation: Utility returns, like all stocks, are ultimately a function of the price you pay. In chart 1, we look at the 20-year history of the utility sector’s forward Price to Earnings ratio. Chart 2 then shows the 20-year history of the sector’s forward P/E relative to the S&P’s. As you can see, the sector is expensive on both a relative and absolute basis. The utility sector trades ~17% above its historical P/E and ~18% above its PE relative to the market. It seems that investors have already begun buying the sector as a defensive hedge against the market.

Chart 1: 20 Year History - Utility Sector
Interest Rates: Many investors hold utility stocks for the strength and stability of their dividends. This means that utility stocks often trade at an inverse correlation to bond yields. As bond yields rise, the dividend yields of utility stocks begin to look less attractive and investors flee. So, we thought it important to measure the sector’s relative performance during the past 5 Fed tightening cycles. Table 4 shows the previous tightening cycles and records their lengths and degrees of change. Table 5 shows how utilities performed during these tightening cycles and how they performed in the 1, 3, 6, and 12 months after these cycles ended. This data show that utilities, on average, underperform (-2.2% annually) during rate cycle hikes and outperform (+2.3% & +5.8%) during the 6 and 12 month periods following a tightening cycle. This could be a bullish indicator, if indeed the Fed has hit the end of its current rate hiking cycle.

Table 4: Fed Tightening Cycles

<table>
<thead>
<tr>
<th>Fed Tightening Cycles</th>
<th>Rate Change (%)</th>
<th>Days</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dec-86</td>
<td>5.88 - 9.75</td>
<td>803</td>
</tr>
<tr>
<td>Feb-94</td>
<td>3.0 - 6.0</td>
<td>362</td>
</tr>
<tr>
<td>Jun-99</td>
<td>4.75 - 6.50</td>
<td>321</td>
</tr>
<tr>
<td>Jun-04</td>
<td>1.0 - 5.25</td>
<td>729</td>
</tr>
<tr>
<td>Dec-15</td>
<td>0 - 2.25</td>
<td>1099</td>
</tr>
</tbody>
</table>

Source: Factset, RIM

Table 5: Returns During and After Fed Tightening Cycles

<table>
<thead>
<tr>
<th>Returns During and After Fed Tightening Cycles</th>
<th>Utilities Relative Performance</th>
</tr>
</thead>
<tbody>
<tr>
<td>S&amp;P 500 Returns</td>
<td>S&amp;P 500 Returns</td>
</tr>
<tr>
<td>CAGR During Cycle</td>
<td>CAGR During Cycle</td>
</tr>
<tr>
<td>+ 1M + 3M + 6M + 12M</td>
<td>+ 1M + 3M + 6M + 12M</td>
</tr>
<tr>
<td>5 Cycles</td>
<td>5 Cycles</td>
</tr>
<tr>
<td>1986-'89</td>
<td>1986-'89</td>
</tr>
<tr>
<td>4.8% -0.2%</td>
<td>7.1% 1.0% 11.7% 21.8% 14.7%</td>
</tr>
<tr>
<td>8.8% 15.8%</td>
<td>14.7% -11.9% -1.2% -2.9% -6.0%</td>
</tr>
<tr>
<td>15.8% 15.8%</td>
<td>15.9%</td>
</tr>
<tr>
<td>1994-'95</td>
<td>1994-'95</td>
</tr>
<tr>
<td>-8.3% -0.9%</td>
<td>-8.4% -4.1% -8.7% -13.6% -15.9%</td>
</tr>
<tr>
<td>0.6% 5.4% 19.9%</td>
<td>0.1% 3.2% 9.3% 19.0% 35.7%</td>
</tr>
<tr>
<td>1999-'00</td>
<td>1999-'00</td>
</tr>
<tr>
<td>5.0% 0.2%</td>
<td>7.8% -0.1% 0.9% -6.4% -12.4%</td>
</tr>
<tr>
<td>11.9% 20.2% 21.3%</td>
<td>-2.7% 0.3% 11.0% 26.6% 33.6%</td>
</tr>
<tr>
<td>2004-'06</td>
<td>2004-'06</td>
</tr>
<tr>
<td>16.4% 5.5% 5.5% 13.9% 22.5%</td>
<td>10.8% 5.0% 0.6% 2.3% 4.4%</td>
</tr>
<tr>
<td>2017 Present</td>
<td>2017 Present</td>
</tr>
<tr>
<td>7.9% -1.9%</td>
<td>6.5% 6.7%</td>
</tr>
<tr>
<td>Average</td>
<td>Average</td>
</tr>
<tr>
<td>3.3% 0.5%</td>
<td>5.4% 2.3% 6.7% 11.5% 14.0%</td>
</tr>
<tr>
<td>0.5% 6.7% 19.9%</td>
<td>-2.2% -3.7% 0.0% 2.3% 5.8%</td>
</tr>
</tbody>
</table>

Source: Factset, RIM
Summary

The utility sector outperformed the market during the previous two major downturns, often by a significant margin. Additionally, the sector has on average outperformed in the 6 and 12 month periods following the end of the last five Fed tightening cycles. However, the sector has not been immune during bear markets. Nearly all utilities we measured experienced significant peak to trough declines during the Dot Com Bubble and GFC. These drawdowns were quicker and less pronounced than the S&P, but they were still painful nonetheless. There is also cause for concern with current utility valuations. The sector trades at large premiums to both its historical forward P/E and to its P/E relative to the S&P. So, while the near-term macro backdrop appears favorable, we caution that valuations could limit the sector’s ultimate upside.

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</tr>
<tr>
<td>Are Not Insured by Any Federal Government Agency</td>
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