



Q1 2019 Equity Manager Report: The pendulum swings back toward growth

by Patrick Egan

The first quarter of 2019 saw a mixed bag of results for equity managers, according to our manager research team. Challenging environments were the story of the quarter for U.S. large cap equity managers and Canadian and Japan equity managers. Managers of Australian equities, emerging market equities, and U.S. small cap fared better. And the majority of Europe and UK equity managers beat the MSCI Europe and FTSE All Share, respectively. In most regions, our manager research showed growth outperforming value, though managers from both styles of investing bought the [2018 fourth quarter](#) correction.

At Russell Investments, our distinct relationship with underlying managers allows us to have unique access to insights from specialists across the manager universe—and there's arguably no better time to tap into these insights than during bouts of market volatility. With this in mind, we've compiled our *chief tactical observations* from key geographic and equity regions, in alphabetical order, for the first quarter of 2019.

Australian equities

Confidence in China

- Managers are confident that China will deliver growth as expected, and therefore commodity stocks will be well supported.

Cautious on Australian consumer

- Managers remain underweight companies exposed to the Australian consumer, including banks. Overseas earners continue to be preferred.

Preparing for a downturn

- Following a reporting season which had more misses than beats, managers are considering how stocks will perform in the next downturn. They are preferring companies which have little or no debt, a strong position in their industry and the ability to *self-help* through cost-outs or strategic improvements. Managers note that sectors which have been *defensive* in the past may not be in the future.

Canadian equities

Upside to non-pipeline energy names

- With the massive rally in oil prices in the first quarter of 2019, one could have expected a major rally in oil-related stocks. However, the rally was more focused on the pipelines—vs. servicers and producers—likely given that these more defensively-oriented names also benefited from the decline in interest rates. As a result, it appears there is meaningful upside to non-pipeline energy names, especially vis-à-vis pipelines.

Back and forth on cannabis stocks

- After very weak performance aligned with the low volatility environment in the fourth quarter of 2018, cannabis-related stocks came back strong in the first quarter of 2019. While most managers still have concerns around valuation, management quality and competitive dynamics, some are starting to consider adding them to their portfolios for risk management purposes.

Emerging markets equities

Caution on the rise due to valuations

- On the back of strong sentiment and market recovery in Q1, growth managers increased vigilance over winners where valuations have re-rated quickly.

China flexes its domestic toolkit

- In reaction to trade war tension and slowdown fears, the Chinese central government has implemented an accommodative stimulus program which includes (a) consumer tax cuts, (b) stronger social financing and (c) easier lending focused on helping the real economy.

Back in the low growth camp

- Managers have been rotating from early cyclicals to mid-cycle ideas and pro-growth names. With the U.S. Federal Reserve (the Fed) relaxing interest rates, there is a more constructive outlook for emerging markets fundamentals. Recent political turmoil are now more contained, leaving quality ideas out of favor.

Europe and UK equities

Position for Brexit

- UK managers, on average, are positioned for a soft Brexit. Cross-sectional differences in performance have been driven by portfolios' sensitivity to GBP. Most managers are overweight domestic UK.

Positive prospects for M&A

- Excess fundraising in Private Equity funds combined with low cost of debt and improving corporate cash flows support the potential for M&A activity. This is especially the case in the European pharma sector, where cash holdings are high.

European Financials

- Some value managers have become more positive on Financials following the sector's negative returns in 2018. Managers point at European banks' stronger balance sheets, higher capital levels and improved profitability as indicators of greater resilience.

Global and international equities

Both value and growth managers bought the 2018 4Q correction

- The volatility favored active traders, including relative value managers who rotated into cash-flowing companies at cheaper prices. But [the speed of the rebound surprised many](#), and managers that initiated tactical buys in the fourth quarter of 2018 were trimming their high valuation holdings in the first quarter of 2019.

Most expect continued modest growth and falling fears

- Chinese-US trade war rhetoric is now seen as overblown. Economic interdependence between the two countries will keep tensions in check. Meanwhile, dovish central bank policies are positive for global growth. Value managers are hoping for more volatility, but growth managers still expect a tailwind.

Technology remains in favor -- but not Chinese Tech

- The business risks stemming from increasing government intrusion has made Chinese tech companies uninvestable for many fundamental managers.

Japan equities

Improved risk appetite

- Despite many managers maintaining a conservative stance on the global economy, risk appetite somewhat recovered.
- Growth managers accumulated consistent growth stocks, which fell heavily in the previous quarter due to expensive valuations.
- Value managers expressed interest in bottom-fishing amongst cyclical stocks, though some reduced their positions in banks as expectations on the Bank of Japan's easing policy became longer.

Late economic cycle versus policy support

- Many managers tried to balance cyclicals and defensives due to a mixed view on the economy. Many are concerned about a slowdown, but also expect some positive effects from both the Fed policy change in the U.S. and economic stimulus in China.

U.S. large cap equities

Growth managers remain optimistic

- Despite the growth-led rally in the first quarter of 2019, growth managers continue to express conviction in the underlying business fundamentals for high earnings growth technology stocks.

Investors rewarded for calculated risk postures

- Stock markets recovered sharply following the dramatic Q4 2018 sell-off, rewarding managers who increased cyclical and/or growth exposure during oversold conditions.

Another tough go for quant managers

- Echoing the results from last quarter, quant managers lagged once again in a volatile environment. Since most quantitative managers incorporate some emphasis on stock-price trends, market reversals create headwinds.

U.S. small cap equities

Growth managers mixed on traditional growth sectors

- Growth managers remain overweight technology, however rotation during the quarter was mixed. Momentum managers increased their positions while valuation sensitive growth managers trimmed exposure as technology stocks rallied. Growth managers also pared back healthcare exposure.

Value managers trim cheapest stocks on strength

- Deep value strategies generally fared the best within value, as dynamic value stocks outperformed. However, these strategies were active in taking profits from cheapest decile stocks that rallied. Value managers trimmed financials exposure over yield curve concerns, but added to consumer stocks, which lagged in the market rebound.

Market-oriented managers opportunistic with valuations

- Market-oriented managers generally rotated towards cheaper stocks during the quarter, and favored higher return on equity.

The bottom line

While the volatile swing between Q4 2018 and Q12019 seems to have calmed down, we still believe it's more important than ever to pay attention to the thinking of specialist managers in order to identify potential opportunities for outperformance. The one constant in equity markets is change. Stay tuned as we continue to report on our observations from across the manager universe.

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