



WHY AN ALL-CAP APPROACH MAKES SENSE IN TODAY'S U.S. EQUITY MARKET

In a tight risk/reward environment, stock selection will likely be the key driver of returns.

- After a difficult 2022 for investors, the U.S. equity market narrative has turned more positive in 2023. However, this positivity feels premature, in our view.
- The equity risk premium currently available from the U.S. equity market is around historically low levels, which makes for a disappointing risk/reward profile.
- Stock selection will likely drive near-term U.S. equity returns. An all-cap remit provides the flexibility to find potential alpha sources from across the entire market.



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All-Cap Opportunities Strategy

After a difficult 2022 for investors, the narrative in the U.S. equity market has turned more positive in early 2023. This is largely due to expectations of cooling inflation, which will allow the Federal Reserve to pull back on aggressive interest rate hikes. However, with much that remains uncertain, this positivity feels premature, in our view. There is no denying investor sentiment has become more fragile over the past year. Stocks leading the market are changing at an unusually fast pace, regardless of fundamentals, making it more difficult to find reliable sources of alpha. On a risk/reward basis, the

U.S. equity market also looks broadly expensive, in our view, meaning performance is likely to be driven by individual stock selection. This is where an all-cap equity remit can be beneficial, providing the flexibility to find potential sources of alpha from across the entire market and the broad diversification to better manage risk and potentially deliver more consistent performance outcomes.

Taking Stock of the Current Landscape

Consensus opinion has turned more positive since the start of 2023, with expectations that inflation has peaked, thereby enabling the Federal Reserve (Fed) to stop raising interest rates later this year. However, we do not feel a whole lot has changed since 2022. The rise in inflation has been fueled by structural changes in the U.S. economy; and while it is indeed receding, we anticipate the path back down toward the Fed's 2% target will be a much more drawn-out process than the consensus appears to believe. If we look back to the late 1970s and early 1980s, when inflation was similarly elevated, history tells us that the disinflation process tends to be slow and drawn out, especially when similar inflationary trends are observable in other major regions. As such, we believe that—unless there is a recession—U.S. inflation could take much longer to get down to target level than the consensus currently expects.

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History also argues that a deeply inverted yield curve makes recession difficult to avoid. However, the longer an economic landing is delayed, in the hope that it can be avoided altogether, the harsher the landing is ultimately likely to be. What seems to be underappreciated, in our view, is that we have entered a new investment regime, and there is a great deal that remains uncertain. Adjusting to this new landscape will take time and be potentially uncomfortable along the way.

Investors' more positive outlook in early 2023 sparked a sharp rotation in the equity market, with more cyclical, growth-oriented companies rallying strongly, notably led by beaten-down technology, consumer discretionary, and industrial stocks. More recently, investors have applied the brakes to the market, seemingly wary after such a strong start to the year.

Implications of Banking Sector Duress

More recently, the banking sector has come under extreme duress, with a potential crisis emerging in the U.S. regional banking sphere. We know from history that the Federal Reserve tends to tighten policy until something breaks; reining in inflation is their job. And, in this instance, the first things to break have been Silicon Valley Bank and Signature Bank, and, in Europe, Credit Suisse has suffered the same fate. While we think that the acute crisis will likely pass, the reality is that this shock to the system will cause a tightening of financial conditions. More plainly, regional banks are an important source of liquidity for small and mid-size businesses (SMBs), and the self-preservation instinct means that these banks are going to be more reluctant to make loans. The impacts of this will not be immediate but, over time, if SMBs find it more difficult to get loans, there will be consequences for U.S. economic growth. This is unlikely to spiral into a full-blown banking crisis, in our view, but it is the clearest sign so far of knock-on consequences of the Fed's rate hike campaign.

Another interesting feature of the U.S. equity market during the early part of 2023 is that the companies that have posted the strongest year-to-date returns are generally those that have missed their target earnings. Those that have met their earnings expectations, on the other hand, and where fundamentals appear robust, have generally underperformed. History shows, however, that markets ultimately behave rationally and that the leading stocks of the previous cycle are invariably not the same stocks that lead going forward. History also shows us that fundamentally good businesses have tended to outperform the market over the long term, and an all-cap investment remit is key in finding these businesses.

Corporate Earnings May Come Under Pressure

From an earnings perspective, 2023 looks challenging for U.S. companies. After record monetary and fiscal stimulus supported post-pandemic business activity in 2021, last year proved a more difficult earnings environment. This trend is likely to continue in 2023 with corporate earnings vulnerable to further pressure. The prospect of economic recession looms large, while the full impact of higher input costs has also yet to be fully reflected. The tight labor market means competition for workers will also remain high, putting pressure on margins across a range of industries, but particularly in the service sector.

This all adds up to a much more challenging environment for corporate profitability. A lot of U.S.

companies have either already reported, or are at risk of, declining earnings in early 2023. As such, we expect investor returns to be driven more by individual stock performance than by broad sector trends. Macro considerations remain important, but in our view performance will come from astute selection of individual names—good businesses, at reasonable valuations, where there is a degree of comfort that earnings will be met.

Recent interest rate rises mean that investors can now get returns of close to 5% from 3-Month U.S. Treasuries.

Market Valuation Needs to Be Viewed in Context

After what reasonably can be described as a miserable year for U.S. equities in 2022, particularly for expensive growth-oriented stocks, much has been written about the U.S. equity market now trading at more attractive valuation levels. Certainly, the market today does not look outrageously expensive and is notably cheaper than the peak 2021 valuation levels. However, as with most things, context is everything.

The S&P 500 Index, for example, is currently trading around 19x forward price/earnings (fwd P/E),¹ above the long-term average (15x fwd P/E).² Compared with the consistently higher-level valuations that we have become accustomed to in recent years (in the 20x to 23x fwd P/E range), some might argue that current valuation levels look reasonable. However, this view does not take into account today's structurally altered market conditions. In an environment of elevated inflation, higher-for-longer interest rates, signs of corporate earnings contraction, and the storm clouds of a possible recession, the current market valuation looks less enticing, in our view.

Equity Risk Premium in Focus

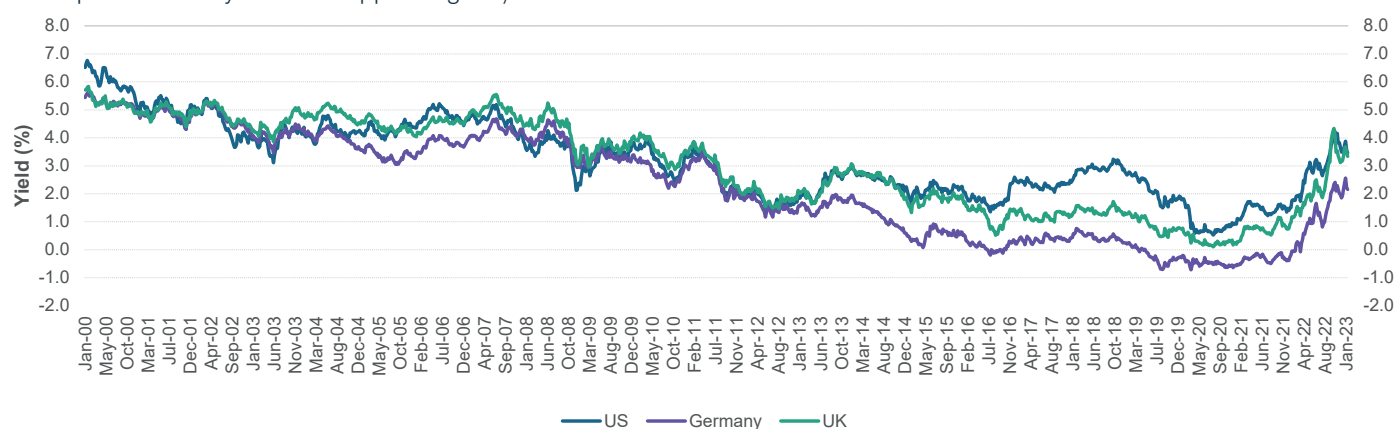
One valuation measure worth highlighting is the equity risk premium (ERP). The ERP effectively measures the additional reward that equity investors can expect to receive above that available from risk-free benchmark U.S. Treasuries. Analysis shows that the ERP on the S&P 500 Index today is around historic lows (Figure 1). Recent interest rate rises mean that investors can now get returns of close to 5% from 3-Month U.S. Treasuries. Given the considerable market and economic risks that have been outlined, one might reasonably expect equities to be paying a sizable premium over and above the return available from Treasuries. However, the current risk premium of around 200 to 250 basis points for investing in the U.S. equity market looks unattractive in this context.

Performance Consistency Over Time

Individual company names, of course, can and should perform well for idiosyncratic reasons. This is where an all-cap strategy can be beneficial, providing an expansive opportunity set in which to find good businesses. The past year has shown us that market volatility can be dramatic. An all-cap mandate allows a manager to quickly adapt to changing market

FIGURE 1: U.S. Equity Market Equity Risk Premium (ERP)

U.S. equities currently offer a disappointing risk/return trade-off



¹ As of January 31, 2023.


Based on the S&P (500 Equal Weight Index). ERP calculated as S&P 500 Index (Equal Weight) Fwd Earnings Yield—10-Year U.S. Treasury Yield.

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¹ Source: FactSet: Financial data and analytics provider, FactSet. Copyright 2023 FactSet. All rights reserved, as of March 15, 2023.

² From 1940 through to December 31, 2022, using year end forward P/E data.¹

conditions, enabling investment anywhere along the market capitalization spectrum and the rebalancing of risk, across themes, sectors, and individual stocks without restraint.



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An all-cap strategy manager can apply a methodical investment framework that revolves around a basic view that stock prices are ultimately a function of supply and demand over the short to medium term. This means that when stocks have more incremental reasons for investors to want to buy them (i.e., they are in higher demand) and fewer incremental reasons for people to sell them (i.e., supply them back to the market), then stock prices must find a higher equilibrium point.

The consistency of good performance outcomes stem from an investor's belief that the supply and demand framework remains true in any market environment and avoids becoming overexposed to either growth or value styles. In 2022, for example,

the inflationary/rising interest rate backdrop turned sharply against growth companies. Conversely, 2022 was a strong year for value-oriented companies, as mean reversion became the driving force behind stock prices. But, while this proved a great support last year, for most of the 2010 decade, it was a substantial headwind.

Cautious for Now

There are still considerable risks in the economy, and a recession in the U.S. at some point remains the most likely outcome, in our view. On this basis, investors could maintain a more cautious stance on the U.S. equity market, particularly as the current risk/reward profile gives little incentive to add risk at this point. We think investor returns are likely to be driven by individual company performances in the near term, rather than by broad-brush decision-making at a sector level. And, while we are cautious about the near-term outlook, it is also important to highlight that the U.S. equity market is enormous, and we believe that investors with an all-cap remit can benefit from tapping the broad range of opportunities, diversifying across investment styles and across the market capitalization spectrum. ■

Risks—The following risks are materially relevant to the portfolio:

Currency—Currency exchange rate movements could reduce investment gains or increase investment losses.

Issuer concentration—Issuer concentration risk may result in performance being more strongly affected by any business, industry, economic, financial or market conditions affecting those issuers in which the portfolio's assets are concentrated.

Sector concentration—Sector concentration risk may result in performance being more strongly affected by any business, industry, economic, financial or market conditions affecting a particular sector in which the portfolio's assets are concentrated.

Small and mid-cap—Small and mid-size company stock prices can be more volatile than stock prices of larger companies.

General Portfolio Risks:

Equity—Equities can lose value rapidly for a variety of reasons and can remain at low prices indefinitely.

ESG and sustainability—ESG and Sustainability risk may result in a material negative impact on the value of an investment and performance of the portfolio.

Geographic concentration—Geographic concentration risk may result in performance being more strongly affected by any social, political, economic, environmental or market conditions affecting those countries or regions in which the portfolio's assets are concentrated.

Hedging—Hedging measures involve costs and may work imperfectly, may not be feasible at times, or may fail completely.

Investment portfolio—Investing in portfolios involves certain risks an investor would not face if investing in markets directly.

Management—Management risk may result in potential conflicts of interest relating to the obligations of the investment manager.

Market—Market risk may subject the portfolio to experience losses caused by unexpected changes in a wide variety of factors.

Operational—Operational risk may cause losses as a result of incidents caused by people, systems, and/or processes.

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