Frontier Advisors

Lessons from the US equity market

June 2023

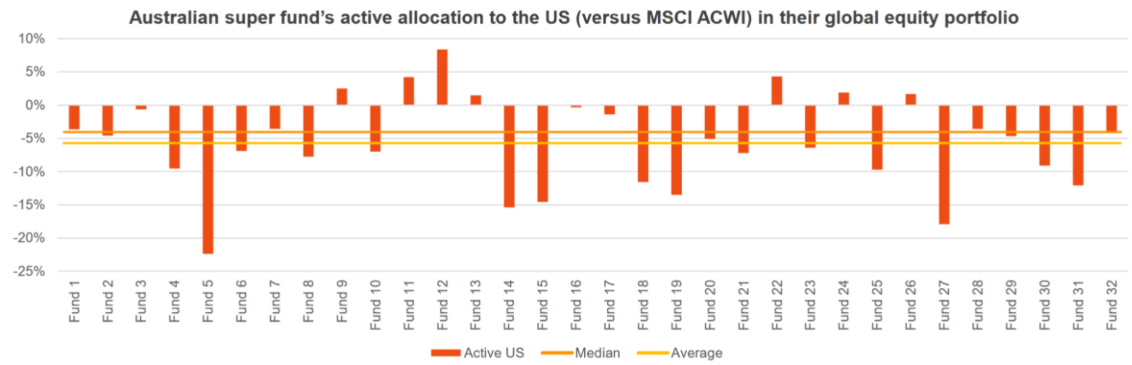
US investors are looking to diversify their domestic equity portfolios to counter increasing stock concentration while emerging markets may be coming back into favour after a long run of underperformance.

These were some of the lessons derived from Frontier's equity team's recent two-week research trip to the US, according to a panel at the annual conference.

"While always important to have the right manager line-up, conviction in your manager selection approach in terms of having the right portfolio construction elements in place will be imperative in order to weather this challenging market environment," Brad Purkis, Consultant, Frontier Advisors, said.

Rising tech stock concentration prompts closer look at new strategies

US pension funds with a home equity bias have benefited over the past decade due to the strength of the S&P 500 and US dollar. However, that strength has weighed down Australian asset owners, with the median investor 5% underweight US equities against the global benchmark.



"This is not a deliberate ploy to be underweight the US – it rather comes about as a result of the active management programs. We have found that global active managers tend to be underweight the US market relative to global benchmarks because of the already significant weight (~60%) in the benchmark alongside the richer valuations US companies have tended to trade on in the recent past," Purkis said.

However, Purkis noted that US equities and the dollar underperformed in the previous decade while new risks were emerging today, such as the outsized index weight of tech stocks. Microsoft and Apple represent about 13.4% of the S&P 500 while FAAMG stocks (Facebook, Apple, Amazon, Microsoft and Google) make up about 20.8%.

"Allocators were increasingly looking to other areas in the market, such as international strategies, global small-cap and mid-cap strategies, as well as emerging markets to diversify this risk away from what are quite large constituents in their home benchmark."

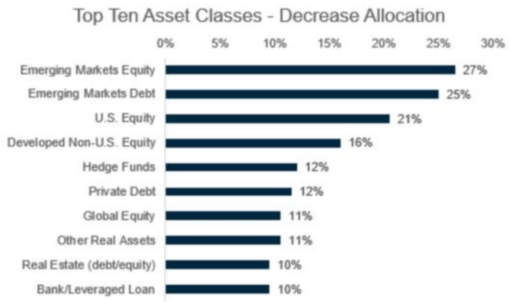
A return to emerging markets?

The US research trip also revealed potential renewed interest in emerging markets after more than a decade of challenging performance relative to developed markets, amplified by geopolitical issues, such as Russia's invasion of Ukraine and concerns about China.

A number of emerging market managers had noted an increase in RFPs while concern about China had also reduced, said Simone Gavin, Senior Consultant, Frontier Advisors.

"Talking to managers in the US, several described concern from their clients over the past couple of years relating to holdings in China, but they hadn't received calls this year, perhaps meaning concerns had eased with the re-opening of China," Gavin said.

Chinese stocks sold off sharply late last year but rebounded after the end of its zero-COVID policies which had shut down the economy. Prior to the re-opening, a Cerulli Associates client survey suggested investors planned to severely cut their emerging market allocations over the next two years from already low levels.



Source: Cerulli Associates

Closer to home, the largest 32 Australian super funds had a wide dispersion in emerging market and Chinese equity exposure leading to significantly different global equity portfolio performance, according to Frontier research.

While China only makes up about 3.5% of the MSCI ACWI, its volatile performance and low correlation to developed market equities has meant that the choice to exclude or significantly underweight Chinese equities is leading to ever increasing tracking error levels, Purkis said.

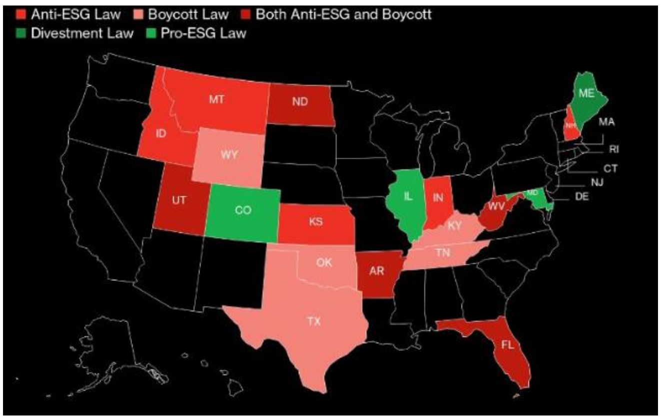
"While the proposed changes to the Your Future, Your Super legislation benchmark is allowing super funds to create a standalone EM sleeve to reduce the overall benchmark risk that funds face, we still see it as a key source of peer risk between funds who are looking to outperform each other within that international equity space," he said.

The politicisation of ESG

The US political landscape continues to be a headwind to the broad adoption of ESG principles across the country with some states passing legislation to limit ESG investing or prohibit state governments from doing business with financial institutions that adopt certain 'pro ESG' policies. However, regulations relating to sustainability are increasingly being rolled out by the Securities and Exchange Commission ("SEC").

The chart below illustrates the current state of play (June 2023) and how the political climate is creating a minefield for investors, asset managers and companies.

ESG Laws by US State



Source: BloombergNEF (June 2023), State Legislature

“The political backdrop is fragmented, which has been a significant headwind for the country to move forward on decarbonisation in any clear way,” Gavin said. “Our key takeaway from all this is, despite this backdrop, pleasingly there's currently momentum around US ESG regulation with the SEC expected to finalise three rules pertaining to ESG this year related to disclosures.”

This fractured landscape means US-based fund managers must perform a delicate balancing act to avoid alienating either the pro or anti-ESG camps. Managers held a wide variety of views with one suggesting ESG should be regarded as a ‘value’ or ideology and was best kept separate to investing. Interestingly one manager noted that the focus on impact resonates with the middle of the country which is much more interested in new technologies and financing and likes the idea of being part of it and innovation. While the West Coast and East Coast were noted to be much more open to discussions on net zero and stewardship. Anecdotally it sounds like many clients want to understand how components of ESG have added value and are trying to work out what it means for them.

While all managers were aware of the US Inflation Reduction Act (IRA), which will propel forward renewable energy projects and help tackle climate change, responses from the managers about beneficiaries and the opportunities differed greatly.

“We found those with particular experience investing in commodities – specialists with knowledge of the energy transition for example – were able to provide very clear intelligence on the companies that were benefiting,” Gavin said. “Notably, though, it wasn't just the so-called experts on climate transition that were across it, but specific managers across the spectrum of our peer group, including a buy-rated small caps manager.”