Public Equities

Major Trends

Historically concentrated equity market returns in 2023

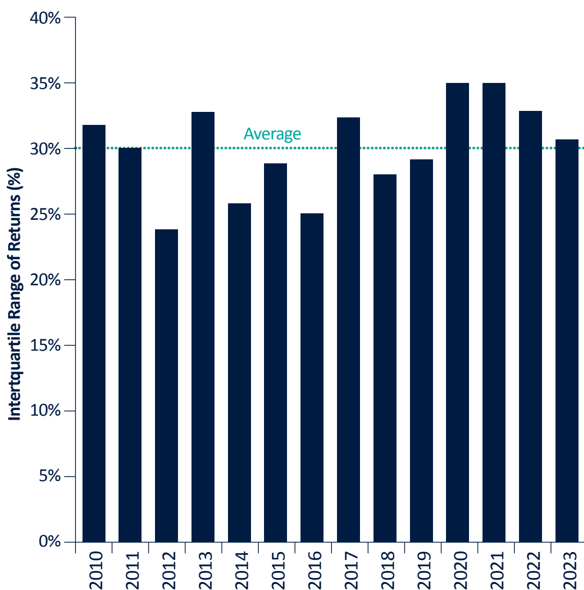
A defining feature of public equity markets in 2023 was the degree to which overall index returns were concentrated in a small number of mega cap stocks. The largest US technology companies dominate that group: among the 20 largest positions in the MSCI All Country World Index, there is only one non-US stock, TSMC. The "return concentration" in global equity markets drove a historic wedge between the average stock return and capitalisation-weighted index returns across markets in 2023: +8.9% for equal-weight vs. +22.7% for the standard index in global equities (MSCI ACWI) and +13.8% for equal-weight vs. +26.3% for the standard index in US equities (S&P 500).

What has been very unusual is that it's been the very largest companies that were the biggest winners. The largest 7 companies in the S&P 500 (dubbed the "Magnificent 7" by the financial press) were on average up +76% (weighted average) over the course of the year, compared to +14% for the remaining 493 companies in the S&P 500. This makes for a difficult year to outperform the index for most traditional long equities managers, who size positions in their portfolios based on conviction on an absolute basis, not relative to benchmark weights. Said differently, in a year like 2023, market cap weighted indices displayed exceptional position sizing skill – only that there is no long-term skill in market-cap weighting.

Another way of looking at the same problem is to determine the share of stocks that have outperformed the traditional market cap-weighted index (Exhibit 2).

Exhibit 1

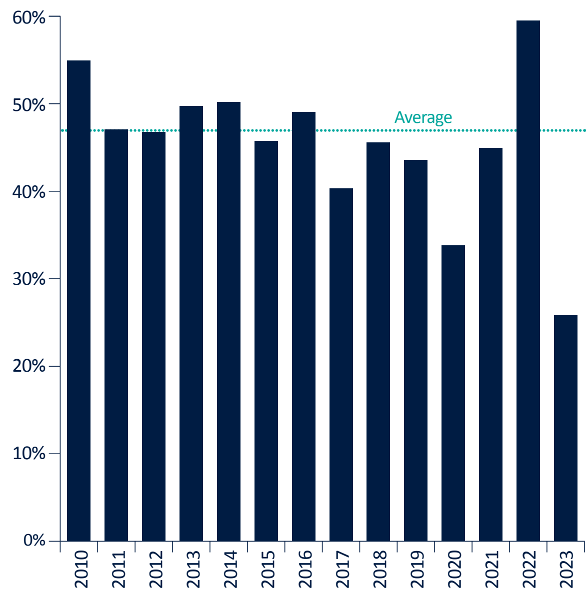
Return dispersion (the difference between the stocks that have gone up the most and the stocks that have gone down the most) has not been unusually high in 2023



Source: *Bloomberg*

Exhibit 2

In 2023, only 25% of stocks outperformed the S&P 500, substantially below the long-term average of just under 50%



Source: *Bloomberg*

What are the implications for investors? History suggests that the relative performance of the largest companies in an index is cyclical. As a result, we don't believe that investors should chase this phenomenon by, for example, taking direct positions in the largest companies. While these companies could continue to outperform due to higher earnings growth, they experienced a significant increase in earnings multiples in 2023, which drove most their return. The resulting elevated starting point for their earnings multiples makes a repeat of last year's differential performance unlikely.

Generative AI goes mainstream, but at this point only driving a narrow portion of the market

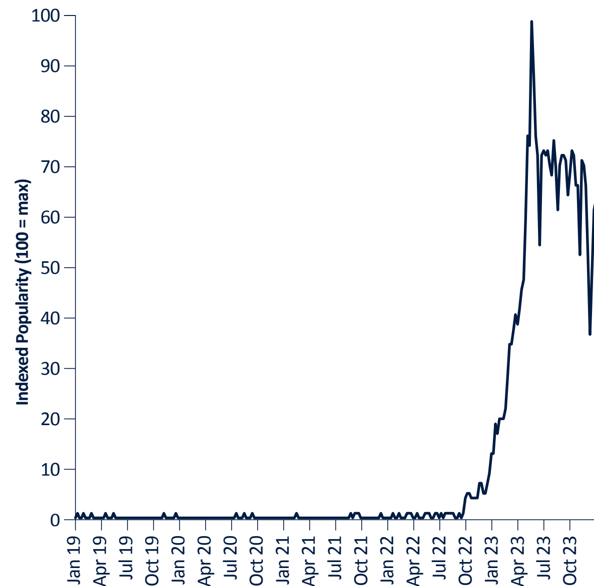
Generative AI, a term hardly even seen before the start of 2023 (Exhibit 3), became a key equity market theme last year. The release of Chat GPT sparked the imagination of the market for the potential use cases for this new technology and their implications for companies' revenue and margin potential. Initial gains were mainly concentrated in AI enablers, companies that provide the hardware and infrastructure required for increasing compute to power Generative AI. The SOXX Semiconductors Index (+67% in 2023) had its strongest year since 2009, and the large internet cloud providers (Microsoft, Alphabet, Amazon) all benefitted as well.

Over the course of the year, as valuation levels for these initial beneficiaries increased, we have seen our managers' exposure broaden: Tech specialists invested in other parts of the compute value chain, such as memory or transmission, and other managers looked at the intersection of industrials and technology to identify companies that should benefit from increased investments in data center infrastructure.

As we head into 2024, we expect the focus on Generative AI to continue. Managers focused on the technology sector will have to contend with assessing the hype vs. reality in AI-driven innovation, balancing the future growth opportunities for companies providing computing power and infrastructure with their valuation levels. As the technology's application widens, all investors will have to grapple to identify the winning, losing and relatively less-impacted companies across industries. The question of how the successful application of generative AI technology can affect a company's revenue growth or margin structure has become a question all investors must contend with.

Exhibit 3

Google searches for Generative AI show the rise in interest in 2023



***Source:** Google Trend*

Significant rally over the last two months of 2023 as interest rate expectations fall

The impressive equity market returns in 2023 are largely due to a significant rally at the end of the year. Through October 27, the S&P 500 was up +8.6%, driven by the mega cap stocks, with the average stock in the index actually down -3.9%. The market then experienced a strong, broad-based rally in the last 2 months of the year. At the end of October, strong Q3 US GDP growth, lower core PCE inflation and dovish comments from Fed Chair Powell increased the market's expectation of a "goldilocks scenario" of falling inflation and robust economic growth. As a result, long-term interest rates fell significantly, with US 10-year Treasury yields falling from a high of 5% in October to under

Public Equities
continued

4%. This change in market sentiment triggered a 16% rally in the S&P 500 through year end. This market move benefitted segments of the market which had been "left behind" during the first 10 months of the year. Small caps, for example, rallied strongly in November and December, with the Russell 2000 up +24% (nevertheless finishing the year around -10% behind the S&P 500). A basket of unprofitable technology companies rallied by +46% during that same period, benefiting from the rate declines. Biotech also surged, with XBI (small cap biotech index) up +39%. While the positive market sentiment from lower interest rates certainly supported the market, there was also a specific boost from a number of announced M&A transactions.

This market behavior serves as a reminder of the importance of avoiding market timing. Running with lower public equity exposure during these two months of the year could have had a significant negative impact on full year and even multi-year returns. This is true both at the manager level (where we have a strong aversion against managers who actively swing around their market exposure) and the portfolio level (where we eschew "market timing" in our asset allocation).

Golden Rules

- Focus on stock selection as the main driver of sustainable outperformance in public equities. Our experience suggests that market timing, sector rotation or factor exposures are not reliable sources of risk-adjusted returns.
- Capture a diverse set of idiosyncratic sources of return, with limited market, sector and style skews at the portfolio level.
- Partner with managers possessing (a) differentiated research capabilities and expertise in their strategy area, (b) disciplined process for investment diligence and portfolio management and (c) strong alignment with investors.
- Size manager allocations based on active risk contribution, strategy/alpha source weightings and portfolio-level skew minimisation. Grow into investments with new managers over time. Rebalance regularly.
- Diversify sources of active risk across investment strategies and approaches. No strategy works all the time. Do not try to time strategy exposure but monitor environment for changes in fundamental strategy attractiveness.

Sub-Strategy Attractiveness

As discussed in more detail in the active equities spotlight chapter, we have evolved our investment approach to long equities to increase the stability of alpha generation. We are therefore adding capital risk-managed beta-1 and equity market neutral strategies, complementing our existing investments in traditional generalists and specialist managers.

Risk-Managed Beta-1 and Equity Market Neutral

- Favorable view. We believe that both Risk-Managed Beta-1 and Equity Market Neutral strategies have high utility for our client portfolios. These strategies provide a core allocation in our portfolios with meaningful, stable alpha and modest, predictable active risk. While the alpha in these strategies can also be cyclical, we expect it to be less dependent on which sectors, regions or styles happen to be in favor during any given period.

Traditional Generalist Long and Hedged Equities

- Neutral view. We have been reducing our allocation to traditional generalists as we add capital to more risk-managed strategies. However, we continue to see a role for traditional generalist long and hedged equities managers in our portfolios. Our

desired managers in this area invest with a longer-term horizon, concentrated capital in their highest conviction fundamental ideas and/or seek to add value via company engagement. In hedged equities, we believe that the outlook for short alpha generation has improved. A normalisation of interest rates reduces the ability of underperforming companies to extend their runways through low-cost financing. Companies that went public during the IPO "bubble" of 2020-2022 provide a particularly fertile area for short opportunities.

Specialists

We continue to allocate to what we believe to be high quality specialist managers in strategy areas where we see strong return potential and clear benefits to expertise.

Life Sciences

- Favorable view. We believe the structural investment thesis for biotech remains intact in spite of a challenging period for the market. In 2023, the biotech market, proxied by the Nasdaq Biotechnology Index, underperformed global equity markets for the third year in a row (up only +3.7%). While the majority of our managers outperformed this index in 2023, they still did not generate alpha relative to global equity markets. The last two months of 2023, however, were a reminder of the alpha potential in the sector. The combination of a more friendly market environment, a pickup in M&A activity and a number of positive drug trial datapoints propelled biotech market beta and our managers' alpha during that period.

Emerging Technology

- Favorable view. We continue to invest in emerging technology specialists given the attractiveness of the space for company-specific alpha generation and to access a high-growth subset of the technology, consumer discretionary and communication services sectors. The technology, communication services and consumer sectors offer consistently attractive share price dispersion. We maintain modest directional exposure to emerging technology for growth-driven returns. This is a function of higher revenue growth potential (e.g., large global addressable markets, ability of digital products and services to grow faster than traditional physical businesses) in companies that should over the long term have attractive margin structures (e.g., high gross margins and sustainable pricing power). Risks include high level of competition (e.g., spend required to grow/defend market share), valuations that can become frothy and the increasing challenge of fast growth as businesses become larger.

  Generative AI has become the key disruptive force in emerging technology. In 2023, we witnessed technology-focused investors rotate capital into the infrastructure layer supporting AI, largely semiconductors, semiconductor equipment and software and cloud providers. While we believe that these businesses can continue to benefit from AI adoption, we are cognizant that the euphoria around perceived AI winners has placed high valuations and high expectations for company-specific execution on them. For instance, the semiconductor index currently trades at 10-year high forward P/E multiples. In 2024, we think investor focus will shift to the tension between driving profitability via AI-driven cost-cutting and investing in AI-related infrastructure. Investors will be closely watching to see which companies can show

Public Equities
continued

evidence of monetising their AI investments. We also expect that capital flows into perceived AI winners, and out of perceived AI losers, by less sophisticated investors will provide material alpha opportunities as companies begin to report the results of their AI initiatives.

Energy Transition

- Favorable view. We believe that the world's transition towards electrification and renewable energy production results in structural changes to competitive landscapes and profit pools across a wide range of industries in the energy, materials, utilities and industrials sectors.

  The energy transition space underperformed in 2023, with the S&P Global Clean Energy Index declining -20.4%. The higher level of interest rates and input cost inflation started to harm companies in the sector, with wind energy companies being the most visible example of aggressive growth strategies from 2020-21 coming back to haunt companies. This was a difficult environment for our managers in the space and serves as a reminder that this transition is not always smooth. The year also reinforced our view that the space presents good opportunities for long/short strategies that can take advantages of both sides of the disruption. Going into 2024, we see signs that the market continues to work through the issues created by the 2020-21 exuberance. Managers emphasise the importance of being selective. Some areas will have strong years ahead as the economics of power generation work in their favor or as they benefit from the capex required to upgrade energy infrastructure. In other areas, the realisation that the energy transition will be costlier than anticipated will put pressure on company share prices.

Small Caps

- Mixed view. Last year, we wrote about the attractive valuation of small cap relative to large cap companies in the US. This valuation gap did not narrow in 2023. US small caps (as measured by the Russell 2000 index) returned +16.9% in 2023, lagging the large cap S&P 500 by almost -10%. However, this underperformance was exclusively driven by the largest 7 US stocks. Compared to the equal-weighted S&P 500, small caps actually outperformed by +3%. Structurally, we continue to believe that small caps are a fruitful area for stock selection due to larger company universe and greater pricing inefficiencies. This view is supported by the strong performance of our small cap specialist managers in 2023, which all outperformed the Russell 2000. While the valuation setup for small cap remains attractive, we are mindful of the lower quality and resilience of many of these smaller companies, which particularly pressures them if macroeconomic conditions were to worsen.

Changing opportunity set in Asia

- Negative view on China and favorable view on Japan. As we wrote about in last year's Insights, we eliminated our overweight to China going into 2023. Chinese equities went on to become the worst-performing major equity market globally, down -11.2% in 2023. The geopolitical and macroeconomic outlook on China remains negative, and trading and liquidity dynamics in the market have worsened. We maintain small "at weight" exposure to the market concentrated in high-quality domestically-oriented companies trading at historically low valuations through a specialist manager. On the other hand, we are constructive on Japan as corporate governance reforms

appear to have real traction. We are revisiting the specialist manager opportunity set and seeking to increase our exposure to Japan. We are mindful that the promised corporate governance reforms have been incredibly slow to bear fruit since the publication of Japan's Corporate Governance Code 10 years ago, but we see increasing evidence of shareholders unlocking value in undervalued Japanese companies.

2024 Strategic Priorities

- **Continue to expand our line up of risk-managed beta-1 strategies:** The manager specification discussed in our active equities spotlight chapter has focused us on a few key strategies, including quantitative/systematic, sell-side or buy-side alpha capture and beta-1 versions of equity market neutral strategies. We are shifting capital to these strategies, while being mindful to diversify our exposure across the different "alpha engines" outlined above.
- **Search for what we believe to be the best investment options in currently attractive specialist areas:** Key areas of focus for 2024 include: (a) Active management in emerging markets outside of China, including both single-country strategies in India and other significant markets and broad EM ex-China systematic strategies; (b) Lower net-exposure Emerging Technology strategies as a way to exploit long and short alpha opportunities while reducing large thematic skews; and (c) Japanese equities strategies exploiting positive economic developments and corporate governance reforms in the market.
- **Increase the breadth and quality of our manager line up:** We continue to place an emphasis on casting a wide net in our search for the most attractive strategy areas and what we believe to be the best investment talent. We also constantly seek to upgrade our existing manager portfolio. We place a premium on investing in what we believe to be high quality strategies with inherently different approaches to generating alpha in order to increase the robustness and reduce the systemic risk in our active equities portfolio.
- **Aim to partner with the highest calibre new launches:** We continue to believe that we can benefit from our ability to identify, what we believe to be exceptional investment talent early in their lifecycle and partner with them on accretive pricing, terms or capacity. As a result, we seek to meet with all high-potential new launches, from which we will selectively invest only in the highest calibre ones.

Long-Term Expected Return

Exhibit 4

Based on our 10 year forecasts, we target the following long-term expected returns for Hedged Equities and Long Equities[1]

	Hedged Equities	Long Equities
Risk-free Rate	4.0%	4.0%
Risk Premium	1.5%	3.0%
Illiquidity Premium	—	—
Manager Alpha	2.0%	1.0%
Total Return	**7.5%**	**8.0%**

Beta return of 7.0% for Long Equities reflects 4.8% p.a. nominal revenue growth (in line with IMF's forecast of nominal GDP growth); +0.6% in profit margins expansion due to impact of AI; - 0.9% from contraction in equity risk premium and +2.5% dividend yield. Beta return of 5.5% for Hedged Equities derived from 0.5x Cash + 0.5x Long Equities exposure. Manager alpha of 1.0% for Long Equities and 2.0% for Hedged Equities in line with our rolling 3-year pooled vehicle results over the past 10 years.

Hypothetical return expectations are based on simulations with forward looking assumptions, which have inherent limitations. Such forecasts are not a reliable indicator of future performance.