The Frontier Line

Global equities 2022 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

Consultant

Brad joined Frontier as an Associate in March 2021 before being promoted to Consultant in August 2022. His responsibilities include both equities research and client support.

Prior to joining Frontier, Brad worked for five years at Intrinsic Investment Management firstly 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 Frontier's Equities Research Team covering both domestic and global 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 2021/22 financial year has seen the world and investment markets encounter significant events.

In an earlier paper Frontier observed the nine months to 31 March 2022 had proven to be a difficult performance period for global equities investment portfolios to keep up with the index. However, the June quarter was a strong quarter for active management in global equities with the Mercer median manager outperforming the MSCI ACWI by 0.7%. This paper provides updated data for the full year.

Table 1 shows a summary of active management result in global equities which, in the end, disguise the volatility we have seen.

Table 1: Global active management results for 2021/22

Index	1 year return (%)
MSCI ACWI	-8.0
Mercer median	-7.5
Relative performance	+0.5
% Managers ahead of MSCI ACWI	52%
% Manager ahead of MSCI World Index	42%

However, there is more to the global equities story than just active management results. Table 2 shows funds have performed more poorly than the median active manager (using the SuperRatings SR50 International Shares median which is representative but understates the degree of FY22 underperformance of asset owners[1]).

Table 2: SR50 International Shares median result to 30 June 2022

Index	1 year return (%)
MSCI ACWI	-8.0
SuperRatings SR50 International Shares median	-9.1
Relative performance	-1.1
% Funds ahead of MSCI ACWI	40% (19 of 47)

[1] We acknowledge SR50 option performance is an imperfect measure of relative performance. Firstly, SR50 option performance is after tax (helpful in a negative year) versus a before tax benchmark. Secondly, there are options which employ (full or partial) foreign currency hedging.

Factors contributing to outcomes in global equities

The following analysis discusses both active management and the positioning of funds. The analysis breaks down the first nine months to 31 March 2022 and then the June 2022 quarter, referencing the same factors that were contributing to sizeable underperformance in the first nine months of the 2022 financial year.

Country/region allocation

The US market was the strongest market in the past year and, consistent with history, managers are, on average, underweight the US market. This feature was a likely detractor for active management in the past year. Non-US and emerging markets outperformed the US market in the June quarter assisting active management in the final quarter.

Many asset owners have a long-term strategic overweight to emerging markets in their global equities portfolios and emerging markets lagged developed markets by a large amount (13%) in the 2022 financial year. Emerging markets are lowly represented in the MSCI ACWI (about 10%) and advisers such as Frontier recommend a more meaningful weight such as 15-20% because we believe this will be beneficial over time. The impact of this decision would not be seen in the Mercer survey results but would be more evident in a survey such as the SuperRatings survey. Those funds with a strategic overweight to emerging markets would be expected to have struggled to match the MSCI ACWI in the financial year.

Table 3: Country/region return over the 2022 financial year

Index	9 months to 31 March 2022 (%)	June quarter (%)	1 year (%)
MSCI ACWI	-0.1	-7.9	-8.0
MSCI USA	4.4	-9.2	-5.2
MSCI ACWI ex-US	-6.6	-5.8	-12.0
MSCI EM	-15.7	-3.3	-18.4

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 34% v MSCI ACWI in the past year). Utilities also outperformed significantly, while interestingly materials ended up lagging MSCI ACWI.

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 underperformed through this rebound.

While we have commented on the likely reasons for active management underperformance, it is also Frontier's observation that some asset owners employ low-carbon overlays on their passive exposure. Despite these strategies being designed in a risk-controlled manner, the spike in commodity markets (particularly energy) has led to the underperformance of low-carbon passive strategies.

Table 4: Sector returns over the 2022 financial year

Index	9 months to 31 March 2022 (%)	June quarter (%)	1-year (%)
MSCI ACWI	-0.1	-7.9	-8.0
MSCI ACWI Energy	24.3	1.5	26.2
MSCI ACWI Materials	1.2	-13.6	-12.5
MSCI ACWI Utilities	9.3	-0.1	9.1

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Style balance in portfolios

The ‘value’ style clearly outperformed the ‘growth’ style in the financial year. This was observed in the first nine months of the year, but accelerated in the June quarter, when markets were negative and it seemed higher interest rates were driving a continued de-rating of higher multiple stocks, i.e. growth stocks.

Frontier has observed many investment portfolios have drifted away from the value style and have more growth style exposure. The past decade had seen the growth style significantly outperform the value style. The growth style comprises large exposures to sectors like information technology and health care, while the value style includes financials and many of the cyclical sectors, such as energy, materials and industrials.

There had been insufficient rebalancing to be positioned for the style reversal of the past year. Frontier has encouraged investors to maintain a portfolio which is balanced across style factors and we discussed this 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, for much of the past decade, diligent rebalancing of styles had 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, not undertaking rebalancing will have contributed to asset owners’ underperformance in the 2022 financial year.

Further, many asset owners 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 5: Style returns over the 2022 financial year

Index	9 months to 31 March 2022 (%)	June quarter (%)	1-year (%)
MSCI ACWI	-0.1	-7.9	-8.0
MSCI ACWI Growth	-4.2	-12.8	-16.4
MSCI ACWI Value	3.8	-3.4	0.3

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.

Over the 12 months to 30 June 2022, there has been a significant divergence of performance between large caps and small caps which has been a headwind for active managers.

Table 6: Returns across the cap spectrum over the 2022 financial year

Index	9 months to 31 March 2022 (%)	June quarter (%)	1-year (%)
MSCI ACWI	-0.1	-7.9	-8.0
MSCI ACWI Large Cap	0.5	-7.7	-7.2
MSCI ACWI Mid Cap	-3.4	-8.9	-12.0
MSCI ACWI Small Cap	-5.7	-9.5	-14.7

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Market concentration

We discussed in a February 2022 research paper the effect increased market concentration has been having on global equities active management. In the nine months to 31 March 2022, we found this effect had been particularly strong. At that time, global equities returns had largely been concentrated in large cap US growth stocks which had been leading market returns.

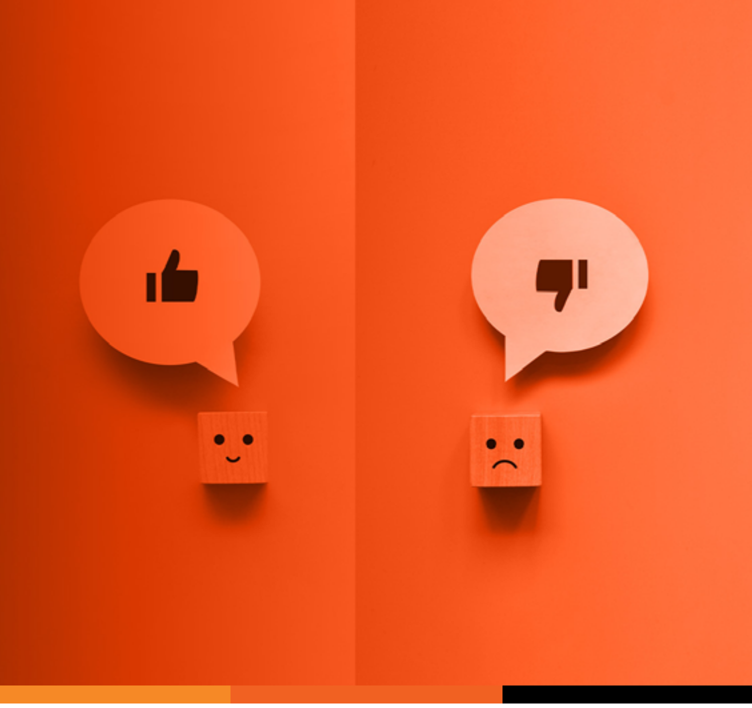
In the June 2022 quarter, there was a significant reversal of this trend. Large cap US growth stocks led the market declines. As a result, large cap growth stocks (whether US or non-US) ended up being laggards over the financial year.

For active managers and funds more broadly, we had been finding the market leadership of US large cap growth companies (which were increasingly representing a larger weight within MSCI ACWI) had made it far more challenging to match benchmark returns. The poor performance of US large cap growth stocks in the June quarter was likely one of the main contributors to strong active management results in that quarter.

Table 7: Market concentration effects over the 2022 financial year

Index	9 months to 31 March 2022 (%)	June quarter (%)	1-year (%)
MSCI ACWI	-0.1	-7.9	-8.0
MSCI US Large Cap Growth	2.7	-16.7	-14.7
MSCI ACWI ex-US Large Cap Growth	-12.0	-7.3	-18.5

The final word



The June 2022 quarter has been a stronger period for active management than the nine months beforehand and has represented a degree of damage control in what was an otherwise difficult financial year for active management in global equities.

The purpose of this paper has been to identify short-term cyclical factors behind the poor results in order to retain conviction in the long-term outlook for active management. This serves as yet another reminder that active management is cyclical. It is best to consider the merits of active management over longer periods and we should avoid being reactive to the short term. For example, shifting to passive management after a difficult period for active management (such as in Australian equities after the 2018 financial year) can often result in worse return outcomes overall.

We encourage asset owners to retain their conviction in global active management despite this recent period of sub-par returns.

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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