The Frontier Line

Active management outcomes in the 2023 financial year

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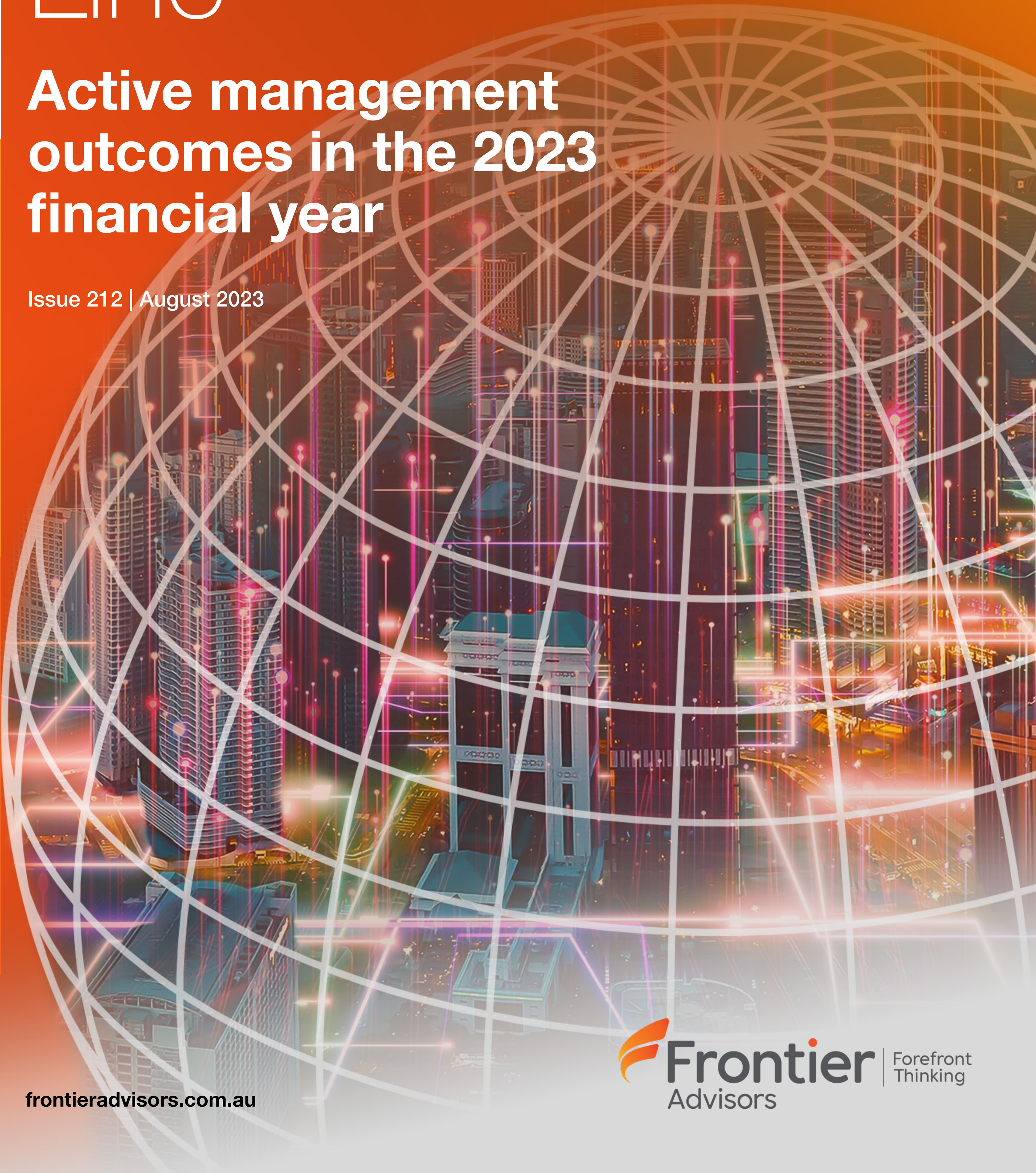

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Forefront Thinking

About us

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

Our 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.

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Consultant

Brad joined Frontier Advisors 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.

Global equities

The 2023 financial year was a more conducive environment for active management in global equities, with the median manager in Frontier's curated list delivering returns of 1.2% ahead of the MSCI ACWI ex-Aus over the year to 30 June 2023.

Despite the strong overall result, we saw significant volatility in active management outcomes between the first half and the second half of the financial year and within style cohorts as forces leading the market changed throughout the year. Table 1 summarises active management results in global equities which, in the end, are indicative of the volatility and rotation we saw in equity market conditions over the period.

Table 1: Frontier's curated list median returns against the MSCI ACWI

Index	Six months to December 2022 (%)	Six months to June 2023 (%)	One-year return (%)
MSCI ACWI	3.7	16.1	20.4
Frontier's curated list median	4.9	16.2	21.6
Relative performance	+1.2	+0.1	+1.2
% of managers ahead of MSCI ACWI	72%	52%	64%

It was a tale of two halves in the 2023 financial year, in more ways than one. While the overall global active management cohort posted strong alpha in the first half of the year before fading away in the second half (as shown in Table 1), there was also a significant story to tell when it came to styles. Table 2 illustrates that value managers performed well in the first half while growth managers performed well in the second half and led over the year.

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Table 2: Growth and value cohort returns in global equities

Index	Six months to December 2022 (%)	Six months to June 2023 (%)	One-year return (%)
MSCI ACWI	3.7	16.1	20.4
Frontier's curated list median value manager	6.7	13.2	20.7
Frontier's curated list median growth manager	3.2	18.8	22.8
Value manager excess	+3.0	-2.9	+0.3
Growth manager excess	-0.5	+2.7	+2.1

The analysis in the next section of this paper dissects active management outcomes over the year and seeks to explain some of the rationale behind these outcomes in global equities over the financial year. The analysis breaks the year down into two halves as these periods reflect a significant shift in leadership which ultimately led to a change in fortunes for active managers in global equities.

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Factors contributing to outcomes in global equities

Country/region allocation

- Regionally, performance shifts were also evident between the first and second half of the 2023 financial year. In terms of country allocation, the first half saw the underperformance of the US market and outperformance of other regional markets such as Europe, Japan and the UK. This environment was good for many value managers who we have found are typically overweight these markets for relative valuation reasons. We believe this also contributed to the overall strength of global active managers as a cohort in the first half of the financial year.
- The second half of the financial year saw market leadership reverse in global equities with the US again strongly outperforming relative to all other regional markets (although notably Europe and Japan were not too far behind). Due to the significant weight of the US in the benchmark, when it outperforms, and especially when it meaningfully outperforms, it tends to result in the underperformance of all other regions relative to the ACWI benchmark. This resulted in the outperformance of growth managers (typically overweight the US market) against value managers but also the muted performance of global active management in the second half. This suggests that while value managers hold larger underweight positions to the US market, the global active management cohort as a whole exhibit underweight allocations to the US market.
- Another performance consideration for both active managers but also investors' overall international equity portfolios is the performance of emerging markets (EM). The MSCI EM had another poor year relative to developed markets, underperforming in both the first and second half of the year. While we have witnessed both active managers and institutional investors more broadly reducing their allocation to EM over time, those who remain overweight relative to the MSCI ACWI benchmark will have again faced beta headwinds in FY23.

Table 3: Country and regional index returns (in AUD)

Index	Six months to December 2022 (%)	Six months to June 2023 (%)	One-year return (%)
MSCI ACWI	3.7	16.1	20.4
MSCI USA	3.3	19.0	22.9
MSCI Europe	8.7	15.7	25.8
MSCI UK	5.1	10.1	15.7
MSCI Japan	6.0	15.1	22.0
MSCI ACWI ex-US	4.4	11.5	16.4
MSCI EM	-1.6	6.9	5.1

Style factors

- Similar to the regional indices, the style factors in global equity markets saw a significant reversal from the first half to the second. Value demonstrated modest outperformance in the first half with growth being dragged down by the de-rating in large US tech companies in response to ongoing central bank policy tightening.
- The second half of the year saw markets absorbed by developments in the AI space and the emergence of the 'magnificent seven', namely Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla. The result was a complete turnaround in the performance of growth against the value factor. Growth significantly outperformed in the second half of the year to leave it comfortably outperforming the value index (as measured by the MSCI ACWI Value Index) over the financial year. In this context (13.5% growth outperformance over value), we think the overall returns of value managers (0.3% ahead of the benchmark) was a strong result. Worth mentioning at this point is the significant underperformance by growth managers against the MSCI ACWI growth benchmark and the significant outperformance by value managers against the respective value benchmark over the year. We believe this highlights the limitations in using these indices alone in the assessment of manager performance given the simplistic nature with which they are constructed. Further analysis would be required to determine whether the respective performance outcomes could be a result of style drift from either cohort.

Table 4: Style index returns (in AUD)

Index	Six months to 31 December 2022 (%)	Six months to 30 June 2023 (%)	One-year return (%)
MSCI ACWI	3.7	16.1	20.4
MSCI ACWI Growth	0.4	26.5	27.1
MSCI ACWI Value	6.9	6.2	13.6

Market capitalisation effect

- The substantial change in market leadership between the first and second halves, particularly when considering market capitalisation, may not come as a surprise.
- Over the years, we have observed a tendency for global active managers to seek alpha/outperformance opportunities further down the market cap spectrum due to more inefficiency and diversification of increasingly concentrated benchmarks. This has led to active managers being underweight mega and large-cap companies and overweight mid and small-cap companies. This also contributed to the stronger results of active managers in the first half compared to the second half of the year.

Table 5: Country and regional index returns (in AUD)

Index	Six months to 31 December 2022 (%)	Six months to 30 June 2023 (%)	One-year return (%)
MSCI ACWI	3.7	16.1	20.4
MSCI ACWI Large Cap	3.4	17.3	21.2
MSCI ACWI Mid Cap	5.6	9.6	15.7
MSCI ACWI Small Cap	6.1	10.1	16.8

Market concentration effect

- For active managers and institutional investors more broadly, market leadership of US large cap growth companies (which were increasingly representing a larger weight within MSCI ACWI) made it far more challenging to match benchmark returns. The poor relative performance of US large cap growth stocks in the December half was likely one of the main contributors to strong active management results. Conversely, the strong rebound in this group of stocks' performance in the second half is likely to have played a large role in the more muted outcomes of global active managers over this period.
- To illustrate how concentrated the markets became, we'll consider the period up to 7 June 2023. A group of seven stocks (Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla) collectively returned 53% on a market cap weighted basis, while the S&P500 only grew by 11%. In contrast, the other 493 stocks that make up the S&P500 had returned 0%. This underscores just how difficult the second half of FY23 was for stock picking. While only very short-term, market breadth has significantly improved since the start of June perhaps signalling a change in fortunes for active managers.

Table 6: Market concentration effect

Index	Six months to 31 December 2022 (%)	Six months to 30 June 2023 (%)	One-year return (%)
MSCI ACWI	3.7	16.1	20.4
MSCI US Large Cap Growth	-3.4	40.3	35.5
MSCI ACWI ex-US Large Cap Growth	3.8	13.0	17.3

Australian equities

Active managers in Australian equities had a modest year in comparison to the past few years, but still managed to post a return that was 0.7% ahead of the S&P/ASX300 over the year to 30 June 2023. Contrary to what occurred in global equities, Australian managers suffered a weak first half before a strong second half, which led to overall gains across the year at a median level, as shown in Table 7.

Table 7: Frontier's Australian equity curated list performance against S&P/ASX 300

Index	Six months to December 2022 (%)	Six months to June 2023 (%)	One-year return (%)
S&P/ASX 300	9.6	4.4	14.4
Frontier's curated list median	8.9	5.3	15.1
Relative performance	-0.7	+0.9	+0.7
% Managers ahead of S&P/ASX 300	32%	74%	53%

It was also a tale of two halves in terms of active management outcomes. We found the relative performance between growth and value managers interesting. Our growth cohort of managers outperformed the value cohort (+2.0% versus +0.1%) over the year, but dissecting these results into halves, we saw directionally similar results from the opposing styles cohorts of managers. Table 8 exhibits both growth (-1.9%) and value (-0.4%) managers underperformed the benchmark in the six months to December 2022 and each cohort outperformed in the second half (growth +1.8% and value +0.6%). Over the year, we found a wide range of managers at the top of our curated list with both growth and value managers afforded an opportunity to outperform through stock selection in their respective opportunity sets. This suggests that there are more factors than just style playing a role in determining outcomes in Australian active management.

Table 8: Growth and value cohort returns

Index	Six months to December 2022 (%)	Six months to June 2023 (%)	One-year return (%)
S&P/ASX 300	9.6	4.4	14.4
Frontier's curated list median value manager	9.2	5.0	14.5
Frontier's curated list median growth manager	7.7	6.2	16.5
Value manager excess	-0.4	+0.6	0.1
Growth manager excess	-1.9	+1.8	2.0

Sector effects

- While there are less factors affecting active management outcomes in the Australian equity market relative to global equities (one equity market, less currency), the unique structure of our market leads to active management trends that can be observed over time. We have observed that Australian managers are generally underweight resources, or more specifically BHP as well as the big four banks given their respective weights in the benchmark. Since its unification in early 2022, BHP has represented ~10% of the local benchmark while the combined weight of the materials and financials sectors is >50%. Therefore, the relative performance of both the financials and materials sectors can often significantly impact performance in Australian equities.
- In the past five years, many investment managers and asset owners have been responding to decarbonisation initiatives and have been reducing the level of carbon emissions in their portfolios. We observed many investment managers are maintaining lower allocations to market segments with high emissions and capital-intensive characteristics, including energy, materials, and utilities. Therefore, these managers have underperformed during this period of market rebound.
- The first half of the period saw outperformance from the four more value-oriented sectors: energy, materials, financials and utilities, as shown in Table 9. Meanwhile, every other sector underperformed relative to the S&P/ASX 300, which likely contributed to the headwinds faced by active managers in the Australian equity market. This largely reversed in the second half with the energy and financials sectors underperforming the broad cap benchmark and the materials sector largely in line. We believe this is a key reason for the improved excess return profile shown in the second half by Australian active managers.
- It is also worth mentioning the REIT sector's performance over the financial year. We have in the past noted equity managers in Australian equities are typically underweight this sector relative to the index. Although its only ~6% of the S&P/ASX 300 benchmark currently, the relative performance of the sector can have a meaningful impact on the relative returns of managers. Over the financial year, REITs underperformed over both halves though more so in the first half of the year. This proved to be a tailwind for relative returns across Australian equity managers.

Table 9: Growth and value cohort returns

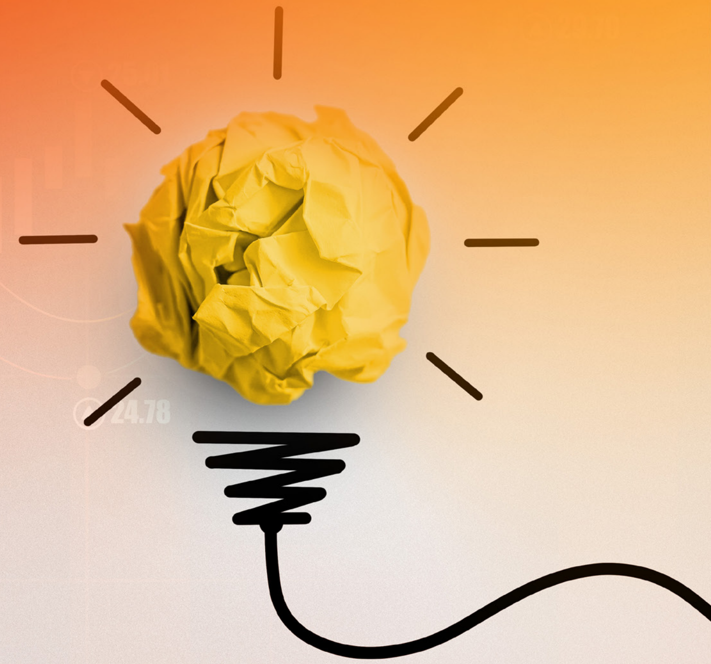
Index	Six months to December 2022 (%)	Six months to June 2023 (%)	One-year return (%)
S&P/ASX 300	9.6	4.4	14.4
S&P/ASX 300 Energy	13.6	3.0	17.1
S&P/ASX 300 Materials	16.3	4.5	21.5
S&P/ASX 300 Financials	12.5	0.4	12.9
S&P/ASX 300 Utilities	12.0	7.4	20.3
S&P/ASX 300 A-REIT	3.9	3.5	7.5

Size effects

- Like global equities, in Australian equities, we find active investors are often underweight large-cap companies in favour of alpha opportunities further down the cap spectrum. There has been a common belief (backed up by historical evidence) that the market becomes less efficient further down the cap spectrum which has often led active managers to be underweight large-cap companies and overweight mid and small-cap companies.
- In the first half of the financial year, we found large caps (as denoted by the S&P/ASX 20) outperformed the broad market. This was likely driven by the underperformance we saw from growth and value managers alike in the first half. Conditions reversed in the second half with large caps underperforming the broad market and mid-caps continuing their outperformance, providing a more conducive environment for active managers to generate excess returns (refer to Table 10). Of note is the underperformance of small caps (S&P/ASX Small Ordinaries) across the year which would have produced substantial headwinds for managers with higher small cap allocations.

Table 10: Market caps returns of Australian equities

Index	Six months to 31 December 2022 (%)	Six months to 30 June 2023 (%)	One-year return (%)
S&P/ASX 300	9.6	4.4	14.4
S&P/ASX 20	10.4	3.3	14.1
S&P/ASX Mid Cap 50	12.8	4.6	18.0
S&P/ASX Small Ordinaries	7.0	1.3	8.5



The final word

The 2023 financial year was an alpha recovery year for global active managers following a tough period for active management in global markets in the previous financial year.

Managers took advantage of a conducive market environment in the first half of the financial year before a narrow second half muted excess returns, with the median manager outperforming the MSCI ACWI by 1.2% over the full year. In Australian equity markets the reverse occurred, with a weak first half for active managers (both value and growth) followed by a strong second half resulting in a 0.7% excess return for the median manager. While still positive, this was a softer result compared to the past three years in Australian equities.

The paper serves as a reminder to investors that active management is cyclical, and factors beyond just traditional style biases affect performance relative to equity benchmarks. We believe it is important to assess individual active management performance not only against their style peers, but equally against a range of other factors such as market breadth, country/sector leadership and size impacts, which can ultimately impact benchmark relative outcomes.

A word on Frontier's curated lists

Frontier curates granular style-based peer groups in both Australian and global equity markets to better understand active management outcomes for clients, while also taking into account the prevailing market environment. By eliminating duplicate data and conducting thorough assessments of the underlying manager constituents to ensure correct style classification, we believe these curated lists and the underlying cohort performance provide investors with greater insight into the performance of their active managers.

These cohorts are at a more granular level than what is presented in this paper. Our Equities Team is available to discuss this service in more detail with interested clients.

If you want to discuss this paper in more detail, please reach out to your consultant or a member of the Equities Team.

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