

# Session 6: Equities: On the road again – US perspective

2023 Frontier Advisors Annual Conference

Chair:



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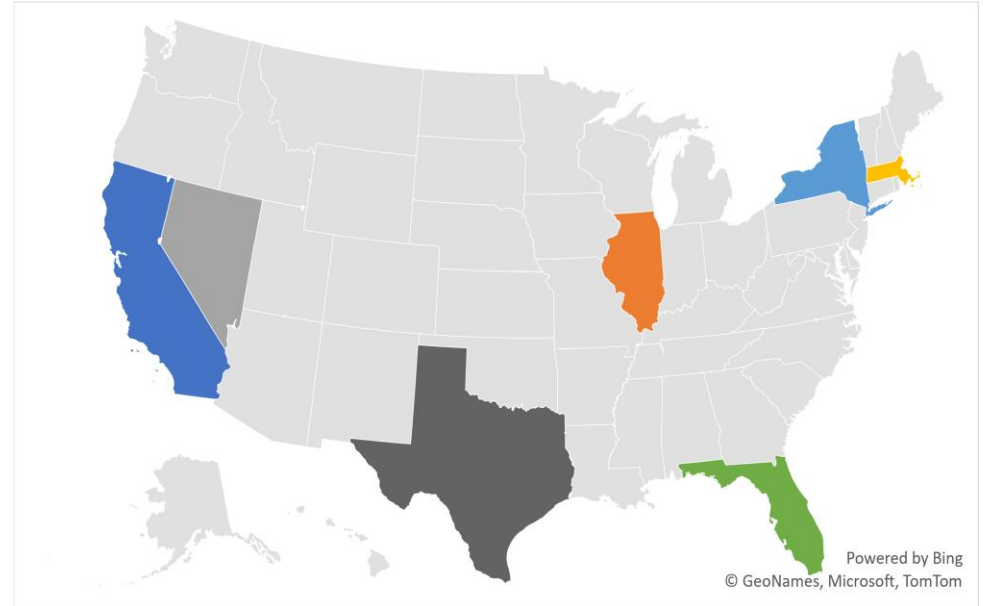
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# Frontier Equities US Trip 2023

## Key priorities

- Onsite manager monitoring
- Idea generation/new opportunities
- Relevant perspectives for Australian investors
  - Portfolio construction
  - ESG
  - Emerging thematic

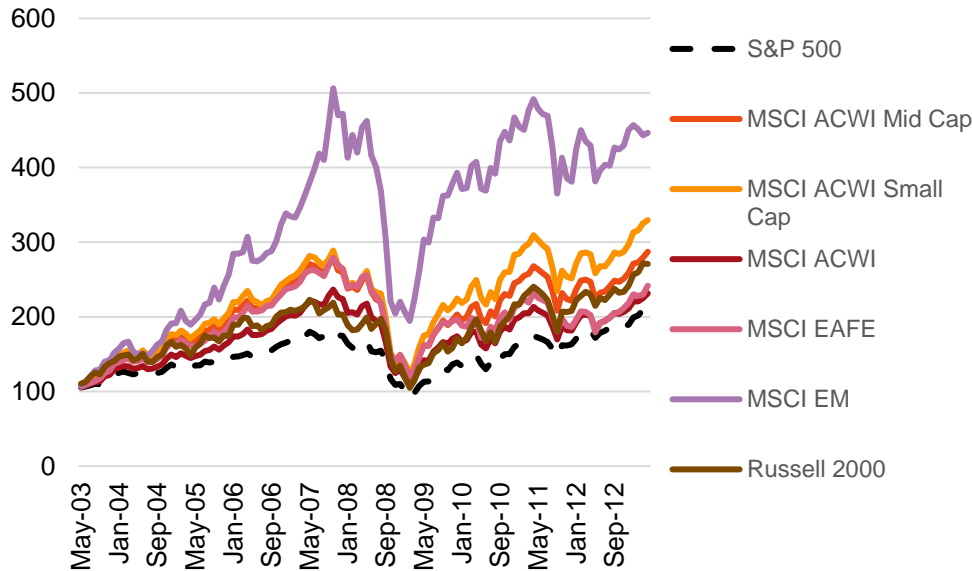


# Portfolio construction insights

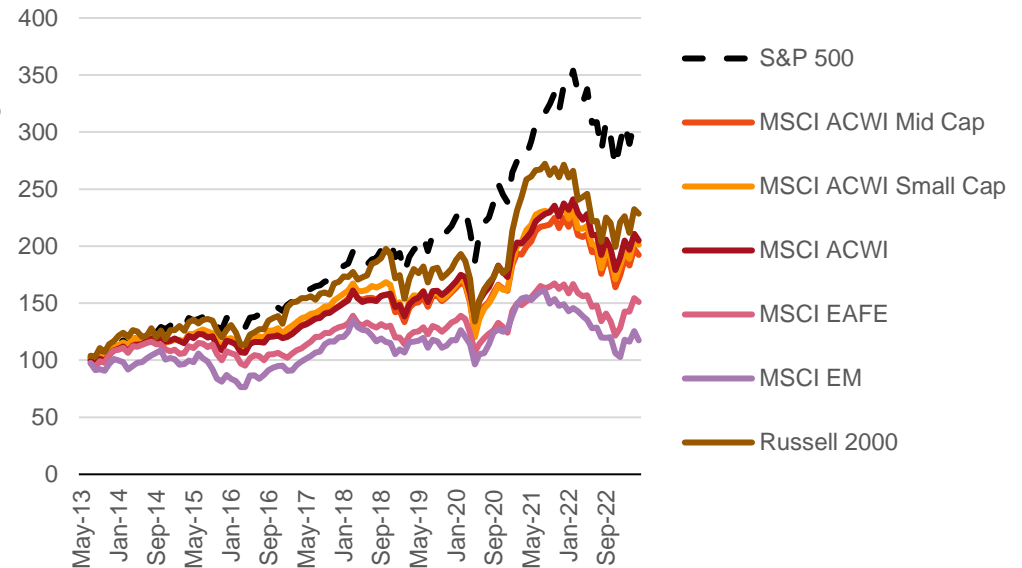
# Portfolio construction insights

## Setting the scene – A tale of two decades

Cumulative performance of S&P 500 and various other indices May 2003 – May 2013 (USD)



Cumulative performance of S&P 500 and various other indices since May 2013 (USD)

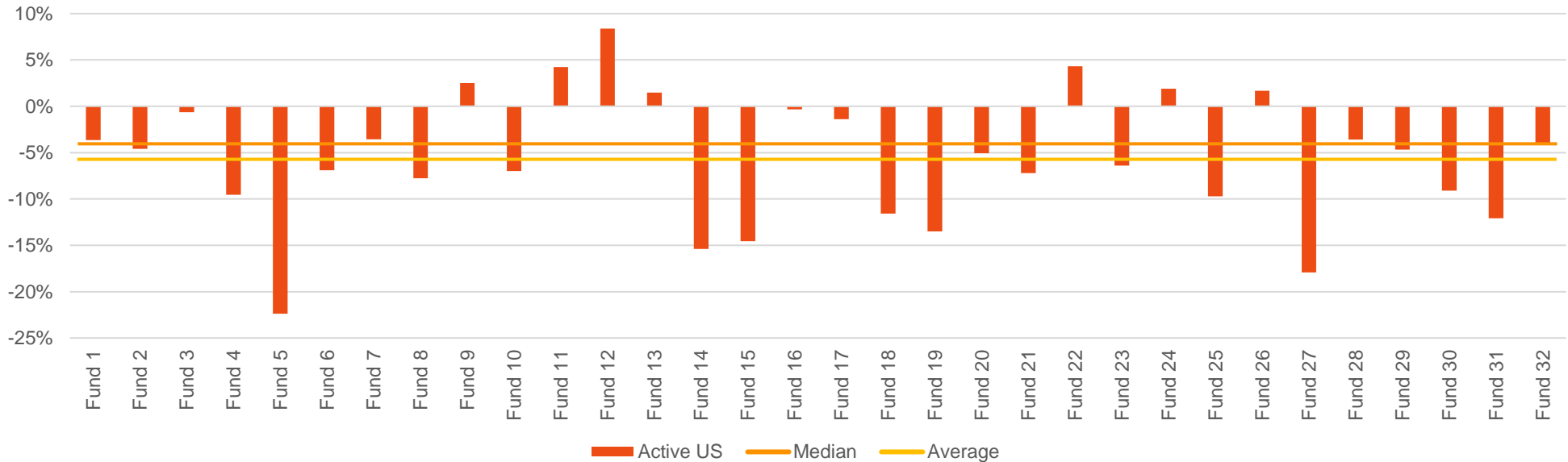


- Over the past 10 years, US-based asset owners have faced a dilemma where any attempt at diversification away from their home market has resulted in lower overall returns.

# Portfolio construction insights

## Australian-based investors have faced significant return headwinds

Australian super fund's active allocation to the US (versus MSCI ACWI) in their global equity portfolio

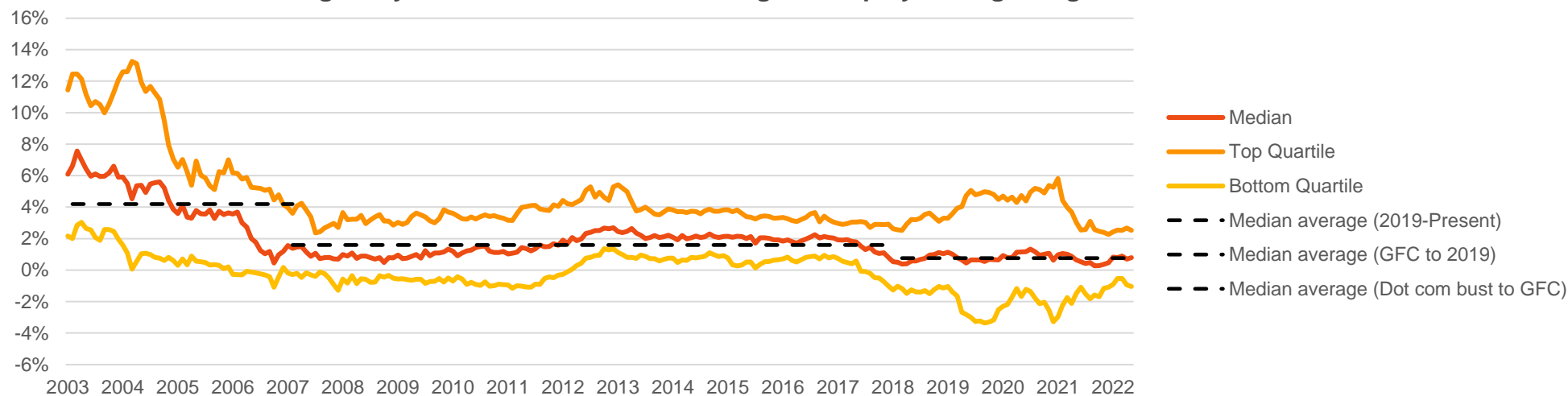


- Over the past decade, for US investors, being underweight in US equities has been thought of from a nominal return perspective which has been a disadvantage to investors.
- For Australian investors, the underweight to US markets is largely a result of active management programs as opposed to an explicit decision.

# Portfolio construction insights

## The active management industry has been challenged

Rolling five year median excess return of global equity managers against the MSCI ACWI



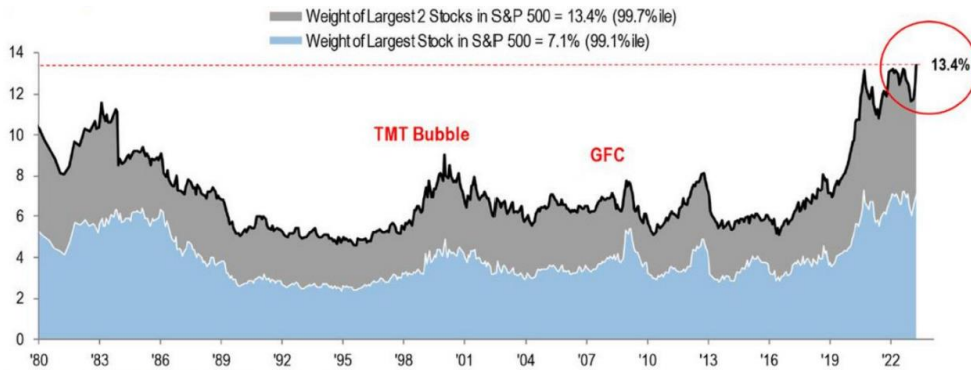
Source: Frontier cleansed universe, eVestment

- Challenging conditions in the US have produced headwinds for global active management alpha.
- Passive fund flows into mega-cap stocks commonly cited as a contributor.
- Having the right equity managers matters a lot in uncertain times.

# Portfolio construction insights

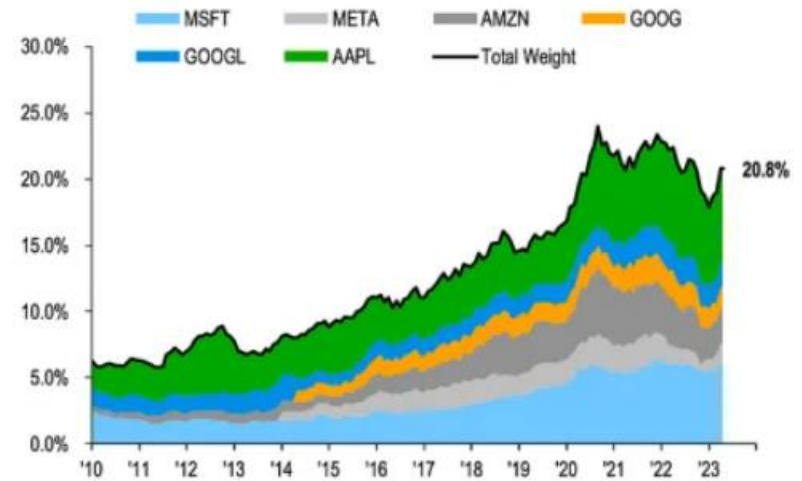
## Emerging concentration risks for investors

Weight of the two largest stocks in S&P 500 (MSFT and AAPL)



Source: Goldman Sachs

Weight of FAAMG in S&P 500



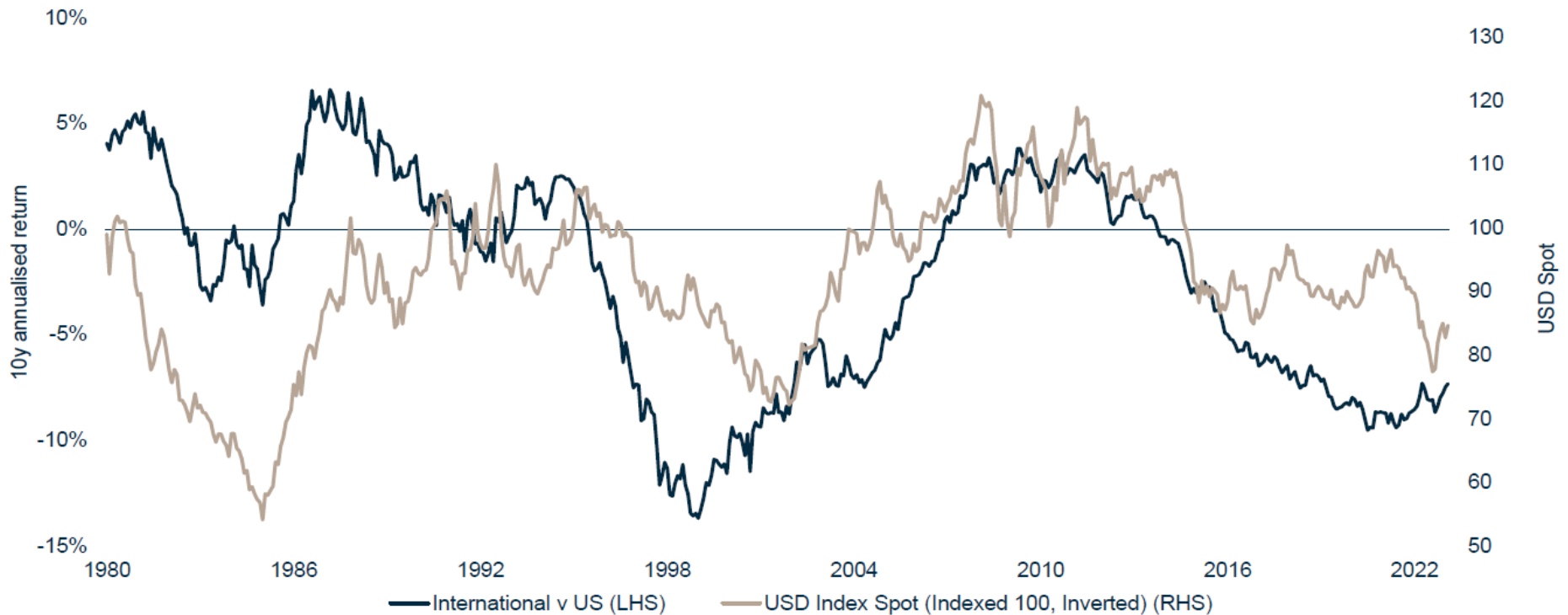
Source: JP Morgan Equity Macro Research

- Growing weariness of index concentration in both US and global indices.
- Growing interest in the US in areas outside of large-cap growth.

# Portfolio construction insights

## Growing interest in international strategies from US investors

In the past, USD weakness has correlated with non-US outperformance





# Portfolio construction insights

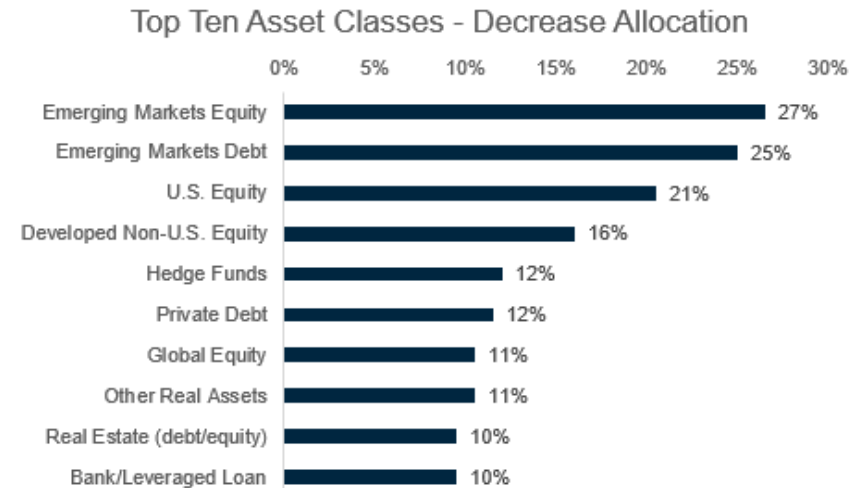
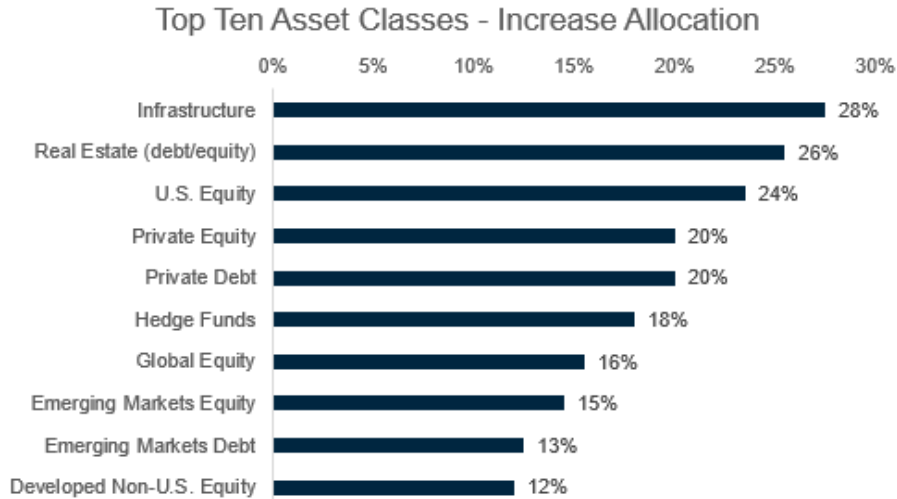
## Key takeaways for Australian investors

- The US is home to the largest pension system in the world.
- US-based investors are growing weary of rising levels of index concentration and decade of US dollar strength.
- Growing interest in ex-US ex-large cap growth strategies from US investors.
- This represents an emerging opportunity for Australian investors.
- Frontier's manager research program is focused on return enhancing strategies.

# Emerging market equities insights

# Emerging market equities insights

## Renewed interest in emerging markets (EM)/China?



Source: Cerulli Associates

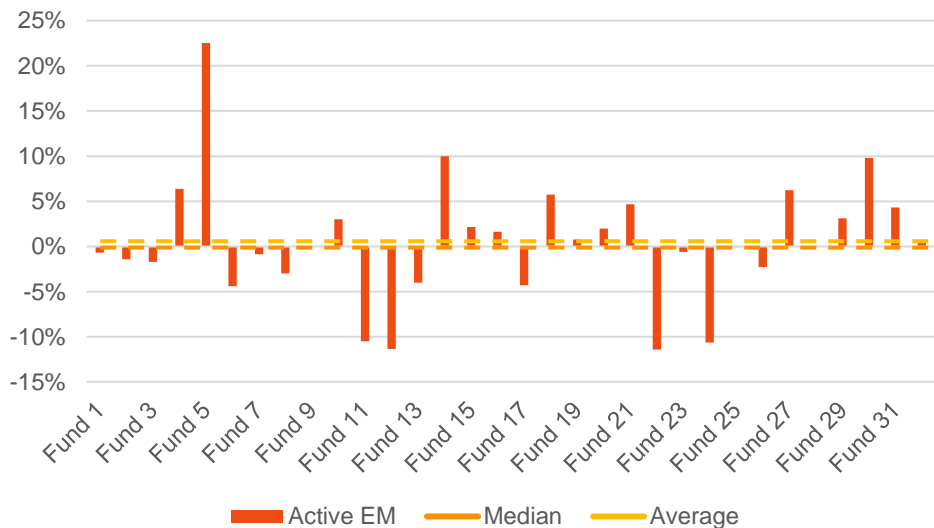
- A challenging decade for emerging markets.
- Client concern heightened in 2021 and 2022.
- Managers noted an increase in RFPs from potential clients.
- However, Cerulli's chart indicates an expected reduction in emerging markets equity.

# Emerging market equities insights

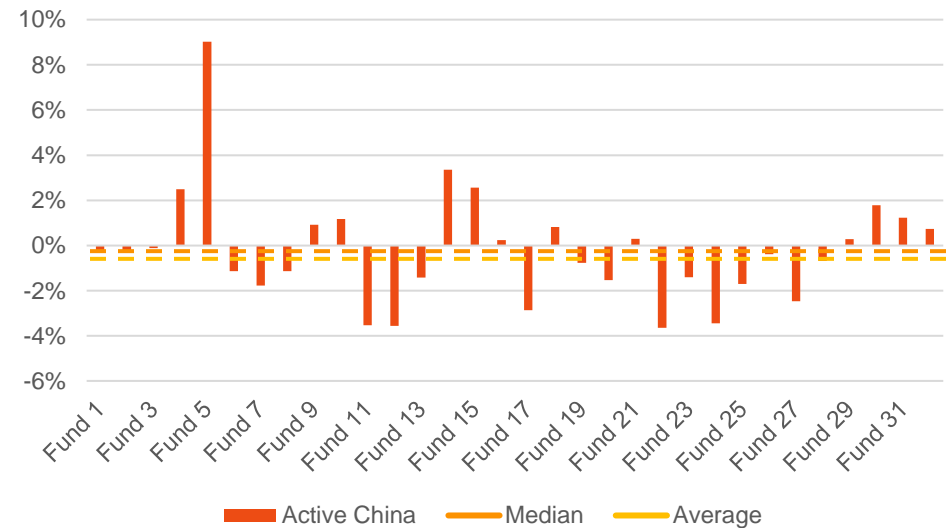


## Australian asset owner exposure

Super fund active emerging markets exposure (versus MSCI ACWI) at 31 December 2022



Super fund active China exposure (versus MSCI ACWI) at 31 December 2022



- Wide dispersion in the emerging market and Chinese equity exposure of super funds.
- This is a significant factor in the relative returns profile of Australian investors' global equity portfolios.

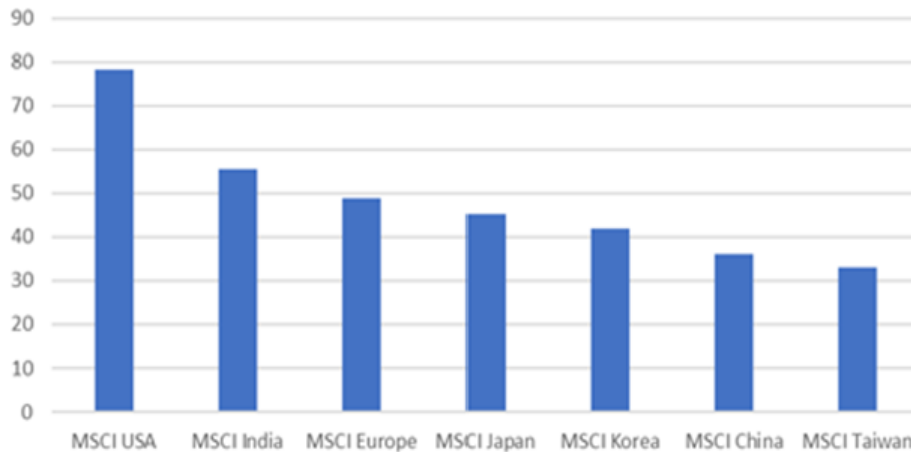


# Emerging market equities insights



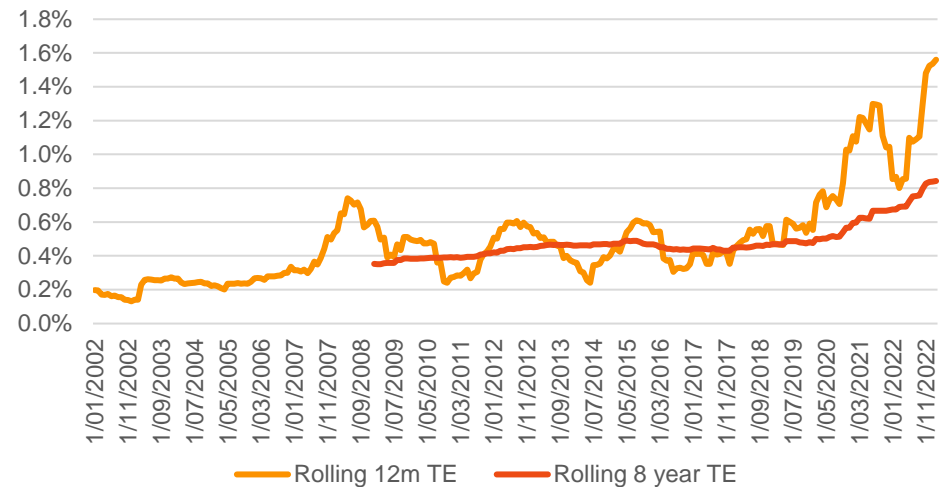
## Tracking error considerations

Estimated institutional ownership (%) of float



Source: Vinva Investment Management

Tracking error between MSCI ACWI ex-China and MSCI ACWI



Source: Bloomberg, Frontier Advisors

- A lack of flows into emerging markets and China has resulted in significant institutional under ownership.
- China represents a growing source of tracking error for institutions.



# Emerging market equities insights

## What does this mean for Australian investors?

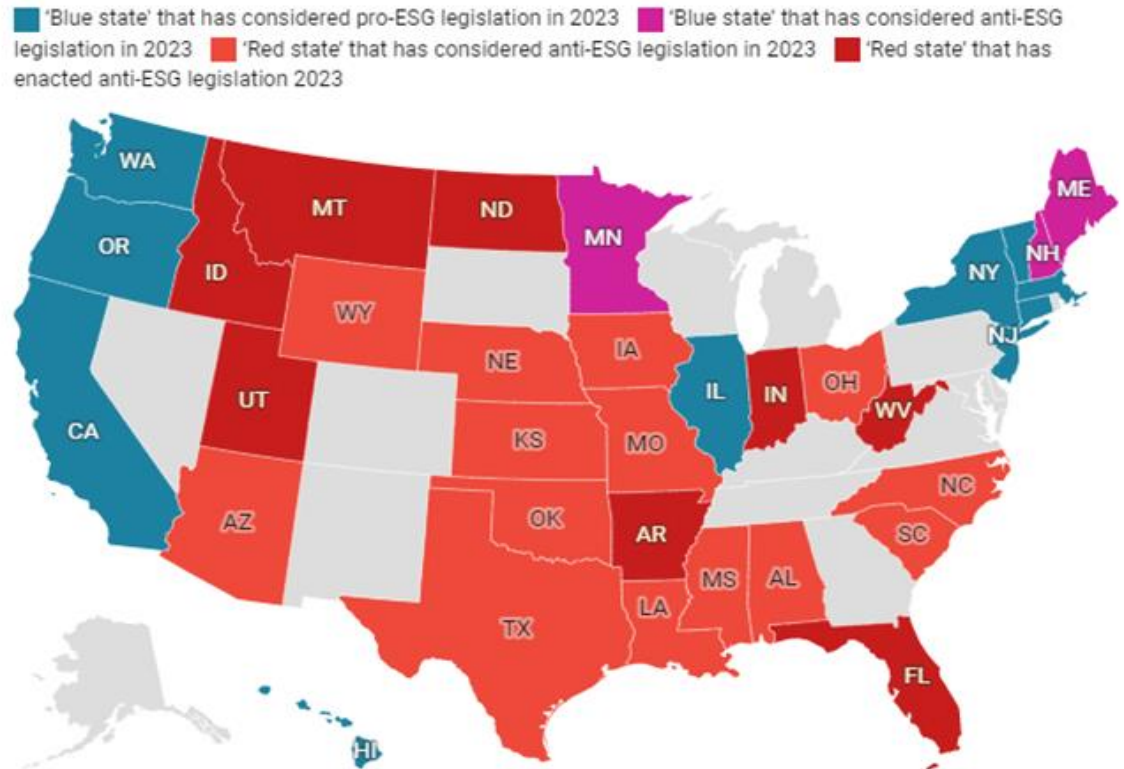
- US investors' allocations to China and emerging markets is very low relative to historic levels.
- Australian investors' allocations to emerging markets and China show high levels of dispersion.
- The exclusion or under allocation to Chinese equities can have an outsized impact on the overall tracking error in Australian investors' international equity portfolios.
- Does the reopening rally in Chinese/emerging market equities signal future return potential if US investor appetite materialise from increased activity levels viewed?

# Environmental, social and governance insights

# ESG insights

## The politicisation of ESG

- Regulations relating to sustainability are increasingly being put in place.
- ESG means different things to different groups.
- The fragmented and partisan political backdrop has been a headwind.
- Frontier will continue to monitor these developments and question managers about them.
- Australia may look to the US for guidance on some of its regulation settings.



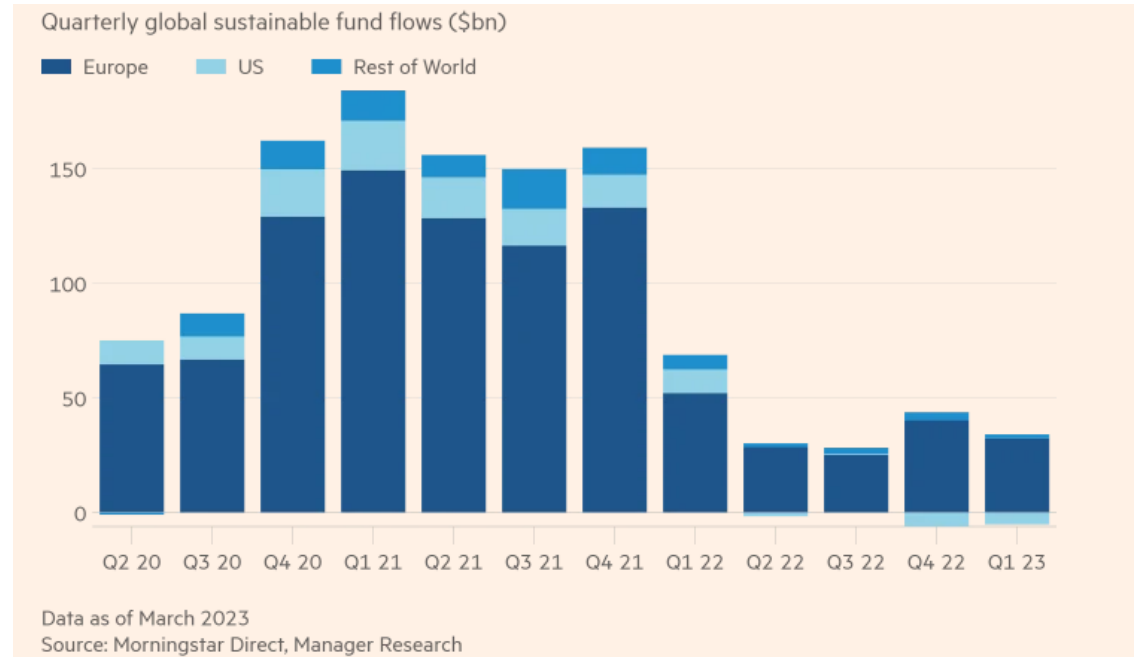
Source: [Harvard Law School Forum on Corporate Governance, State Net](#) • [Get the data](#) • Created with [Datawrapper](#)



# ESG insights

## US interest in 'green' funds

- US interest in 'green' funds negatively impacted by the political landscape.
- BlackRock removed iShares ESG Aware US ETF from its model portfolio.
- MSCI changed its methodology on ESG in March 2023 which led to hundreds of funds being stripped of their ESG ratings and thousands more downgraded.
- Frontier will continue to test managers on their ESG integration based on our own objective, proprietary assessment model.



# ESG insights

## Perspective from managers

- Managers are expected to perform a delicate balancing act to avoid alienating either the pro- or anti-ESG camps.
- Communication or marketing to clients may vary depending where clients are based.
- ESG integrated from the basis of better long-term risk-adjusted returns rather than being ‘values’ based.

‘Clients felt they had to ask questions about ESG but there was no genuine interest’

‘ESG should be regarded as a ‘value’ or ideology and kept separate to investing’

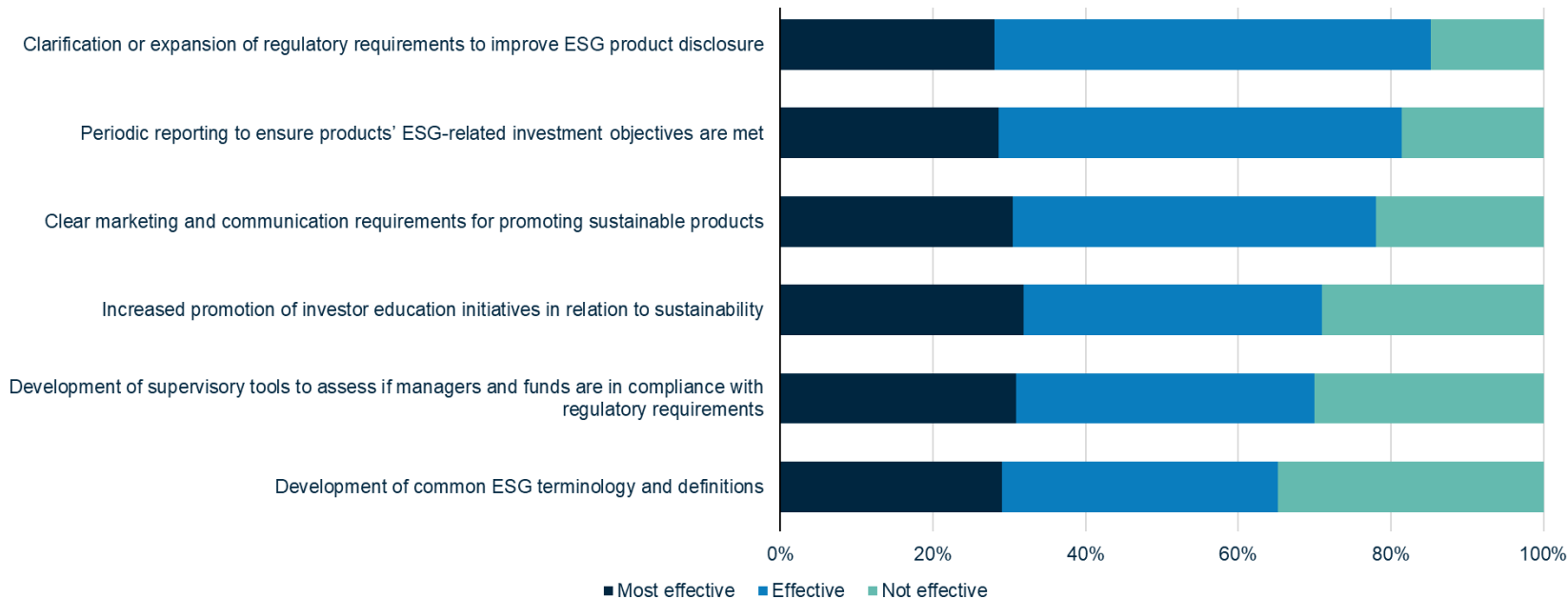
‘East Coast and West Coast clients are more open to discussions on net zero, stewardship’

- Clients with ambitions to enhance their ESG approach should seek fund managers that have a strong alignment with their own values and beliefs around sustainability.

# ESG insights

## Increased regulatory actions to curb greenwashing

- Greenwashing concerns with a number charged by the SEC.
- Cerulli conducted a survey on effective means of curbing greenwashing.
- There may be a greater dispersion in the future between those managers that incorporate ESG and those that don't.



# ESG insights

## The IRA and its opportunities

- The US Inflation Reduction Act (IRA) is an important move by the current federal government in helping to tackle climate change.
- There will be broad-based beneficiaries from the IRA including beneficiaries outside the US.
- All managers are aware but responses from beneficiaries and the opportunities differed greatly.
- Frontier will continue to test managers and their efforts in keeping up with regulation and assessing the resulting risks and opportunities.

# ESG insights

## Key takeaways

- Clients with ambitions to enhance their ESG approach should seek fund managers that have a strong alignment with their own values and beliefs around sustainability.
- There may be greater dispersion in the future between managers that incorporate ESG and those that don't.
- Frontier's ESG scorecards on managers help clients better understand a manager's integration of ESG and focus on engagement as well as its disclosure.
- The ISSB's standardisation of ESG disclosures will help managers navigate this and Frontier will monitor developments closely.

## Frontier's RI philosophy:

*“We integrate responsible investment considerations into our processes because incorporating environmental, social and governance (ESG) factors provides another lens to allow clients to manage risks better and generate sustainable long-term returns.”*

# Thank you for joining us.

## 2023 Frontier Advisors Annual Conference

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