The Frontier Line

Active management outcomes in equity markets over the 2023 calendar year

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About us

Frontier Advisors has been at the forefront of institutional investment advice in Australia for over 25 years and provides advice on around $660 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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Global equities

The 2023 calendar year produced a year of modest relative returns for global active managers with the median manager in Frontier's Equities Peer Set achieving just 0.4% of excess returns over the year to 31 December 2023.

Despite the strong headline returns for the MSCI ACWI over the year, returns were driven by an increasingly narrow cohort of stocks leading to challenging conditions for active managers. While the first and second half of the year yielded similar results for the overall cohort, we found significant divergence in manager performance based on style over the year. Table 1 summarises active management results in global equities.

Table 1: Frontier's Equities Peer Set list median returns against the MSCI ACWI

Index	Six months to Jun 2023 (%)	Six months to Dec 2023 (%)	One-year return (%)
MSCI ACWI	16.1	4.6	21.4
Frontier's Equities Peer Set median	16.3	4.9	21.9
Relative performance	+0.2	+0.3	+0.4
% Managers ahead of MSCI ACWI	52%	58%	52%

As noted in our 2023 financial year active management paper, growth managers enjoyed a very strong six months to June 2023 as the MSCI ACWI Growth Index outperformed the value index by ~20%. As Table 2 shows, while the next six months proved to be marginally more productive for value managers, it wasn't enough to bridge the gap over the full year with growth managers comfortably outperforming their value counterparts. While not included in Table 2, core managers posted a strong first half of relative returns before moderating in the second half to finish the year with solid excess returns.

Table 2: Growth and value cohort returns in global equities

Index	Six months to Jun 2023 (%)	Six months to Dec 2023 (%)	One-year return (%)
MSCI ACWI	16.1	4.6	21.4
Median value manager	12.8	5.0	18.4
Median growth manager	18.9	4.8	23.5
Value manager excess	**-3.3**	**+0.4**	**-3.1**
Growth manager excess	**+2.8**	**+0.1**	**+2.0**

The following analysis dissects active management outcomes over the calendar year and explains some of the rationale behind these outcomes in global equities. The analysis breaks the year down across various country, style, and capitalisation factors and splits them into different time periods where there has been a significant inflection in markets.

Factors contributing to outcomes in global equities

Country/region allocation

- Regionally we saw consistent leadership from US equities over the 2023 calendar year. Given the US market's large (~63%) share of the ACWI benchmark, all other markets underperformed the broad benchmark over the year in Australian dollar terms. While Japanese markets led returns over the full year, the substantial depreciation of the Japanese yen reduced Australian dollar returns.
- The more meaningful outperformance of US equities in the first half of the year is likely to have been a determining factor behind the level of outperformance we saw from growth managers (relative to value managers and the benchmark) during this period. The overall active management cohort is underweight the US market and as such, the outperformance of US equities over the year has proven to be a headwind for managers.
- Another performance consideration for both active managers and investors' overall international equity portfolios is the performance of emerging markets. 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 remained overweight relative to the MSCI ACWI benchmark will have again faced beta headwinds in 2023.

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

Index	Six months to Jun 2023 (%)	Six months to Dec 2023 (%)	One-year return (%)
MSCI ACWI	16.1	4.6	21.4
MSCI USA	19.0	5.6	25.7
MSCI Europe ex-UK	17.3	3.1	20.9
MSCI UK	10.1	3.3	13.7
MSCI Japan	15.1	3.9	19.6
MSCI ACWI ex-US	11.5	3.0	14.9
MSCI EM	6.9	2.1	9.2

Style

- The first half of the year saw markets absorbed by developments in the AI space and the prominence of the 'Magnificent Seven' (Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla). The result was a complete turnaround in the performance of growth against the value factor when compared to 2022. Growth significantly outperformed in the first half of the year to leave it comfortably outperforming the value index (as measured by the MSCI ACWI Value Index) over the calendar year.
- Similar to the trends observed in country/regional returns, the second half of 2023 brought about a moderation in the overall leadership of styles in the market. Interestingly, we saw identical returns between growth and value indices, allowing for the slight outperformance of value managers (relative to growth) over the period.
- In this context (21.3% growth factor outperformance over value for the full year), we think the overall returns of value managers (-3.1% behind 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 in 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 Jun 2023 (%)	Six months to Dec 2023 (%)	One-year return (%)
MSCI ACWI	16.1	4.6	21.4
MSCI ACWI Growth	26.6	4.6	32.4
MSCI ACWI Value	6.2	4.6	11.1

Market capitalisation

- It is unsurprising there was a moderation in market leadership between the first and second halves which occurred on a market capitalisation basis. The market was dominated by large caps in the first half of the year before a slight reversal in the second half of the year saw mid and small cap stocks marginally outperform their large cap peers. Nonetheless, overall, it was still a year dominated by large cap stocks as demonstrated in Table 5.
- Over the years, Frontier has observed a tendency for global active managers to seek alpha/outperformance opportunities further down the market cap spectrum due to more inefficiency and the diversification of increasingly concentrated benchmarks. This has typically led to active managers underweighting mega and large-cap companies and overweighting mid and small-cap companies. This contributed to the modest results we saw for active managers over the year.

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

Index	Six months to Jun 2023 (%)	Six months to Dec 2023 (%)	One-year return (%)
MSCI ACWI	16.1	4.6	21.4
MSCI ACWI Large Cap	17.3	4.6	22.7
MSCI ACWI Mid Cap	9.6	4.6	14.6
MSCI ACWI Small Cap	10.1	5.5	16.1

Market concentration effect

- For active managers and institutional investors more broadly, market leadership of US large cap growth companies (which are increasingly representing a larger weight within MSCI ACWI) made it far more challenging to match benchmark returns. While US large cap growth stocks outperformed over the entire year, this outperformance was far more pronounced in the first half of 2023. During the second half, a more muted level of outperformance for this cohort led to improved outcomes for value managers as well as a slightly improved outcome for active managers in general, with 56% of global managers outperforming in the second half relative to 51% in the first.
- To illustrate how concentrated markets became, in the calendar year to 15 November 2023, the 'magnificent seven' group of stocks referred to earlier (Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla) had, on an equal weighted basis, collectively returned 71%, compared to the S&P 500 return of 19%. In contrast, the other 493 stocks that make up the S&P 500 had returned just 6%. Without these seven stocks, benchmark returns would have been significantly lower, illustrating just how difficult 2023 was for stock pickers who held little or no positions in this cohort.

Table 6: Market concentration effect

Index	Six months to Jun 2023 (%)	Six months to Dec 2023 (%)	One-year return (%)
MSCI ACWI	16.1	4.6	21.4
MSCI US Large Cap Growth	40.3	7.4	50.6
MSCI ACWI ex-US Large Cap Growth	13.0	0.0	13.0

Australian equities

Active managers in Australian equities had an underwhelming year in 2023, with a return equal to the S&P/ASX 300 over the year to 31 December 2023 (pre-fees).

There was a greater degree of volatility in the alpha profile for Australian managers this year when compared to global equites, with a strong first half of the year offset by a weak second half which left the median manager largely square with the benchmark (see Table 7).

Table 7: Frontier Australian Equities Peer Set performance against S&P/ASX 300

Index	Six months to Jun 2023 (%)	Six months to Dec 2023 (%)	One-year return (%)
S&P/ASX 300	4.4	7.5	12.1
Frontier's Equities Peer Set median	5.4	6.3	12.1
Relative performance	1.0	-1.2	0.0
% Managers ahead of S&P/ASX 300	76%	39%	52%

It was also a tale of two halves in terms of active management outcomes, where we found the relative performance between growth and value managers interesting. Our growth cohort of managers outperformed the value cohort (+2.2% versus -2.4%) over the year, but dissecting these results into halves, we saw directionally similar results from the opposing style cohorts of managers (see Table 8). Both growth (+1.8%) and value (+0.6%) managers outperformed the benchmark in the six months to June 2023 with each cohort's performance moderating in the second half (growth +0.1% and value -3.2%). While it was growth managers that topped our Equities Peer Set over the year, there was a clear trend of moderating performance for both cohorts between the first and second half of the year. This suggests there are more factors than just style playing a role in determining outcomes in Australian active management.

Table 8: Growth and value cohort returns in Australian equities

Index	Six months to Jun 2023 (%)	Six months to Dec 2023 (%)	One-year return (%)
S&P/ASX 300	4.4	7.5	12.1
Median value manager	5.0	4.3	9.8
Median growth manager	6.1	7.5	14.3
Value manager excess	**+0.6**	**-3.2**	**-2.4**
Growth manager excess	**+1.8**	**+0.1**	**+2.2**

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. 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 materials and financials sectors can often go a long way to explaining outcomes (positive or negative) in Australian equities.
- When considering the point above, we see the sector performance across the first half of 2023 proved to be a tailwind for Australian active management. The underperformance of the financials sector and in line performance of the materials sector (Table 9) has benefitted managers with portfolios that are more diversified than the ~50% of the benchmark these sectors represent. While only representing 2.6% of the overall benchmark, it is worth calling out the IT sector's strong outperformance in the first half which is likely to have aided growth managers who we typically see hold above benchmark weights of many IT stocks.
- It is also worth mentioning the REIT sector's performance over the calendar year as well. In the past, we have observed Australian equities managers are typically underweight this sector relative to the index. While 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. In 2023, REITs underperformed in the first half of the year before expectations of falling interest rates led to significant outperformance in the second half. This proved to be a headwind for relative returns across Australian equity managers over the full year.

Table 9: Sector returns of the S&P/ASX 300

Index	Six months to Jun 2023 (%)	Six months to Dec 2023 (%)	One-year return (%)
S&P/ASX 300	4.4	7.5	12.1
S&P/ASX 300 Materials	4.5	10.1	15.1
S&P/ASX 300 Financials	0.3	10.7	11.1
S&P/ASX 300 A-REIT	3.5	13.0	16.9
S&P/ASX 300 IT	26.2	1.3	27.9

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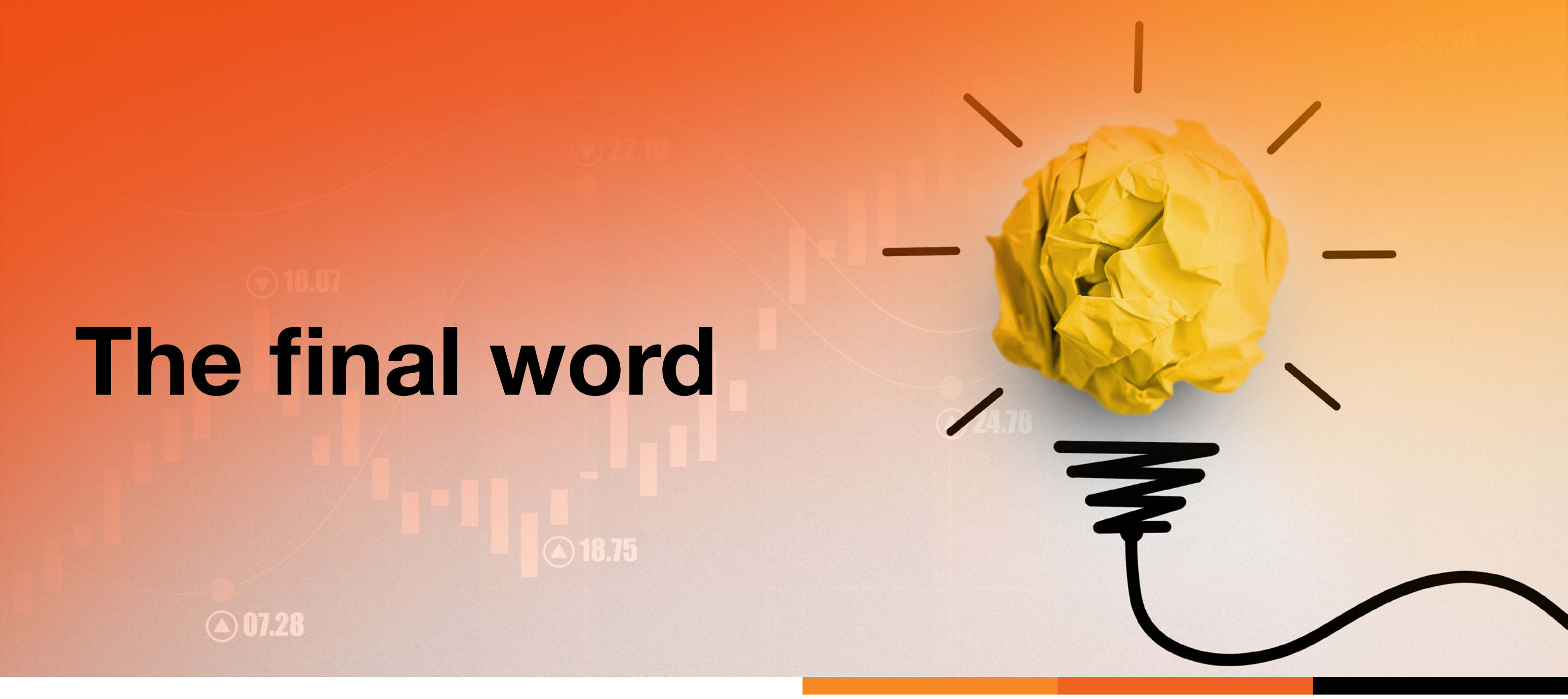
Size effects

- Similar to 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 calendar year, performance up and down the cap spectrum was relatively equal, though small-caps (as denoted by the S&P/ASX Small Ordinaries Index) underperformed both large and mid caps. Conditions reversed in the second half with large caps outperforming the broad market and both mid and small cap companies underperforming (see Table 10). Over the full year, the large cap outperformance likely contributed to the lack of excess returns posted by the median Australian equity manager.

Table 10: Market caps returns of Australian equities

Index	Six months to Jun 2023 (%)	Six months to Dec 2023 (%)	One-year return (%)
S&P/ASX 300	4.4	7.5	12.1
S&P/ASX 50	4.7	8.3	13.4
S&P/ASX Mid Cap 50	4.6	3.0	7.8
S&P/ASX Small Ordinaries	1.3	6.4	7.8



The final word

The 2023 calendar year represented a modest outcome for global active management as the strong absolute returns delivered by global benchmarks (driven by the 'magnificent seven') led to only slight outperformance (pre-fees) for the full year.

Growth managers outperformed value managers due largely to the first half of the year, though by a smaller magnitude than what was suggested by style benchmarks (such as MSCI ACWI growth and value). Overall, we found managers continue to face a challenging market environment as narrow leadership and high levels of concentration lead to outcomes below our expectations and historical evidence. While growth managers in Australian equites also outperformed their value counterparts, there was a higher degree of volatility in alpha profiles from the first half to the second half. The outperformance of large caps (dominated by the materials and financials sectors) led to a -1.2% outcome in the second half for the median Australian manager, all but cancelling out the relative gains seen in the first half.

This 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. Frontier believes it is important to assess individual active management performance not only against style peers, but equally against a whole other range of factors such as market breadth, country/sector leadership and size impacts, that ultimately can impact benchmark relative outcomes.

A word on Frontier's Equities Peer Set

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 our peer set and the underlying cohort performance provide investors with greater insight into the performance of their active managers.

These cohorts exist at a more granular level than 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 Frontier's Equities Team.

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