



Equity Manager Report: Are growth concerns growing?

Report Analysis



Has growth reached a tipping point? According to our latest Equity Manager Report, growth managers in most regions have expressed concern over extended valuations - particularly regarding some tech and consumer names. These growth managers have become more selective as a result, reducing exposure to stocks with stretched valuations. Many managers have been paying closer attention to downside and valuation risk, and have deployed more capital to defensive areas of the market in response.

Looking past just growth, a favourable environment prevailed for emerging markets, Australia, UK and U.S. small-cap equity managers during the third quarter of 2019. Times were more challenging for U.S. large-cap, Europe, Japan and Canada equity managers. Despite these contrasts, most markets continued to build on their returns for the year, with the majority in positive territory for Q3 (in local currencies). The exception? Emerging markets, which continue to suffer from a lack of resolution to the China-U.S. trade war. The sector also suffered from an investor aversion to risk - or the perception of it.¹

At Russell Investments, our distinctive relationship with underlying managers allows us to have a unique window into the views of specialists from across the manager universe. Amid a high degree of economic and market uncertainty, there's arguably no better time to tap into these insights. With this in mind, we've compiled our *chief tactical observations* from key geographic and equity regions, in alphabetical order, for the third quarter of 2019.

Australian equities

Favourable conditions for Australian equities look to continue

- There's a belief among managers that Australian stocks can outperform other equity markets due to high dividends, falling interest rates and a floating currency. The world's third largest pension pool,² with an average allocation of 25% to domestic equities, provides support to this idea. Stocks with attractive and sustainable dividends are expected to outperform as interest rate expectations have declined.

Adding to cyclical

- Managers are selectively adding to stocks exposed to the economic cycle, as the more defensive sectors are considered fully priced.

Gold losing its lustre

- We have noted that managers are starting to trim their holdings in gold stocks, particularly in large-cap miners, following a strong rally in the sector.

Canadian equities

Are quality value stocks poised for recovery?

- Prolonged value stock underperformance has been painful, but has also forced companies to improve balance sheet quality and capital allocation decisions. Companies started to get credit for these improvements in September - perhaps an early sign of sentiment shifting for value stocks.
- The abundance of well-managed, appropriately capitalised businesses trading at compelling **valuations remains vast and an attractive space for long term investments.**



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¹ Source: Russell Investments equity manager research, Q3 2019. From analysis of manager returns and factor returns.

² Source: <https://www.reuters.com/article/us-australia-funds-pensions/australian-pension-funds-168-billion-wall-of-cash-may-lead-overseas-idUSKCN1VV07S>

Private markets moving in

- Private market and strategic buyers are capitalising on record low valuations, particularly in the small- and mid-cap space, which poses risks to (a) companies not realising true intrinsic values and (b) the reduction of an already narrow investment universe.

Emerging markets equities

Growth managers showing cycle awareness

- There's increasing caution of valuation in certain areas, with positioning moving toward Growth at a Reasonable Price (GARP) names and defensive quality. China e-commerce is seen as crowded, and there's also profit-taking on Brazil's rally.

Value managers remain disciplined

- Value investors reaffirmed conviction in markets such as Russia and Korea, where negativity is priced in and opportunities continue to present themselves. Risk is deemed acceptable as low historic valuations may help buffer against the global slowdown.

Macro-oriented managers becoming opportunistic

- Market-oriented investors have increased contrarian ideas amid macroeconomic noise and growth valuations. Opportunities include Korea's cyclical recovery, dynamic random-access memory consolidation and attractive policy regimes, such as Indonesia. Managers remain selective of consumers with resilient growth prospects.

Europe and UK equities

Managers capitulating on value – does that equal opportunity?

- Valuation spreads between value and growth continue to persist at all-time highs. Private equity buyers are taking advantage of the relative valuation opportunity.
- For the first time since 2010, a majority of fund managers in Europe believe growth will outperform value.³ This is a significant shift in sentiment, which could indicate investors are capitulating on value. Historically, following this type of environment - i.e., when sentiment toward value is at a particularly low level - the style has recovered strongly (i.e., 2009, 2012).

UK domestic companies

- In anticipation of Brexit, UK domestic companies have sharply de-rated. Increasingly, we see managers opportunistically adding to domestic companies as they believe risks surrounding Brexit are already priced in.

Global and international equities

Growth managers are getting wary of high valuations

- Some growth managers are trimming high fliers and adding defensive positions. Several have expressed wariness over the high valuations of software as a service (SaaS) stocks and narrow market performance. However, most managers remain sanguine about global growth.

³ Source: Bank of America Merrill Lynch Fund Manager Survey, September 2019

Cyclical sectors are pricing in recession conditions

- Deep value and contrarian managers see little downside to hard-hit sectors like autos and select industrials. Multiple contraction has widened spreads. Value and growth managers focused on future cash flow remain overlapped.

Market-oriented managers

- Changes in momentum continue to challenge quant model performance. The same holds true for the performance of value stocks. Traditional smart beta factors have failed to deliver, and some see crowding as the cause. Many managers are pursuing alternative data sets, particularly in less efficient markets.

Japan equities

Consistent growth managers trimming expensive stocks

- Many growth managers have started to trim outperformers due to expensive valuations, while maintaining the view that concerns on the economy and tariffs would positively affect performance of secular growth stocks.

Value managers broadly sticking with existing holdings

- Value managers generally maintained existing positions due to a large valuation gap in the market. Value managers who bought tech stocks on weakness maintained their exposures, despite the relatively good performance, partly due to upward revisions in their earnings estimates.

Market-oriented managers adding beta

- Many market-oriented managers increased positions in cyclicals, particularly in tech, where 5G-related demand was a hot topic. While many maintain a mixed view on the economy, some managers are starting to expect a cyclical recovery.

Real asset equities

Global property managers

On a price-to-net asset value basis, developers in Hong Kong, Japan and Singapore are trading at significant discounts versus historical levels, while Australia and Japanese real estate investment trusts look expensive.

- Managers are tilting toward opportunities in the U.S. residential sector as well as niche segments, including data centers, cloud storage and cold storage. They're avoiding U.S. malls and offices due to continuing weakness and higher capital expenditures to keep tenants.

Global infrastructure managers

- Largely driven by replacement capital expenditures, we believe the appeal of regulated income should remain resilient during a period of low economic growth or a recession.
- We believe opportunities exist in towers, which are expected to benefit from structural growth due to demand for mobile data.



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U.S. large-cap equities

Growth managers express valuation concerns

- Growth managers are sceptical of extended valuations and are more selective regarding high-growth tech stocks. They're also starting to cut back on exposure to tech and valuation risk.

GARP presents opportunity

- GARP managers are optimistic about prospects for stocks with moderate earnings growth, since high-growth stocks are expensive, cyclical value stocks are challenged by the trade war and the interest-rate environment has punished banks.
- Emerging opportunity in healthcare
- While continuing negative sentiment in healthcare is expected ahead of the 2020 U.S. elections, the weak year-to-date performance is creating a relative value opportunity in the sector. A majority of U.S. equity managers believe regulatory risk concerns have been overdone in stock prices.

U.S. small-cap equities

Growth managers opportunistically buying into the market's rotation to value

- Growth managers continue to favour consumer discretionary and information technology stocks, as fundamentals remain strong while valuations have recently become more reasonable.

Value managers leaning into industrials

- Value managers see opportunities in industrials, with a specific emphasis on transportation, aerospace and defence spending cycles.

Core managers with style flexibility leaning into defensives

- With small-cap significantly lagging large-cap and generating negative returns over the past 12 months, core managers believe quality stocks are attractively priced. Managers who allocate to both value and quality stocks are leaning toward quality.

The bottom line

Amid an ageing bull market, expensive valuations and an uncertain economy, managers are increasingly reconsidering their exposure to more expensive growth stocks and adopting more defensive positions. In such an environment, we believe paying attention to the views of specialist managers to identify opportunities for outperformance is more important than ever. As always, we'll continue to keep you apprised of the latest observations throughout the manager universe.

About Russell Investments

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