



How Value Can Flex to Shifting Market Dynamics

Agility to offer cyclical and defensive opportunities.

February 2023

KEY INSIGHTS

- Broadly, the market backdrop for value investing remains favorable, with both near- and long-term factors providing support, but volatility could return.
- An active value approach can help negotiate shifting market dynamics to target cyclical opportunities and provide more defensive positions when volatility rises.
- In the near term, indicators suggest that equity markets may be returning to earnings as the main driver of equity performance.



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Markets have started 2023 strongly as some of the headwinds that dominated markets in 2022 have started to dissipate. China has reopened its economy faster than expected; warm weather in the euro area has eased concerns over natural gas shortages; and recent data from the U.S. have pointed to continued growth, moderating inflation, and a slower pace of Fed rate hikes. Combined, this has caused market consensus to lower the probability of a synchronized global recession in 2023. That said, although the outlook has improved versus last year, we are still likely to see volatility in equity markets as they continue to react to differing macroeconomic and earnings data points. However, with value offering a combination of defensive and cyclical attributes, we believe the style is well positioned to negotiate shifting market scenarios.

Key Value Drivers Continue to Persist

The backdrop for value remains favorable, with both near- and long-term factors providing support. Valuations remain relatively attractive versus growth stocks, even after oversized outperformance versus growth stocks in 2022. We are, however, witnessing a more subdued value opportunity set compared with the abundant opportunities we found in the past. It is also likely that we may see risks of broad earnings downgrades as margins are pressured by inflation and low growth. Equity markets may once again return to earnings as the main driver of equity returns. Companies offering profits resilience and those able to pull levers to protect shareholder returns are likely to be rewarded. With value offering both a healthy representation to defensive areas, such as utilities and other traditional industries with strong pricing power,

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but also to economically sensitive areas like industrials, we believe investors are less likely to be left behind if markets move in a particular direction.

Potential to Flex if Market Dynamics Shift—Defensive and Offensive Opportunities

We are becoming a little more optimistic on the overall economic picture. Economic data are holding up well, and early fears of a prolonged global recession are receding. Some countries may even avoid a recession altogether. Consequently, we leaned into more cyclical areas of the market and continued to add to energy and materials. The energy cycle could be sustained for longer, especially with geopolitical concerns remaining prominent. A potential tailwind could also emerge from the sudden reopening of China following an extended zero-COVID policy, alongside government support to help reignite its economy.

We can use the value spectrum to help position for shifting market conditions. In relation to our portfolio, this included an increased allocation to more defensive parts of the universe to help ensure the portfolio was better positioned for the difficult market conditions last year. The focus is on companies that can deliver higher free cash flow, but we also have a good representation of cyclical and deep value areas of the market. This can help mitigate the potential for severe drawdowns, while featuring exposure to companies that might benefit from a rerating and any upturn in the economy.

The ability to flex the portfolio to capitalize on emerging areas of improvement is a key feature of constructing the portfolio. Recently we started to reconsider semiconductors, which sold off sharply last year. We now have a more sanguine view and believe we could see turnaround for the sector in the next 12 to 18 months. Other cyclical areas that could benefit if recessionary pressures ease further include industrials and consumer discretionary, where UK housebuilders are looking more attractive in our view.

Overall, we believe we are well positioned in the areas where you would expect to find a value manager. Financials, utilities, and health care all remain favored areas, while we have limited exposure to technology and consumer discretionary. We have added to European and Japanese banks given their potential to benefit from rate rises and less risk of recession.

Ultimately, we aim to create a dynamic portfolio that represents the best asymmetric opportunities. That includes deep value areas where, if we are correct with our thesis, we could generate greater alpha. These tend to be smaller positions that are risk controlled by the position size but have demonstrated in the past to contribute meaningfully to overall portfolio returns. This is important as we continue to evolve the portfolio, exploiting the breadth of the value opportunity, but also being flexible and agile enough to position for evolving global economic and market dynamics.

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