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International

Global research and insights from Frontier Advisors

Observations on Equities

Northern American Research Trip

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Frontier regularly conducts international research trips to observe and understand more about international trends, and to meet and evaluate first hand a range of fund managers and products.

In conjunction with insights we share with our Global Investment Research Alliance partners, these observations feed into our extensive international research library.

This report provides a high level assessment on the key areas and observations unearthed during this recent research venture. We would be pleased to meet with you in person to provide further detail on these observations.

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Do the recent market movements indicate an inflection point for equities markets?

Trends observed in global equity markets have been reasonably consistent over the last five years, with growth outperforming value, developed markets outperforming emerging markets and defensives outperforming cyclicals. These trends mainly reflect low global growth expectations, concerns of a China "hard landing", and investors' preference for yield and companies with more stable earnings profiles. In the March 2016 quarter, investor market fears moderated, market sentiment improved and many of the negative performance trends reversed; significantly in some areas (for example, in emerging markets).

Table 1: Performance of developed versus emerging markets and growth versus value

	5 years to Dec 2015	March 2016 quarter
DM minus emerging markets[1]	8.8%	-4.7%
Growth minus value[2]	2.1%	-1.0%

1. MSCI World ex-Australia Index minus MSCI Emerging Markets Index (LC)
2. MSCI World Value minus MSCI World Growth (LC)

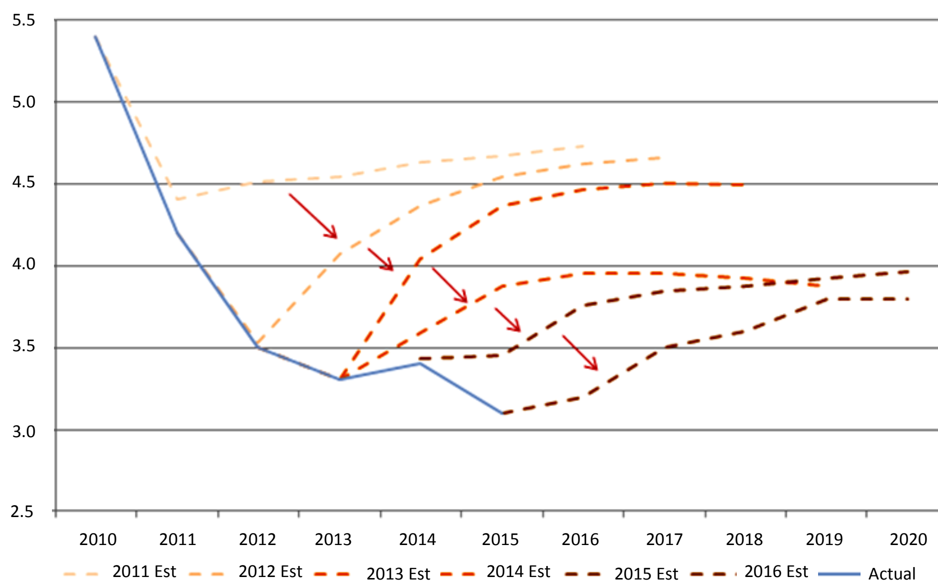
Members of Frontier's equities team recently visited around 40 investment teams over a two-week period in North America. We met with a broad spectrum of managers, including managers that have benefited from these market trends (i.e. high growth managers with an overweighting to strong-performing segments such as information technology and consumer staples) as well as those that have not benefited (i.e. deep value managers with an overweighting to weak-performing segments such as energy and emerging markets).

Meeting an eclectic group of managers gave us the opportunity to compare and contrast different views on whether the recent equity market reversal could be the beginning of a new trend – where emerging markets outperform developed markets, where value outperforms growth and where cyclicals outperform defensives.

Manager views

Regardless of the managers' view on the timing of reversal in equity market leadership, there was near unanimous support that such an event would be based on an improvement in macroeconomic factors, or at least some market acknowledgement of already improving macroeconomic factors (this was a comment made by a number of deep value managers). This included factors such as economic growth – see Chart 1 for IMF global growth expectations, which forecasts a slow rise in global economic growth in coming years.

Chart 1 – IMF global growth expectations



Source: Epoch, IMF World Economic Outlook

Some managers talked about a number of secular headwinds like deleveraging, demographic challenges, weak productivity growth and China's rebalancing.

Many of these managers (typically growth managers) believe mean revision built around improving macroeconomic fundamentals is potentially some time away. Specific comments made by these managers include:

- "There remains too much uncertainty in macroeconomic factors."
- "Given the current macroeconomic backdrop, interest rates (and yields) will remain low."
- "It is likely the world is in for an extended period of low interest rates with little likelihood of broad based economic growth."

While these managers acknowledge that sentiment has improved, particularly in many of the "unloved" market segments, the general expectation is that this will be short-lived and markets are not at an inflection point.

This is because the macroeconomic picture does not support a sustainable recovery.

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Counter views

A few managers, mostly those whose portfolios stand to benefit from an inflection in equities (i.e. deep value and emerging market managers), appeared more hopeful than confident that equity market leadership was reversing or that the recent reversal was sustainable. Our sense was that many managers (in particular value managers) are a little "gun shy" having observed a number of false dawns since the GFC.

Those managers that expect the recent reversal in equity market leadership continue to do so because: 1) they tend to be more positive on the macroeconomic picture (i.e. growth will be stronger than the market expects and central banks are unlikely or unable to push interest rates further down); and 2) despite the slight recovery in the March 2016 quarter, the valuation equation remains sharply in favour of these segments of the market.

One manager tied the potential for an inflection to the consumer, whose confidence has been boosted by cheap debt, cheap energy and low unemployment. This manager went on to comment that microeconomics and reform are more important for a normalisation in equities markets, highlighting that the uncertainty created by banking regulators has sent mixed messages (requiring banks to hold more capital, while trying to encourage them to lend more, for example).

Portfolio positioning

Of the managers we met with, portfolios have not been changing materially. Underperforming managers have not repositioned their portfolios specifically to benefit from a continuation of the trends observed in the past few years, and alternatively, few outperforming managers have repositioned their portfolios to benefit from a reversal in the trends of the past few years. In that respect, we saw global equities managers that have not owned emerging markets stocks at all continue to do so, while other global equities managers retained their large over-weightings to emerging markets.

As a result, most manager fortunes continue to be tied to the same factors which have either helped or hindered their relative performance since the GFC.

There was one growth-at-a-reasonable price (GARP manager which is now "emphasising" value (at the expense of growth) because of its view that growth has become too expensive. But this was the exception, with most managers still biasing their portfolios towards either high P/E growth or low P/E value, depending on their specific investment style.

Frontier's view

Historically, Frontier's preference has been to encourage diversity in international equities configurations, with a bias to value and emerging markets.

As is often the case, the 40-odd investment managers we met with had differing views on the outlook for the equities sector, particularly with respect to a reversal in equity market performance. We are therefore inclined to focus on valuation data, which suggests that value looks more compelling than growth and emerging markets look more compelling than developed markets over a longer time horizon.

The value factor has been shown to exhibit positive return premiums over a long period of time, and across all completed cycles since the early 1970's.

The outperformance of growth and underperformance of value over recent years has seen the valuation multiples of sectors such as healthcare, telecommunication services and consumer staples above their long-term averages. Conversely, valuation multiples of value sectors, energy and materials, are trading below their long-term averages. A reversion to long-term valuation multiples, such as has occurred in the past, should benefit the undervalued sectors, and by implication, the value investment style.

Emerging markets have underperformed the broader market over the past five years, reflecting factors such as weaker than expected growth in China and falling commodity prices. This has seen foreign lending to emerging markets fall to low levels, resulting in their exchange rates falling materially as well. This has, in many cases, restored competitiveness to these economies – historically a pre-condition for outperformance on a medium-term basis.

From a valuation perspective, emerging markets are attractively priced, and investor sentiment toward emerging market equities is extremely negative. We expect these factors will provide a platform for outperformance at some stage.

Our recommendation to structurally overweight emerging markets and value reflects our desire to harvest long-term positive return premiums. That being said, we believe relatively positive (or improving) fundamentals, combined with the underperformance of these segments over the past five years, does provide a platform for improved performance on a medium term basis.

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