The Frontier Line

The value factor has returned, so why hasn't my value manager?

Issue 202 **December 2022**

frontieradvisors.com.au

frontier

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.

Adrian Hoe
Senior Consultant

Adrian joined Frontier in June 2019 and is a Senior Consultant in the Equities team. Adrian had previously worked at Lonsec for seven years, where he was responsible for undertaking manager research in global and domestic equities and alternatives asset classes, with lead analyst responsibilities for global equities.

Prior to Lonsec, Adrian spent five years at IOOF where he held a number of roles including research, consulting and investment operations. Adrian holds a Bachelor of Commerce and a Bachelor of Information Systems from The University of Melbourne, is a CFA charterholder and is RG146 compliant.

Introduction

This report is part of Frontier's active management analysis and delves into the recent period of underwhelming performance delivered by some global value managers. Despite style tailwinds we have observed mixed excess return outcomes against the MSCI ACWI, with a cluster of managers also significantly lagging the MSCI ACWI Value Index. We seek to address whether this has been a result of style drift and, if not, what other factors could be at play. Lastly, we touch on key takeaways for investors.

A word on global active management

While most of this paper is dedicated to the investigation of global value manager performance, for context we wanted to highlight the weakness in overall global active management outcomes to set the scene.

It has been Frontier's observation that the past five years has been a weak period for global active management. Previously we have conducted research into the impact that US mega cap growth stocks such as Apple, Amazon, Alphabet, Meta, Microsoft and Tesla have had on the excess return profile of active managers. More recently, we explored a wide range of factors that were negatively affecting Australian asset owners' international equities relative performance such as an underweight to the US market, an overweight to emerging markets and an underweight to the energy sector. This sub-par performance from the global active management cohort has continued throughout the 2022 calendar year.

Table 1 shows a summary of active management results over the year to 31 October 2022 relative to the widely used Mercer Median. The 0.5% outperformance result is gross of fees, which means on a post institutional fees basis the median manager is likely to have delivered a result more closely in-line with the MSCI ACWI and behind the stronger performing MSCI World Index (noting ACWI has lagged the World due to ACWI including emerging markets which have lagged).

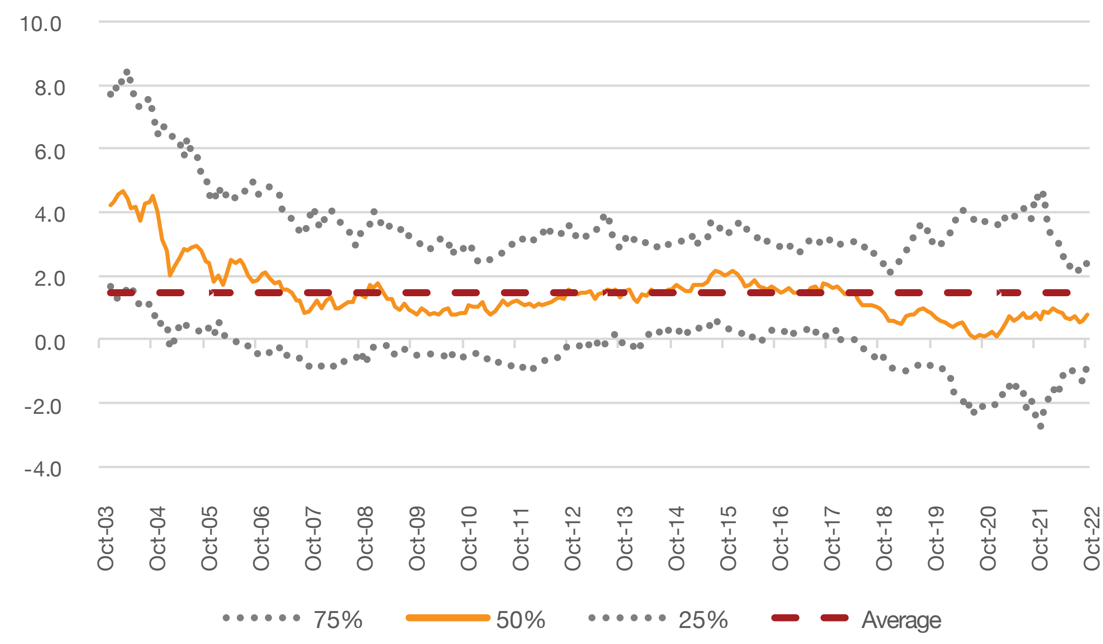
Table 1: Global active management results for the year to October in AUD (pre-fees)

Index	1 year return (%)
MSCI ACWI	-6.0
Mercer Median	-5.6
Relative performance	+0.4
% Managers ahead of MSCI ACWI	53%
% Managers ahead of MSCI World index	45%

Source: Mercer, Frontier

While on a pre-fee basis the median global active manager has still outperformed the MSCI ACWI benchmark – viewing performance over longer time frames illustrates a clear downward trajectory in excess returns. For this exercise, we have used a Frontier cleansed universe from eVestment, which is our best attempt to control for biases such as fund closures and additions within surveys. We have calculated the long-term average median 5-year excess return in global equities to be 1.5% p.a. pre-fees. However, the median manager has failed to achieve this level of excess returns since 2018 and this is the starting point for this research. Chart 1 illustrates this trend.

Chart 1: Rolling 5-year global active management excess returns versus MSCI ACWI in AUD

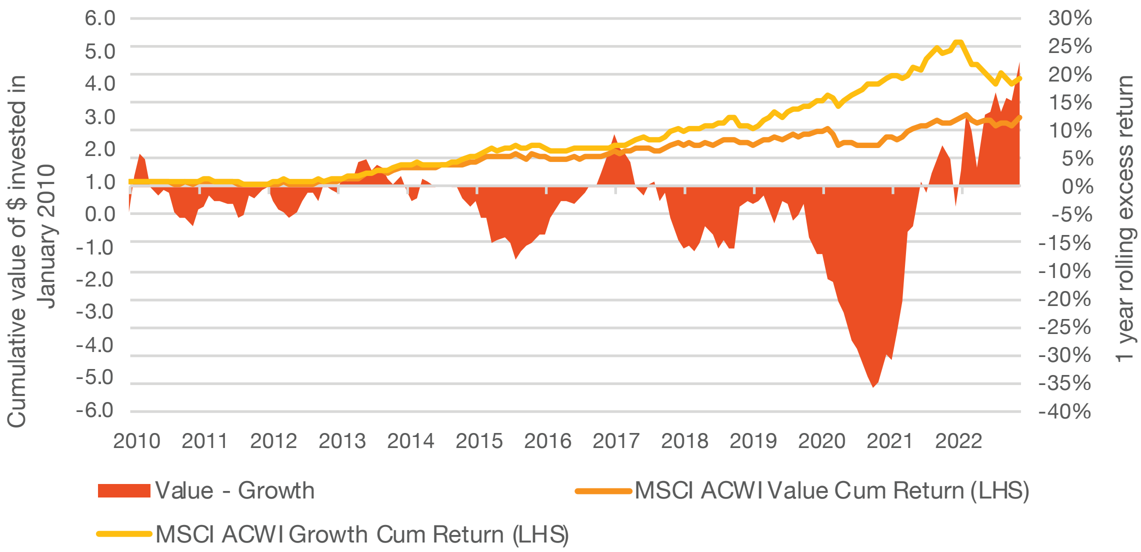


Source: eVestment, Frontier

The return of the value factor

Since 2010 we have witnessed the sustained outperformance of the growth factor against the value factor, until late 2020 when the vaccine announcements around COVID-19 occurred. Subsequently, a more persistent inflationary environment than was expected by central banks coupled with the rapid global monetary policy tightening in the past 12 months has triggered a sustained change in style leadership from growth to value. However, other than this period since late 2020, there have only been small and infrequent periods of outperformance by the value factor such as 2013 and FY17 (see Chart 2). Accordingly, the MSCI ACWI Value has underperformed the MSCI ACWI Growth by 2.7% p.a. over the past 10 years to 31 October 2022.

Chart 2: MSCI ACWI Value versus MSCI ACWI growth



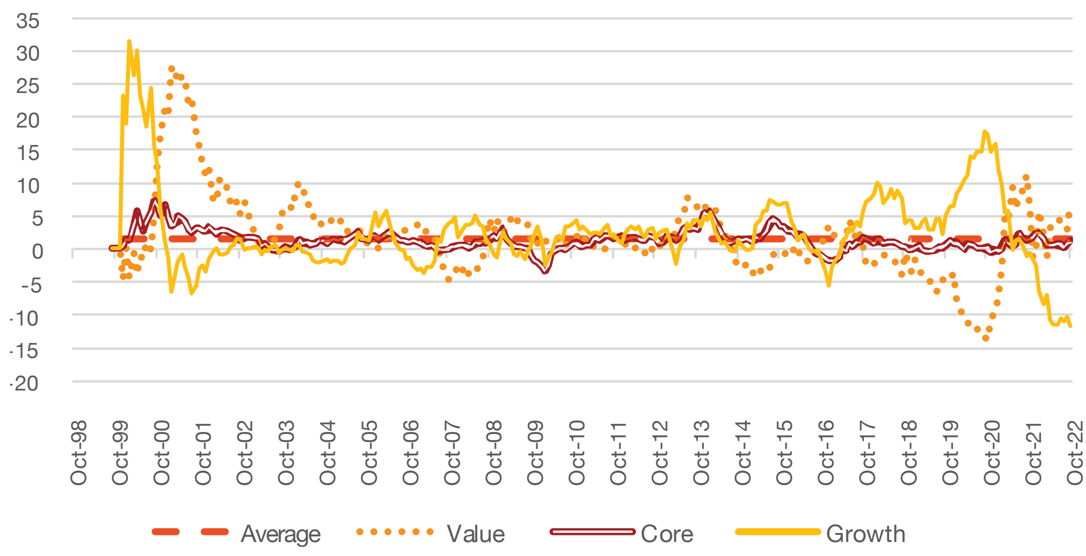
Source: MSCI, Frontier

Since positive news flow on COVID-19 vaccine efficacy in November 2020, the value index has outperformed the growth index by a cumulative 33% to the end of October in what has proven to be a strong reversal of style trends. Frontier has historically advised asset owners to maintain balanced portfolios with multiple factor exposures, while re-balancing as required.

Over the past 12 months we have observed the median global growth manager underperform the MSCI ACWI by 11.6%. This underperformance is far greater than the 4.1% of excess returns that the median global value manager has delivered over the same period. This outcome has resulted in many investors with a balanced style exposure within their international equities sector underperform the broad benchmark. Notably, there were even worse outcomes for those still holding a growth tilt by either design or through a lack of rebalancing,which we warned about in an earlier paper.

The rest of this research paper is dedicated to investigating the factors behind the lower-than-expected performance from global value managers.

Chart 3: Rolling 12-month excess returns (versus MSCI ACWI) by style (in AUD)



Source: eVestment, Frontier

Definitions

When assessing the performance of global value managers, we have sought to split out managers into three sub-sectors. This follows work that Frontier did in 2020 to formally divide the value manager universe into moderate value and deep value. In this classification system, both discretionary value managers and quantitative value managers are captured within these two descriptors. The assessment in this paper goes one step further and separates out a quantitative value cohort for managers which focus on generating excess returns through the quantitative extraction of the value factor premium. In the section below we give our broad definition to each of the three groups of value managers that will be analysed throughout our research.

1. We term **deep value** managers as managers that seek the highest margin of safety from a valuation perspective, these managers typically view valuation through an absolute lens.

2. '**Moderate value** managers while still valuation focused are more inclined to seek quality attributes alongside value attributes and as such are tolerant of higher priced companies than deep value managers.

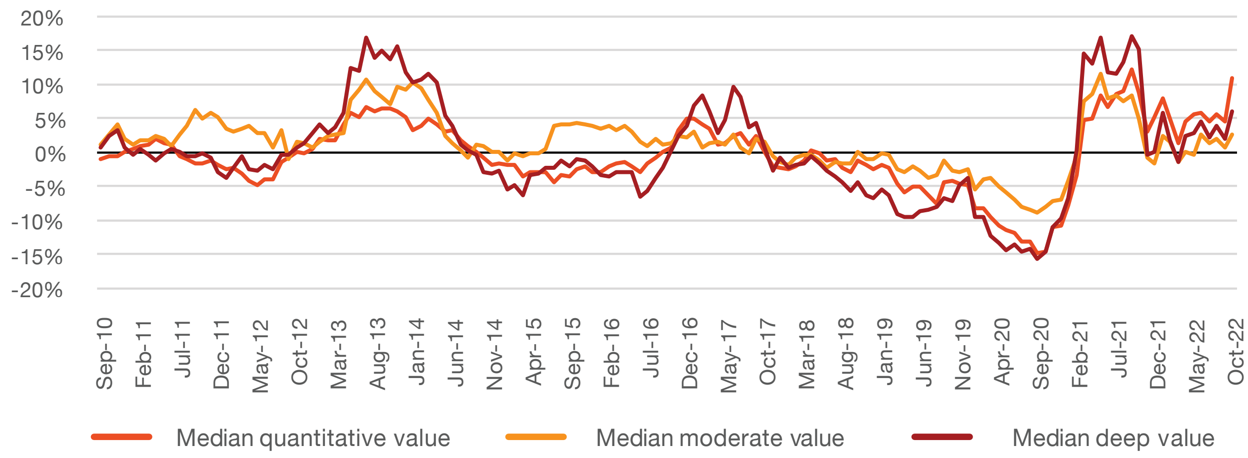
Any reference to discretionary value managers throughout this paper is the combination of both deep and moderate value managers and excludes quantitative value managers.

3. **Quantitative value strategies** can provide exposures to well-established factors that enable investors to harvest some risk or behavioural based premia. Implementation is typically done systematically (i.e. rules based), with minimal human judgement or overlay.

An important distinction between quantitative and discretionary value strategies is their greater breadth of quantitative value strategies (i.e. the number of stocks in the portfolio) and stronger risk controls with regards to sector and country allocations relative to fundamental managers. Quantitative value factor strategies will include simple and well-known value metrics such as P/B, P/E, cash flow yield, sales to price and EV/EBITDA, while more sophisticated quantitative value strategies often will include their own more sophisticated proprietary measures of value.

Performance

Chart 4: Rolling 12-month excess returns versus MSCI ACWI

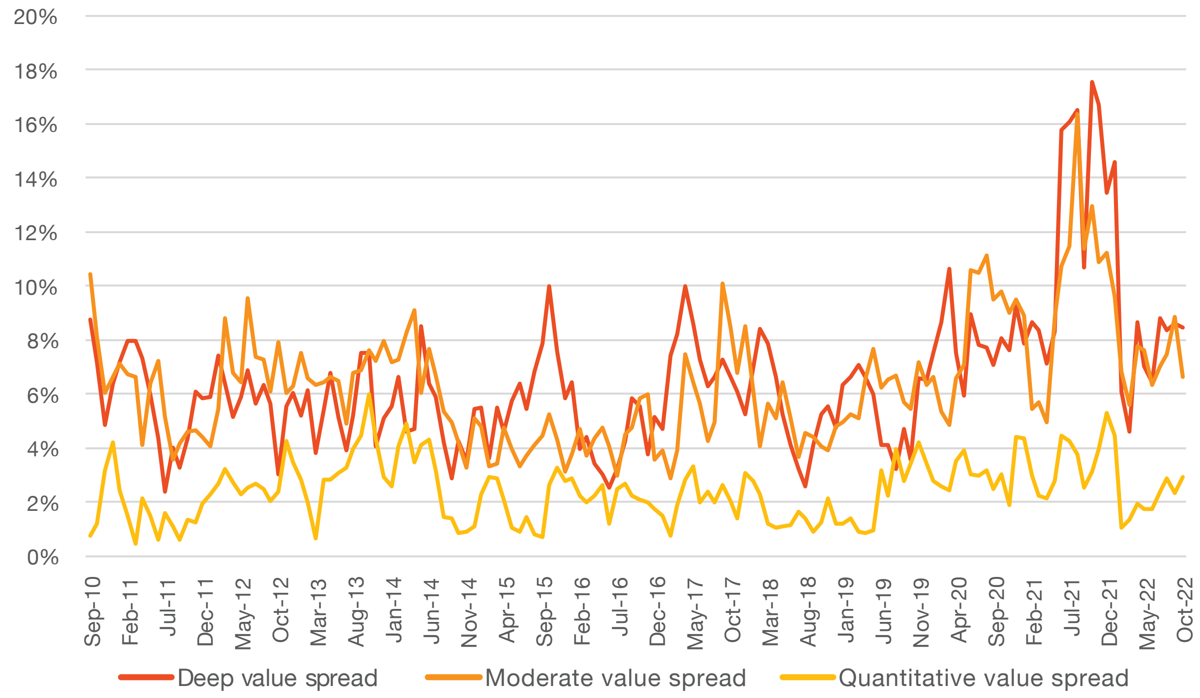


Source: eVestment, Frontier

Chart 4 illustrates the performance of each of the three cohorts against the MSCI ACWI benchmark over rolling 12-month periods. Following the positive vaccine announcements in November 2020, we saw a turnaround in the performance of each of the three groups as market leadership rotated towards value stocks. Deep value managers in particular enjoyed a brief period of strong performance in early 2021 before each group returned back towards a slightly above benchmark performance outcome.

We note however that all three groups underperformed the MSCI ACWI Value Index since March. We have observed that moderate value managers have significantly lagged in the most recent value rally when compared to their quantitative peer group. As we go into more detail later in this paper, the recent period of relative underperformance of the discretionary value cohort has been due to the increasing influence of top-down and inter-sector and inter-regional volatility which have caught out some managers who were on the wrong side of this. As a result, the spread of excess returns of this cohort has significantly increased over this period, as shown in Chart 5.

Chart 5: Spread of excess return outcomes



Source: eVestment, Frontier

In Chart 5, we have also examined the spread of excess return outcomes for each cohort of managers. The spread represents the upper quartile minus the lower quartile of rolling 1-year excess returns against the MSCI ACWI benchmark. Both deep and moderate value managers have consistently exhibited a larger range of excess return outcomes than quantitative value managers and this dispersion grew substantially larger in 2021 as volatility in markets increased.

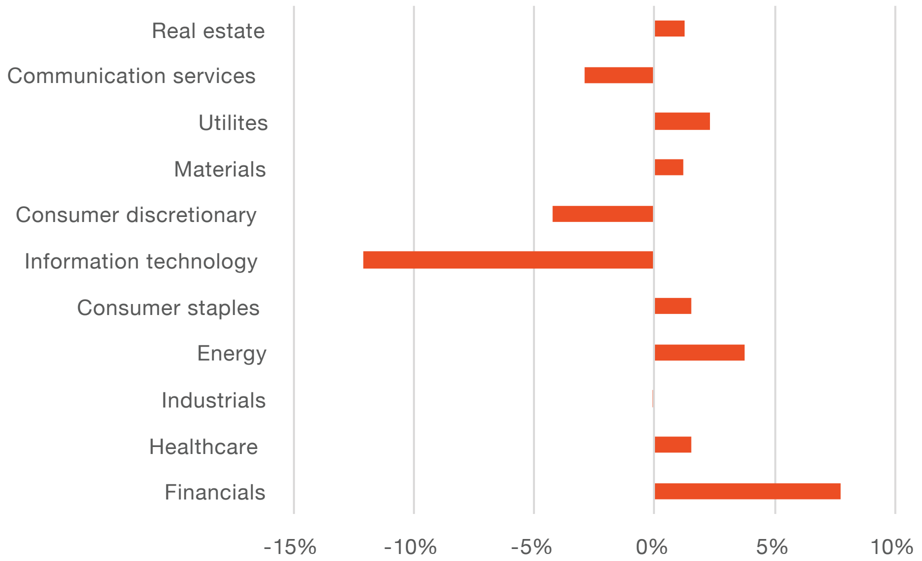
In contrast, quantitative value managers have not suffered from this widening of excess return outcomes as they have been largely protected from these top-down and regional/sectoral factors due to their tight regional and sector risk controls. As a result, their returns have been more consistent and aligned with the returns of 'naive' style benchmarks like the MSCI ACWI Value Index.

A word on the MSCI Value Index

The MSCI ACWI Value benchmark is often used as a benchmark for assessing active global value managers. The index is constructed using three simple value metrics price/book value, price to earnings (12m forward) and dividend yield. An individual stock is scored on all three measures and is ranked against other stocks in it's country of listing. Stocks that exhibit value characteristics in the top 50% of the country index are allocated to the value index. Importantly stocks can exhibit both growth and value characteristics as defined by MSCI which results in a partial allocation of the stock to both the growth and value indices (e.g. 65% value and 35% growth). This results in a relatively country neutral allocation against the parent index (MSCI ACWI), however can result in large deviations in the sectorial allocations between the ACWI Value and ACWI. The ACWI Value Index has 1,739 constituents while the parent index (ACWI) has 2,893.

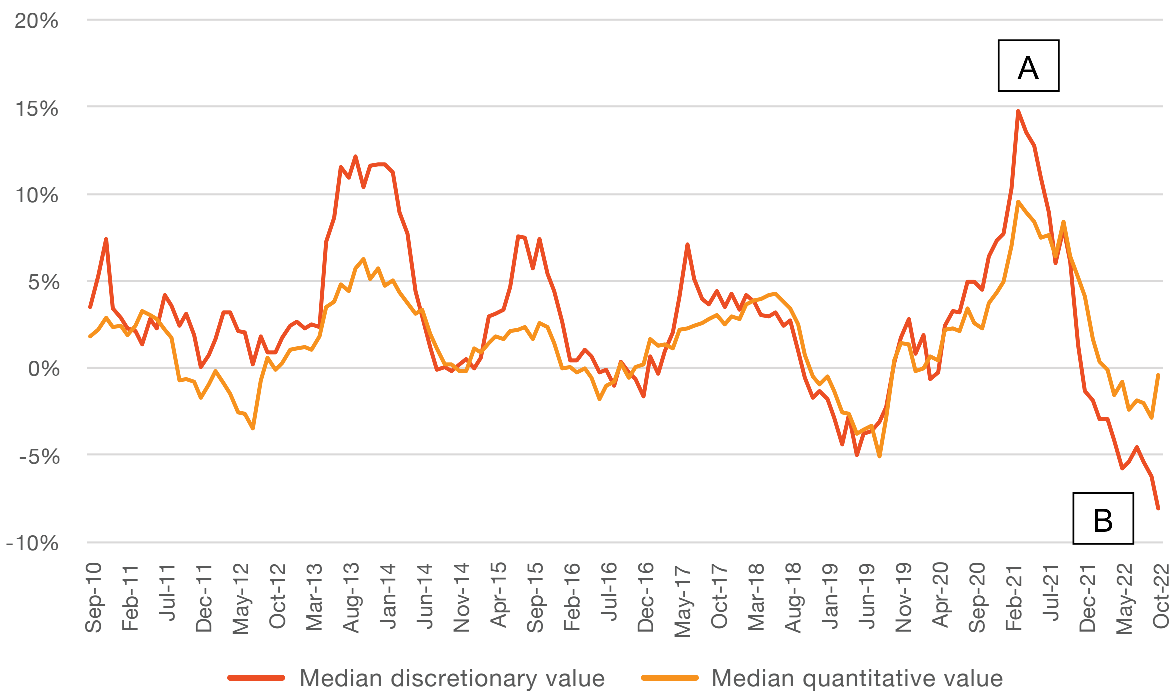
frontier

Chart 6: MSCI ACWI Value weights versus MSCI ACWI (as at 30 November 2022)



Source: MSCI

Chart 7: Rolling 12-month excess returns versus MSCI ACWI Value



Source: eVestment, Frontier. Note: discretionary is a combination of deep and moderate value cohorts.

Our first takeaway from Chart 7 is, both groups of managers have been able to add value against the MSCI ACWI Value at points in time. This validates the active approach taken by each group of managers to deliver returns ahead of the value index. We also note the median quantitative value manager tends to exhibit a lower tracking error against the value index over time. The value factors within the MSCI ACWI Value Index (P/B, P/E and dividend yield) are more basic than the value factors employed by quantitative value strategies, which can include measures to avoid value traps and, in some cases, include intangibles on companies' balance sheets. While these additions have generally proven to be additive to returns over time, since November 2020 more naive value metrics, particularly P/B, have strongly outperformed more sophisticated value metrics, contributing to the underperformance of quantitative value strategies versus the MSCI ACWI Value Index.

Earlier we noted the consistent ability for discretionary value managers to add value above that of the MSCI ACWI Value Index over time. While this continues to be the case, the most recent period of performance involves significant deviation from the MSCI ACWI Value Index firstly to the upside in early 2021 and now to the downside (marked A and B on the graph). The level of deviation of discretionary value managers away from the MSCI ACWI Value Index does lead us to question whether there has been a degree of capitulation or style drift from this cohort in recent years.

A question of style drift

To answer the question on style drift we have aggregated holdings from each manager from our deep, moderate, and quantitative value cohorts over the past 12 years. For this research exercise we selected managers that Frontier has had extensive engagement with in the past and were able to clearly define an investment style into deep and moderate value.

Each portfolio was allocated an equal weight within the overall group to which it was assigned. The overall portfolios were then run through the style analytics platform from 2010 to 2022 against the MSCI ACWI and assessed on a range of different style factors including value factors. We chose six commonly cited value factor measures to include in the analysis, which included: price to book, dividend yield, earnings yield, cash flow yield, sales to price and EV to EBITDA. Importantly, these factors aligned with the MSCI ACWI Value methodology which incorporates price to book, price to earnings and dividend yield to construct the index. For this exercise, we chose to focus on the value managers that adopt a bottom-up research approach (i.e. both deep and moderate value cohorts) as these are the groups that are most at risk of style drift compared to quantitative value managers. Charts 8 and 9 illustrate the results of our analysis.

Chart 8: Deep value manager style value factor skyline over time (in AUD)

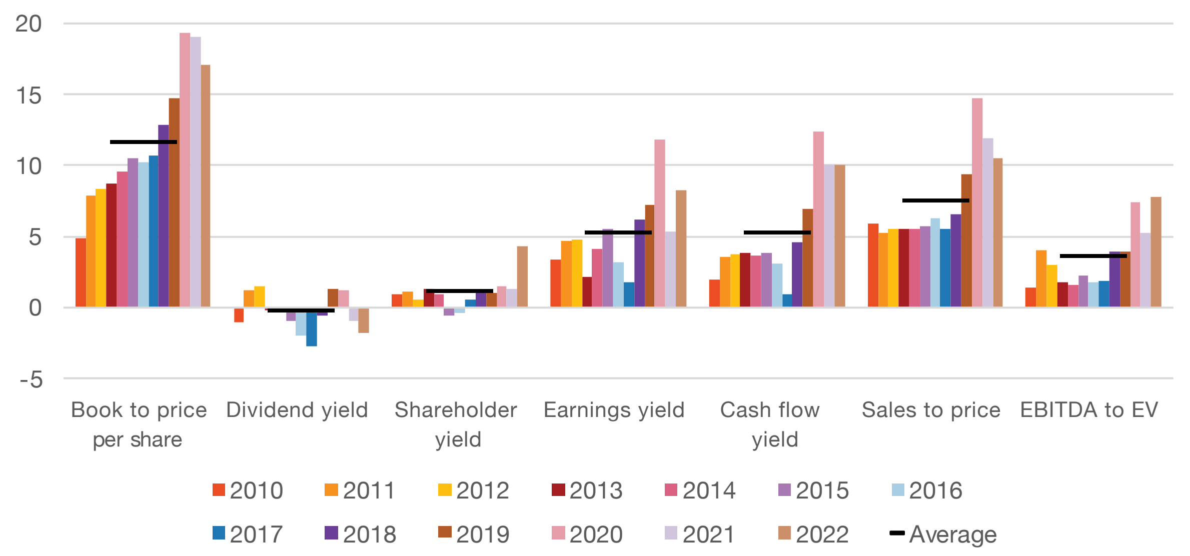
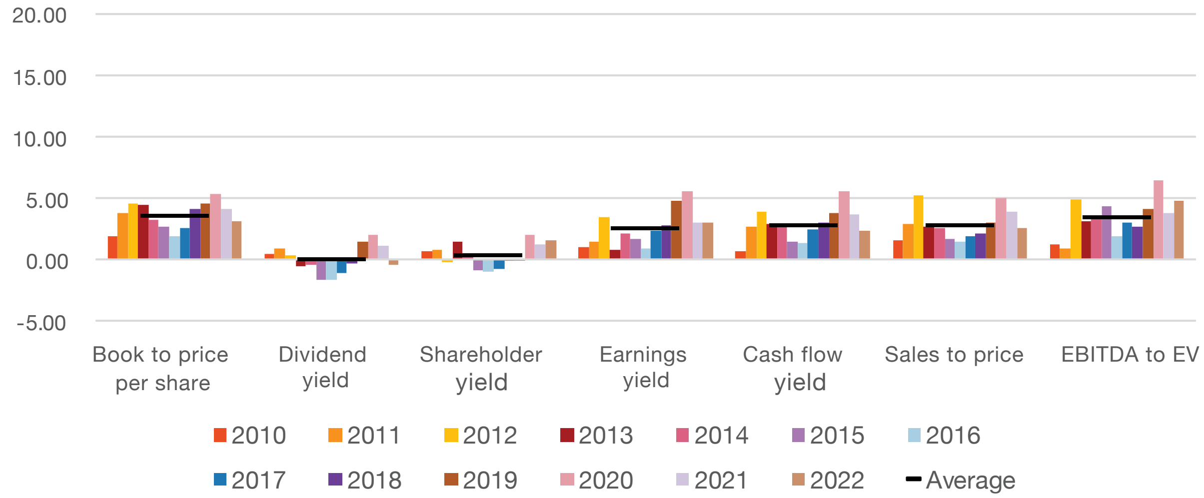


Chart 9: Moderate value manager style value factor skyline over time (in AUD)



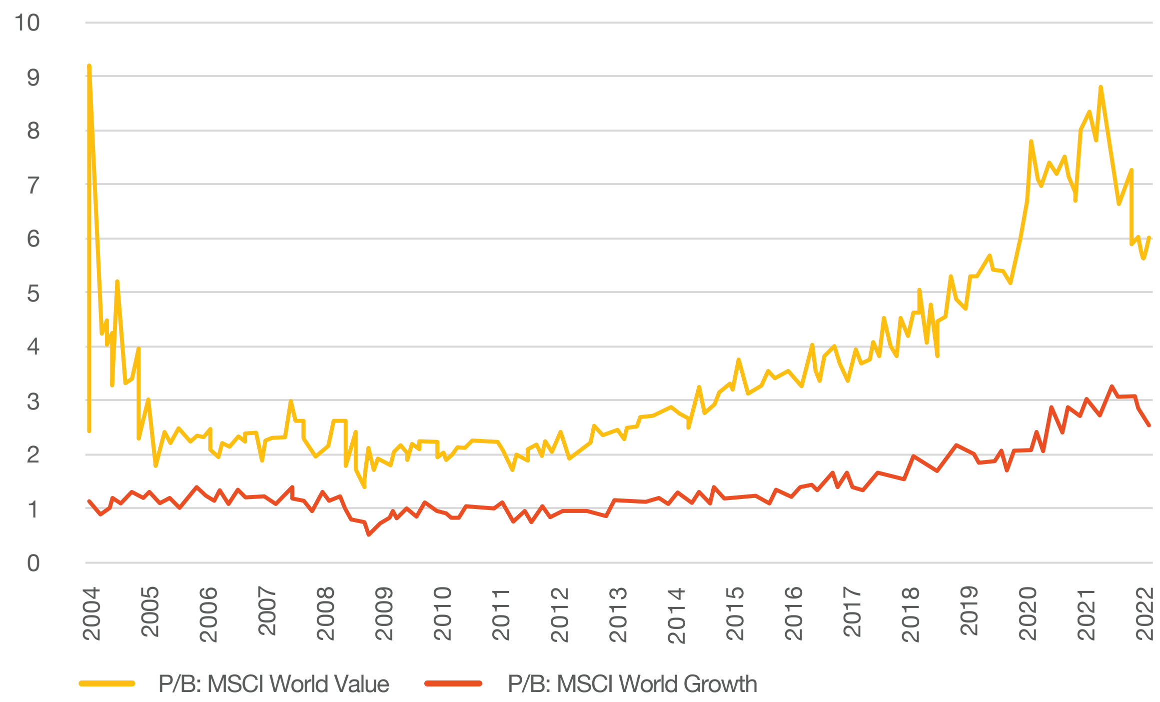
Source: Managers, Style Analytics, eVestment, Frontier

The outputs in Charts 8 and 9 suggest there is no evidence of style drift from either of the deep or moderate value manager cohorts in recent years, which is consistent with analysis we conducted two years ago. This is despite increasingly divergent performance away from the MSCI ACWI Value Index. We found both moderate and deep value managers have increased their exposure to value factors since 2010, which is especially true in the case of deep value managers.

On a first impression, these results may be surprising given the context of increasingly divergent performance away from the MSCI ACWI Value Index illustrated in Chart 7. However, when considering equity market conditions over the past 10 years and the continued increase in multiple dispersion between value stocks and growth stocks, it begins to make more intuitive sense. The portfolios of value managers have become cheaper relative to the MSCI ACWI over the past 10 years as the index became increasingly concentrated with highly priced growth names. Chart 10 demonstrates this valuation dispersion over time illustrating the price to book difference between the MSCI World Value and Growth indices.

frontier

Chart 10: Valuation dispersion between high and low multiple stocks



Source: State Street Global Advisors

Frontier considers any style factor tilts (shown in Charts 8 and 9) greater (less) than +1 (-1) to be material. So, while the moderate value cohort clearly exhibits smaller value tilts than deep value managers, we still consider this group positively exposed to the value factors. We note there is a lack of consistent exposure to the dividend yield factor by both cohorts which stands in contrast with how the MSCI ACWI Value Index is constructed. This highlights that dividends are not deeply considered by global value managers in their decision making, unlike in Australia where far higher dividends are paid.

Importantly, we believe the lack of any widespread trend of decreasing exposure to multiple value factors lead us to conclude there has been no widespread style drift or capitulation on behalf of discretionary value managers, i.e. they are still buying 'cheap' stocks relative to the index. While this analysis concludes there is no evidence of style drift for the entire group of managers, the results may hide individual manager outcomes which are contrary to this conclusion. Individual managers must be assessed on a case-by-case basis to ensure they continue to follow their stated investment process and exhibit a consistent style exposure.

If we have concluded value managers as a group that continues to exhibit a consistent positive exposure to the value factor and have not suffered from any style drift, the question remains as to why each group has underperformed both the MSCI ACWI Value Index and quantitative value manager cohort so significantly over the past 12 months. The next section examines other factors which may have contributed to the below-expectation performance from discretionary value managers.

Regional exposure

An important characteristic of discretionary value managers has been their significant regional biases. These regional biases were explored in more detail in an earlier paper we produced on global active management. These biases are captured in Charts 11 and 12.

Chart 11: Deep value manager regional exposure relative to MSCI ACWI

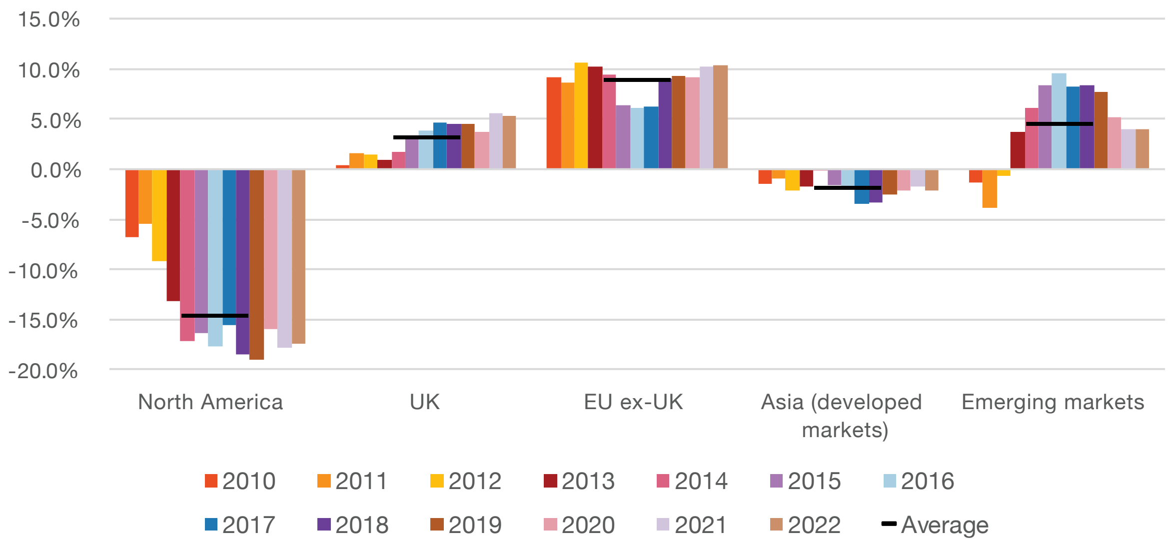
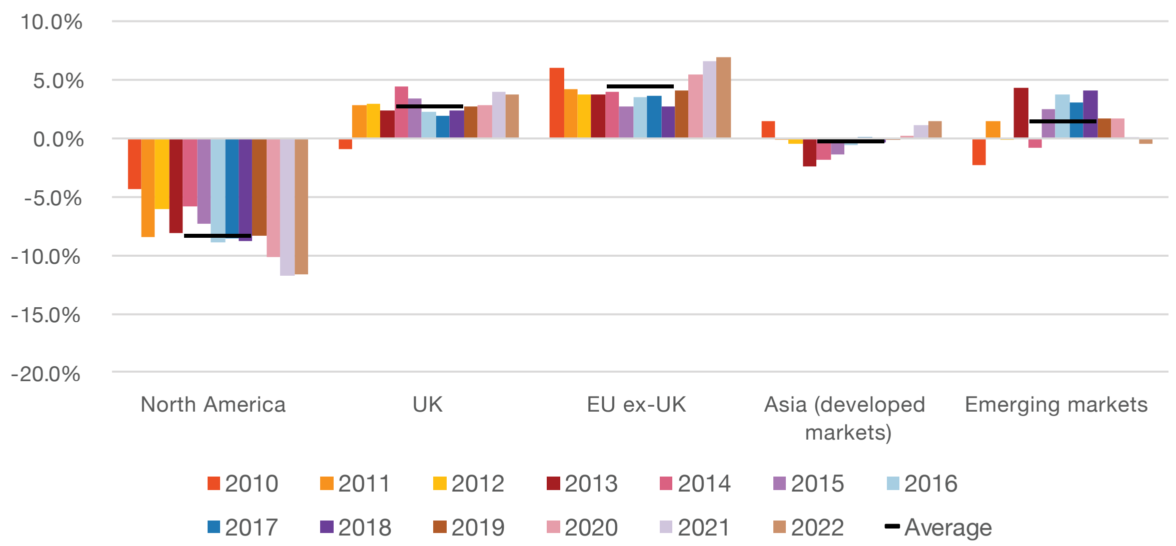


Chart 12: Moderate value manager regional exposure relative to MSCI ACWI



Source: Managers, Style Analytics, eVestment, Frontier

The North American (predominantly US) market has become a larger portion of the overall MSCI ACWI Index, while discretionary value managers became increasingly underweight in their allocations. Further, this underweight allocation to the US results in an overweight to other regions most notably in the UK, EU ex-UK and emerging markets. These significant regional allocations, which have been driven by bottom-up stock selection decisions, has left discretionary global value managers more sensitive to both market and currency risks relative to the MSCI ACWI benchmark.

Table 2: 1-year regional returns to 31 October 2022

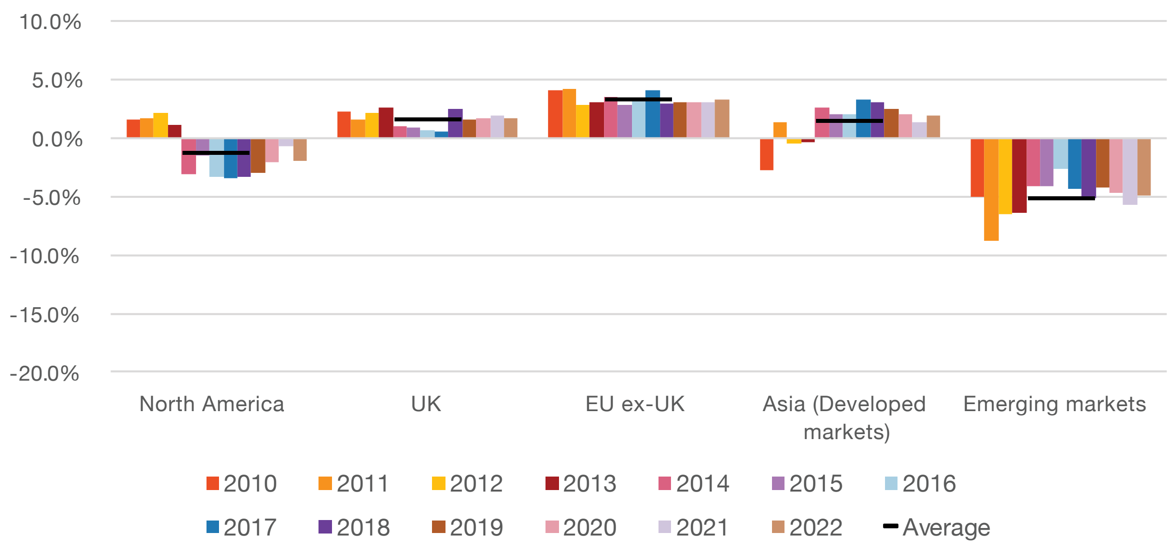
Index	Return in local currency (%)	Return in AUD (%)
MSCI ACWI	-15.0	-6.0
MSCI USA	-16.5	-2.4
MSCI United Kingdom	4.3	2.9
MSCI Europe ex-UK	-13.0	-12.9
MSCI Japan	-1.4	-11.5
MSCI Emerging Markets	-23.9	-19.0

Source: Macquarie, Frontier

Table 2 shows, in the past year, discretionary value managers underweight exposure to the US was positive attributor on a local currency basis. The US markets underperformed all other regional markets apart from emerging markets in the 12 months to the end of October on a local currency basis. However, the persistent rise of the US dollar against most major currencies (including the AUD) has resulted in the US market outperforming all other regional markets with the exception of the U.K in Australian dollar terms. Given the large underweight to the US has been used to fund persistent overweights in other regional markets, the past 12 months has seen a unique situation where most of the value manager's underlying currency exposures (through differing market allocations) detracted from relative returns. Unfortunately for managers and asset owners alike, the 'Return in AUD (%)' column in Table 2 is all that ultimately matters from a return perspective for Australian asset owners. Overall, when considering stock and currency, being underweight the US was a detractor.

In contrast to both the deep and moderate (fundamental) value cohort, we have observed quantitative value managers to be far more constrained in their country allocations. In many cases, this subsection of managers explicitly limits the risk associated with currency and markets by setting portfolio construction rules around active country positioning. The stated rationale of this is so that the strategy can deliver a more risk-controlled exposure to the value factor without other risk factors such as currency, market and sector risks dominating the overall tracking error budget. In practice, there are also many mangers in this cohort that go one step further and adopt a strictly benchmark approach to country allocation, preferring to extract the value premium within countries rather than across them. We believe the constrained approach to country allocation is a large contributing factor to the outperformance of quantitative value strategies in the past 12 months against their discretionary value peers. Chart 13 which illustrates the regional weights relative to ACWI for quantitative value managers is markedly different to Charts 11 and 12.

Chart 13: Quantitative value manager regional exposure versus MSCI ACWI



Source: Managers, Style Analytics, eVestment, Frontier

Long-term impacts from a structural underweight position to the US market

Over the past 12 months we have had many discussions with fundamental global value managers regarding the seemingly structural underweight to the US and this largely comes down to US stocks being priced more highly than other regions. We have typically found value managers have held larger relative positions in energy, materials, industrial and financial sectors (usually considered 'value' sectors) and smaller relative positions in information technology and healthcare sectors (usually considered 'growth' or 'quality' sectors) over time. The MSCI US Index is overrepresented in both information technology and healthcare sectors and underrepresented in financial, energy, and industrials sectors when compared to the MSCI ACWI. It is this sectorial composition of the US index coupled with the growing valuation premium of the market that has not only sustained but increased the underweight allocation from value managers over time.

To investigate the long-term impacts of value managers structural underweight to the US, we have compared the median performance of global value managers and international or ex-US value managers. Using our discretionary global value list (the combination of deep and moderate value cohorts) as a starting point we created an international value list using the same managers but using their international (or global ex-US) strategies instead. In many cases, the respective strategies are managed by identical investment processes, share the same investment analyst team and even the same portfolio managers with the only difference being the exclusion of the US market from the investable universe.

Table 3: Global value versus international value active performance to 31 October 2022 (in AUD)

Index	1 year (%)	3 years (% p.a.)	5 years (% p.a.)
Median global value manager	-2.7	+7.2	+7.4
MSCI ACWI	-6.0	+7.5	+9.1
Excess returns	**+3.3**	**-0.3**	**-1.7**
Median international value manager	-5.4	+2.5	+4.1
MSCI ACWI ex-US	-11.6	+0.8	+3.1
Excess returns	**+6.2**	**+1.7**	**+1.0**

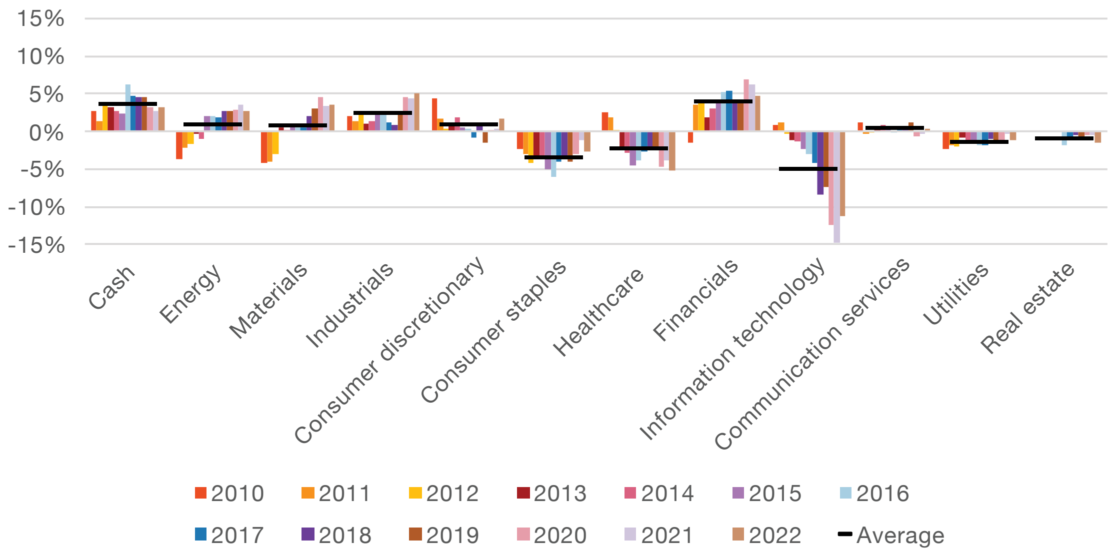
Source: eVestment, Frontier

Table 3 illustrates just how much US equity markets have dominated global equity market returns. Over the past five years, the MSCI ACWI has outperformed the MSCI ACWI ex-US by 6% p.a. (9.1% p.a. v 3.1% p.a.) in AUD. Despite the positive effect the US has had on absolute equity returns, the outperformance has had the opposite effect on the relative returns of active managers (with more growth stock, higher prices, there have been less opportunities for active value managers inside the US). Over the past year, the excess return for the median global value manager is 2.9% lower than for the median international value manager (i.e. with the value factor turning into a positive contributing factor, those opportunities outside the US have delivered greater value). Over the past five years, we find a similar impact with international value managers delivering a 2.7% p.a. better relative outcome than their global value manager peers.

In practice, we note this analysis cannot separate the impact of market/currency allocation effects and stock selection impacts. However, a 2.7% p.a. excess return differential over five years does suggest to us that the long-term impacts of the underweight allocation to the US from both a market and currency perspective has been significant.

Sector exposures

Chart 14: Deep value active sector positioning over time



Source: Managers, Style Analytics, eVestment, Frontier

Chart 15: Moderate value active sector positioning over time

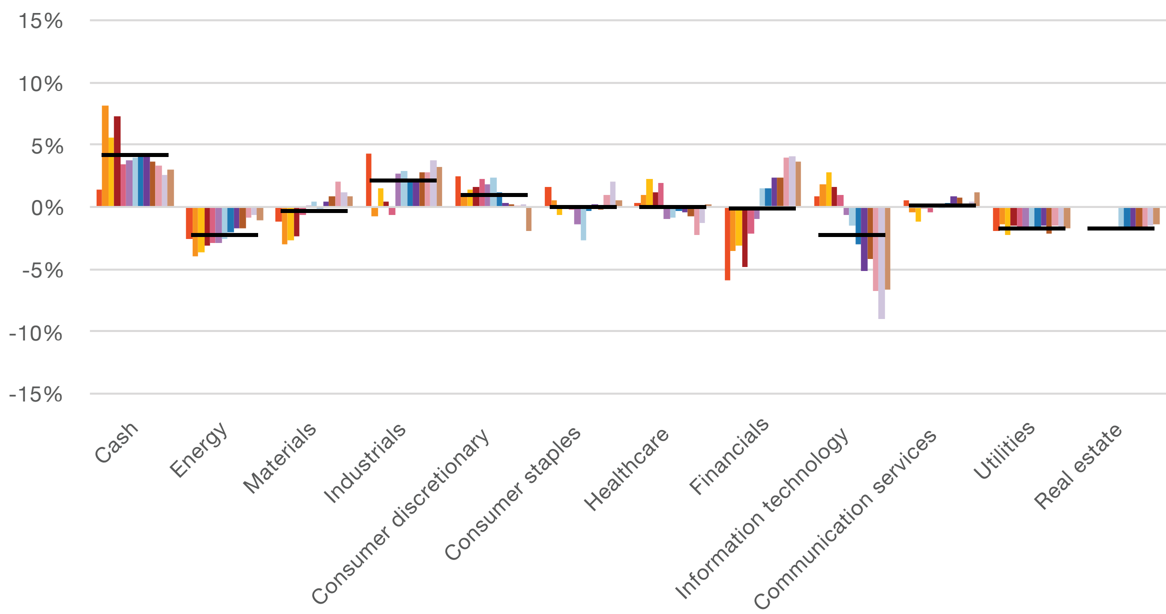
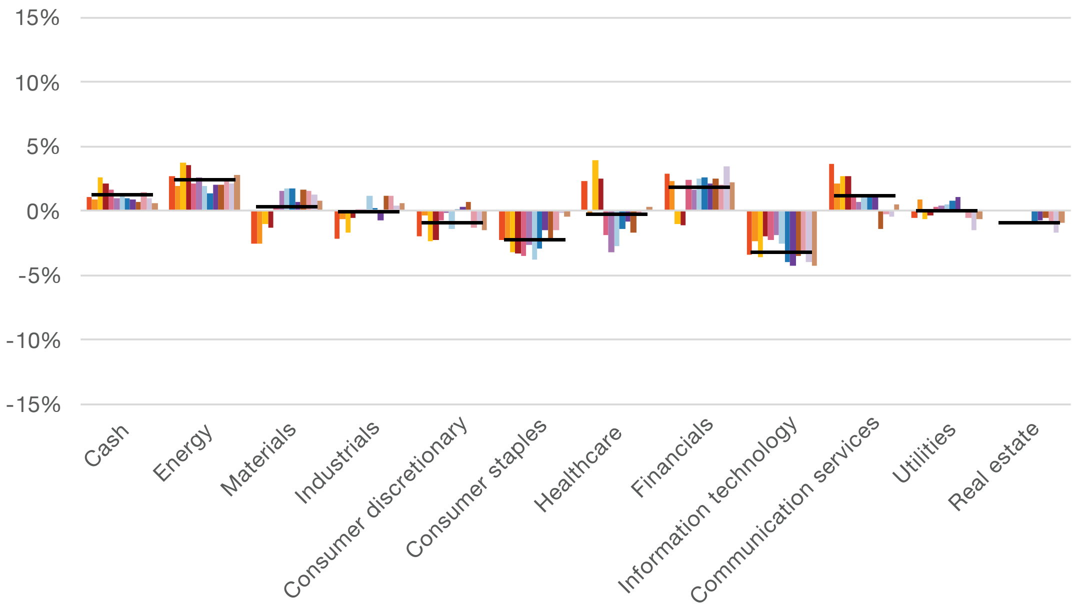


Chart 16: Quantitative value active sector positioning over time



Source: Managers, Style Analytics, eVestment, Frontier

We used the same methodology in the regional exposure section of the paper to produce Charts 14-16 regarding the sectoral positioning over time for each cohort of managers. While there are less clear performance implications from this analysis, there are some important takeaways for investors.

The deep value managers in our analysis have over time tended to take larger sector bets than the moderate value group of managers. These sector biases tend to be in the more cyclical areas of the market such as energy, materials, and financials. Both groups of discretionary value managers hold an underweight position to the IT sector, though this is larger in magnitude for deep value managers. Given the respective approaches of deep value managers typically favour an absolute value mindset and moderate value managers typically have a relative value mindset these findings were expected. They also offer some insight into why deep value managers have outperformed their moderate value peers given the higher allocations to outperforming sectors such as energy and financials.

Much like our analysis illustrated with the regional tilts by value managers, the quantitative value manager cohort has demonstrated a constrained approach to relative sector allocation. In contrast to both deep and moderate value cohorts, quantitative value managers will typically control sources of active risk from sector and regional tilts. Once again, the rationale for this is so the strategy can deliver a more risk-controlled exposure to the value factor without other risk factors such as currency, market and sector risks dominating the overall tracking error budget. In practice, there are many quantitative value managers whose valuation models are based on intra-sector value opportunities and manage the strategy on a sector neutral basis.

A word on deep value managers allocation to the energy sector

The bifurcation in excess return outcomes over the past 12 months from both the deep and moderate value managers has been a result of the high levels of volatility we have seen on both a stock level and a sector level. In particular, the energy sector has outperformed the MSCI ACWI benchmark by 56% over the year to 30 November 2022. For value mangers, especially deep value managers their active positioning in the energy sector has been a large factor in determining their peer relative performance outcome.

At a cohort level we have shown that deep value managers have an overweight allocation to the sector, however individual manager allocations within this cohort vary significantly. A question we often get from clients is whether an underweight or zero position in the sector represents a degree of style drift from a deep value manager. As increasing attention has been drawn to the world's decarbonisation efforts there has been more pressure on managers to reduce their portfolios emissions. This trend may have influenced managers judgement in identifying more value opportunities in the energy sector. Our style research work concluded that deep value managers were finding value opportunities in many sectors of the market (not just energy) and that there had been no evidence of style drift from the cohort. Despite this, we acknowledge that a lack of energy exposure in some deep value managers over the past twelve months does represent a large, missed opportunity from a near term return perspective.

Top-down vs bottom-up stock price influences

An observation often made by global value managers we've met with recently is macroeconomic or top-down factors are becoming increasingly influential over stock price returns. Given most active managers we engage with in global equities and in particular global value managers are predominantly focused on the bottom-up, the macro environment is often cited as a partial reason for any underperformance delivered. Sometimes this is a 'throw away' line and so, we explore this in more detail below.

The last 3 years have seen some large macro-economic events which have had large impacts on markets. The emergence of COVID-19, extraordinary global monetary policy, the Russian invasion of Ukraine and now the spike in inflation have all been large macroeconomic (top-down) events that investors have had to navigate. While not included in the paper, we have cited empirical evidence from managers which shows top-down factors are becoming increasingly influential alongside bottom-up factors in determining stock price outcomes. This affects active management outcomes in the following ways:

- Despite the more conducive environment for active management as suggested by elevated cross-sectional volatility of stocks, analysis suggests that this elevated level of volatility has been driven more by higher volatility across industries (top-down) than within industry (bottom-up).
- Quantitative value managers have greater risk controls limiting their exposure to the higher cross-sectional volatility across industries through constrained sector and country positioning.
- The increasing level of influence that top-down factors have had on stock prices and ultimately active manager performance in the past three years has important implications for discretionary value managers. We have found this group of managers, while still having an awareness of top-down macro factors, spend most of their time assessing the bottom-up investment case and tend to be more exposed (than quantitative value managers) to these risk factors through sector and country tilts.

Overall, this trend in markets has likely added another headwind for discretionary global value managers, though this assumption would have to be assessed on a manager-by-manager basis rather than at an aggregate level. Frontier has gathered further evidence to support this contention which we are happy to speak through in greater detail. Ultimately, we believe this has contributed to the relative outperformance by quantitative value managers over the discretionary value cohort.

Summary and key takeaways for investors

As we highlighted in our July research paper on global active management, the past 18 months has continued to be a tough period for active managers and asset owners in the global equities space. Facing style headwinds, we have witnessed the underperformance of growth managers which for some higher growth and less valuation sensitive managers has been severe. Compounding this issue is the fact that despite significant style tailwinds over the past 12-18 months, fundamental global value managers have only delivered modest excess returns against the MSCI ACWI benchmark and poor relative returns against the MSCI ACWI Value benchmark. A combination of the above factors (i.e. growth underperformance not being offset by value managers) has led to lower overall active management outcomes in global equities than we have historically observed. While being able to explain the reasons behind the underwhelming performance, we believe the analysis has four key takeaways for investors.

Takeaway #1

We have not seen evidence of style drift from value managers

Despite delivering performance which has been below expectations over the past 12 months, we have found little evidence to suggest there has been any style drift from either deep or moderate value managers. Style footprints of each group over time point to a positive exposure to value across numerous metrics. In the case of deep value managers, we have even seen an increase in value exposure over time as company valuations in the market have become more bifurcated. While we can conclude at an aggregate level that there has been no capitulation of value managers, we cannot rule out the possibility that individual managers have strayed from their stated investment philosophy.

Takeaway #2

Discretionary value investors continue to face headwinds from non-stock selection factors

We have found that both moderate and deep value managers held persistent underweight positions to the US equity markets over the periods assessed. These positions have grown over time, stemming from the growing index weight of the US market and the valuation premium attached to the market. This position has been a material headwind to performance in AUD terms particularly over the past 12 months. We also note the greater share of top-down macroeconomic volatility in individual stock returns has been a challenging environment for a cohort of predominately bottom-up investors. This stands in contrast with quantitative value managers who largely neutralise these risks by remaining tightly constrained on both sector and country positions relative to the benchmark.

Takeaway #3

Asset owners need to broaden how they think about manager diversification

Often when selecting managers for an international equities' configuration, investors will concentrate on styles such as value, growth, and quality to ensure a portfolio that is balanced across styles. While we believe this is a strong foundation for a diversified portfolio there are many other lenses with which investors should be mindful of. This includes looking into differences within style categories as well as other factors such as regional, sector and size diversification.

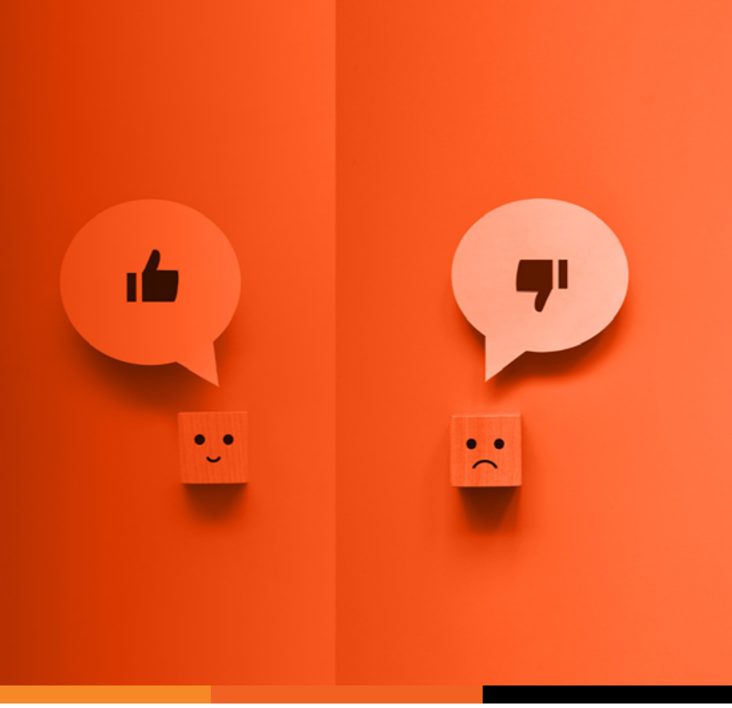
Frontier has split out value (deep and moderate) and growth (moderate and high) managers to help investors build more diverse manager line-ups even within style categories. Our analysis in this paper illustrates some of the differences between these two value cohorts and their differences in turn with quantitative value managers.

While diversification can come from various investment styles (growth, value, quality, momentum, size), it can equally come from the combination of discretionary and quantitative based strategies. This paper has demonstrated how quantitative value strategies have been able to navigate recent markets better than discretionary value managers (through better risk control and improving market breadth), while a different market environment may favour a discretionary approach. Another layer is to think about a combination of managers that have the tendency to invest in different regions in the world to ensure smaller overall portfolio biases.

Takeaway #4

Active management is cyclical

It is important not to dwell on these difficult periods for active management and conclude that active management is dead. The past 12 months has been a difficult period for global active management, which has contributed to a below average 5-year period of excess returns for global active managers. 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 that this confluence of events will repeat over and over again. It is even plausible that this reverses somewhat with a much more conducive environment for active management in global equities. While it is very short-term, we have begun to see vastly improved outcomes for managers since September because of the weakness in the USD.



The final word

Ultimately, we believe, while disappointing, global value manager performance is not a result of broad-based style drift. We continue to encourage asset owners to retain their conviction in global active management and indeed global value managers despite this recent period of sub-par relative returns.

Want to learn more?

Please reach out to Frontier if you have any questions or visit frontieradvisors.com.au for more information.

Frontier

Level 17, 130 Lonsdale Street, Melbourne, Victoria 3000

Tel +61 3 8648 4300

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.

Frontier Advisors Pty Ltd ABN 21 074 287 406 AFS Licence No. 241266