The Frontier Line

Thought leadership and insights from Frontier

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Global equities performance

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About us

Frontier has been at the forefront of institutional investment advice in Australia for over 25 years and provides advice on $600 billion of assets across the superannuation, charity, public sector, insurance and university sectors.

Frontier's purpose is to empower our clients to advance prosperity for their beneficiaries through knowledge sharing, customisation, technology solutions and an alignment and focus unconstrained by product or manager conflict.

Brad Purkis

Associate

Brad joined Frontier as an associate in 2021, his responsibilities include both equities research and client support. Prior to joining Frontier, Brad worked for five years at Intrinsic Investment Management as a research analyst before moving into the role of assistant equity analyst covering the industrials sector of the ASX200. Brad graduated from Monash University with a Master of Applied Finance following on from a Bachelor of Commerce from Deakin University majoring in economics, finance and quantitative business analysis.

Fraser Murray

Head of Equities

Fraser joined Frontier in 2012 and is the Head of Equities. He was previously at Ibbotson Associates/ Intech Investments for nearly 15 years where he held a variety of roles including five years as Head of Manager Research and five years as Head of Equities and Property. Fraser started his asset consulting career at Towers Perrin in 1994 as a Research Analyst in its Melbourne and London offices. Fraser holds a Bachelor of Commerce with Honours from the University of Melbourne and a Graduate Diploma of Applied Finance and Investments from Finsia, and is a Fellow of Finsia.

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Introduction

The 2021/2022 financial year has seen the world and investment markets encounter significant events.

As far as investment returns are concerned, one of Frontier's most notable observations is the challenge experienced by asset owners keeping up with the performance of global equities indices. This includes MSCI ACWI (the benchmark used by most investors and adopted as part of the *Your Future, Your Super* measurement).

The first point to appreciate is that alpha patterns (the degree to which managers outperform common indices at various points in time) are cyclical and there are periods when the index can be hard to beat. Conversely, there are other periods where it is far easier to beat an index. For example, in the 2018/2019 financial year, virtually all Australian equities portfolios of investment managers and asset owners did not keep up with the S&P/ASX 300 Index. At that time, a confluence of factors made it difficult to beat this index and the Median Manager in the Mercer Australian Equities survey was around 3% behind the Index. One of the most significant factors was that the largest stocks led the S&P/ASX 300 Index making it very hard to beat an index with weights assigned based on market cap.

Frontier has observed that the 12 months to 31 March 2022 has proven to be one of the most difficult performance periods for global equities investment portfolios to keep up with the index. The Median Manager in the Mercer International Equities survey has returned 7.6% and is -1.2% behind the MSCI ACWI (8.8%). For those investors still using the MSCI World Index, this has returned 11.6% and the Median Manager is an eye-watering -4.0% behind this Index return.

This period encompasses the first nine months of the 2021/2022 financial year, so we expect this financial year is on track to deliver an outlier result like we saw three years ago in Australian equities. This is important for all investors given the typical size of allocations to overseas equities. For superannuation funds in particular, given the benchmarking of *Your Future, Your Super*, this development is important and should be noted and monitored as the financial year closes out.

Table 1

Index	1 year return (%)
MSCI ACWI	8.8
Mercer Median	7.6
Relative performance	-1.2
% Managers ahead of MSCI ACWI	38%
% Manager ahead of MSCI World	20%

Factors contributing to the underperformance in global equities

Country/region allocation

The US market has been the strongest market in the past year and consistent with history, managers are, on average, underweight the US market. Today, the US market represents over 60% of MSCI ACWI (and this has been growing in stature). This was discussed in our February 2022 research paper on global active management. Many asset owners are overweight emerging markets in their global equities portfolios and emerging markets lagged developed markets by a large amount. Emerging markets are lowly represented in the MSCI ACWI (around 10%) and Frontier, along with other advisors, recommended a more meaningful weight such as 15-20% as we believe this will be beneficial over time. Unfortunately, in the past year, emerging markets have comprised Russian stocks (effectively written down to zero value) and China (which has performed poorly due its regulatory crackdown).

Table 2

Index	FYTD return (%)	1 year return (%)
MSCI ACWI	-0.1	8.8
MSCI USA	4.4	15.3
MSCI ACWI ex-US	-6.6	-0.1
MSCI EM	-15.7	-10.1

Sector allocation

We have seen increased prices in a range of commodity markets, at least partly due to flow-on effects from the Russian invasion of Ukraine. This has resulted in a significant performance rebound in the more capital-intensive cyclical sectors, particularly energy (up 33% v MSCI ACWI in the past year). In the past five years, many investment managers and asset owners have been responding to the world's decarbonisation initiatives and have been reducing the level of carbon emissions in their portfolios. Frontier's observation is that many investment managers and asset owners are underweight to these high emitting capital intensive segments of the market and are underperforming through this rebound.

Table 3

Index	FYTD return (%)	1 year return (%)
MSCI ACWI	-0.1	8.8
MSCI ACWI Energy	24.3	42.0
MSCI ACWI Materials	1.2	13.6
MSCI ACWI Utilities	9.3	19.0

Style balance in portfolios

- Many investment portfolios have drifted away from the value style and have more growth style exposure. The past decade has seen the growth style significantly outperform the value style. The growth style can often comprise of large exposures to sectors like information technology and health care, while the value style usually includes financials and many of the cyclical sectors, such as energy, materials and industrials.
- There has been insufficient rebalancing to be positioned for the style reversal of recent months. Frontier has encouraged investors to maintain a portfolio which is balanced across style factors. This was discussed in our May 2020 Value Matters paper and April 2020 rebalancing considerations paper. Retaining a style balance in the past decade has required steadily taking profits from growth investments and redeploying those proceeds to the value style. It is important to appreciate that, for much of the past decade, diligent rebalancing of styles has actually been costly to performance. In a world of disruption and decarbonisation, minimal rebalancing had been a far more effective strategy for performance delivery than regular rebalancing. However, this is contributing to underperformance now.
- Many funds do not have a meaningful exposure to the 'deep value' style. A tendency of the past decade has been for asset owners to allocate funds to value managers that have a 'moderate value' style. In broad terms, these moderate value managers can be described as managers that balance quality with value in their stock selection. While this is certainly a highly credible investment style, in the past 12 months, it has not helped to limit or not invest in a 'deep value' strategy that is more willing to own the cyclical, capital intensive, high emitting and generally unpopular segments of the market.

Table 4

Index	FYTD return (%)	1 year return (%)
MSCI ACWI	-0.1	8.8
MSCI ACWI Growth	-4.2	6.9
MSCI ACWI Value	3.8	10.4

Market capitalisation effect

- Over the years, Frontier has observed a tendency for global active managers to seek alpha/outperformance opportunities further down the market cap spectrum. There has been a common belief (backed up by historical evidence) the market becomes less efficient further down the cap spectrum which has often led active managers to be underweight mega and large-cap companies and overweight mid and small-cap companies.
- While many funds seek to balance their international equities portfolio with a combination of active manager types, less consideration is typically given towards the balance of size within a portfolio. As a result, funds with a higher proportion of active management, on balance, exhibit a tendency to be overweight in the mid and small-cap area of the market at the expense of the mega and large caps. This has proven costly in the current environment.
- Over the 12 months to 31 March 2022 there has been a significant divergence of performance between large caps and small caps which has been a headwind for active managers.

Table 5

Index	FYTD return (%)	1 year return (%)
MSCI ACWI	-0.1	8.8
MSCI ACWI Large Cap	0.5	9.6
MSCI ACWI Mid Cap	-3.4	4.7
MSCI ACWI Small Cap	-5.7	1.1

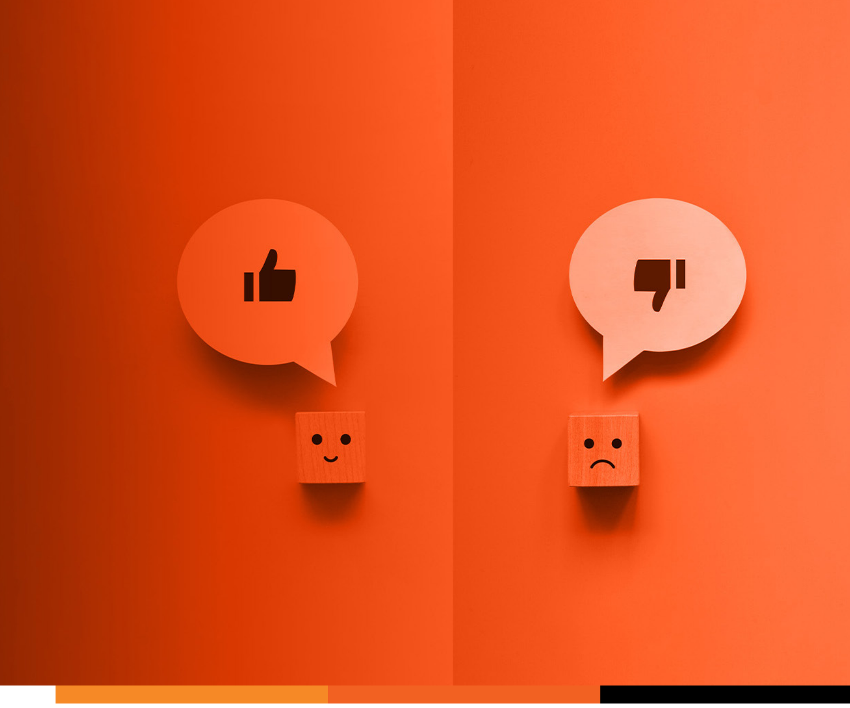
Market concentration

- We discussed in our February 2022 research paper the effect increased market concentration has been having on global equities active management. In the past 12 months, we have found this effect has been particularly strong. Global equities returns have largely been concentrated in large-cap US growth stocks which have been leading market returns.
- While the 12 month return for MSCI ACWI is +8.8% to 31 March 2022, this return quickly diminishes once we back out the large cap US growth stocks from the index.
- For active managers and funds more broadly, we have found the increased market concentration towards US large cap growth companies has made it far more challenging to match benchmark returns whilst still maintaining a balanced portfolio across style, region, and size.

Table 6

Index	FYTD return (%)	1 year return (%)
MSCI ACWI	-0.1	8.8
MSCI US Large Cap Growth	2.7	17.9
MSCI ACWI ex-US Large Cap Growth	-12.0	-5.3

The final word



Unfortunately, when we undertake active management, we do not experience the delivery of consistent outperformance year after year. Instead, active management works well in some periods and not in others. This analysis is helpful to deduce the reasons why this cyclicality in active management occurs.

We saw the dark side of active management with Australian equities in the 2019 financial year and we believe global equities is in the midst of one of its worst ever periods for active management. With 30 June 2022 not far away, it looks likely the 2022 financial year will be an outlier year for active management in global equities.

Takeaway #1

Active management is cyclical. It is important not to dwell on these difficult periods for active management and conclude active management is dead. For example, we are nearly three years post the worst year for active management in Australian equities. The Median Manager in the Mercer Australian Equities survey is likely to deliver a three year outperformance of around 1% p.a. when we reach 30 June 2022. In effect, many of those short-term factors that were hampering active management unwound.

Our first response is to look forward and, on that basis, active management in global equities remains a justifiable strategy, as it is highly unlikely this confluence of events will repeat over and over again. It is even plausible this reverses somewhat and active management in global equities experiences significant upside.

Takeaway #2

Active management is not dead and will likely recover. However, notwithstanding this essentially glass half-full outlook for active management in global equities, we note Australian superannuation funds are subject to *Your Future Your Super* legislation and we doubt the regulator would care to spend time understanding the cyclicality of alpha and why a global equities portfolio is lagging MSCI ACWI. In this regard, this current period in global equities and the 2019 financial year in Australian equities justifiably challenge superannuation funds to think very carefully about active versus passive management and, even if adopting active management, what is the risk budget for active management (in nominal terms and from a *Your Future, Your Super* perspective).

Takeaway #3

If subject to *Your Future Your Super*, then superannuation funds need to consider the cyclicality of alpha in their risk management. In essence, funds ought to understand their dimensions on the five areas examined in this note, on an ex-ante basis, such that any deviation from the market is known in advance, is deliberate and a case articulated for the expected long-term benefits of that deviation (usually in terms of return outcomes) as well as the short-term risks which can arise (as discussed above).

Frontier will be undertaking further analysis of active management in global equities after 30 June 2022 will update our findings at that time.

Want to learn more?

If you want to learn more about global equities performance, Frontier can help. Please reach out to your consultant or a member of the Equities Team.

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Frontier is one of Australia's leading asset consultants. We offer a range of services and solutions to some of the nation's largest institutional investors including superannuation funds, charities, government / sovereign wealth funds and universities. Our services range from asset allocation and portfolio configuration advice, through to fund manager research and rating, investment auditing and assurance, quantitative modelling and analysis and general investment consulting advice. We have been providing investment advice to clients since 1994. Our advice is fully independent of product, manager, or broker conflicts which means our focus is firmly on tailoring optimal solutions and opportunities for our clients.

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