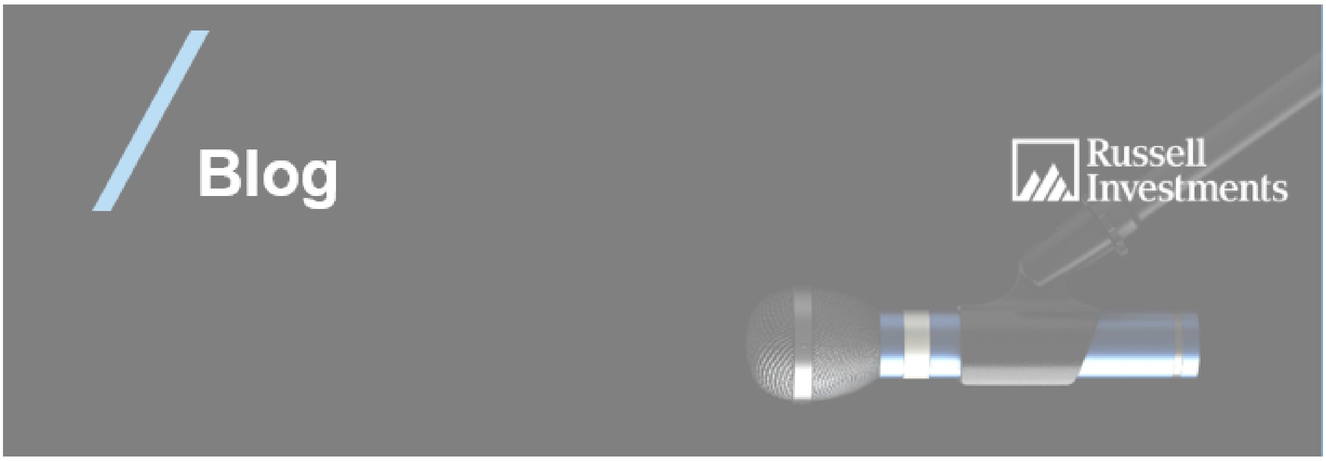

Q2 2019 Equity Manager Report: Piggybacking on the positives

By Gabriel Sauma

The second quarter of 2019 was marked by a favorable environment for U.S. large- and small- cap equity managers, in addition to emerging market and Japan equity managers, according to our manager research team. The quarter proved to be more challenging for Europe, Canada and Australia equity managers. While most markets built on positive returns from the first quarter, the re-escalation of trade tensions between the U.S. and China led to a more subdued environment for emerging markets, particularly China. From a style perspective, growth continued to outperform value, with quality and low-volatility equities also faring well across most regions.[1]

At Russell Investments, our distinct relationship with underlying managers allows us to have unique access to insights from specialists across the manager universe. Amid a slowing global economy and a bull market that may be on its last legs, 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 second quarter of 2019.

Australian equities

Ability for the Australian Securities Exchange (ASX) to continue to outperform

- Due to high dividends, falling interest rates and a floating currency, we believe Australian share markets can continue to outperform other equity markets. Despite reaching 10-year highs, managers agree most stocks are not overvalued.

Increasing focus on dividends

- In the current low-interest environment, we see an opportunity to increase exposure to dividends. This appears to be playing an increased role, versus traditional value and growth factors.

Maintain caution on banks

- While banks have an attractive dividend yield—which is likely to support prices in the short term—we believe expected headwinds from decreasing margins, rising compliance and bad & doubtful debt (BDD) costs justify the underweight held by most active managers.

[1] Source: Russell Investments equity manager research, Q2 2019.From analysis of manager returns and factor returns.

Canadian equities

Gold bounces back

- Gold prices rose in Q2, especially in June, as investors searched for safe haven assets amid geopolitical turmoil. This helped gold stocks outperform in the quarter[2], which hurt most active managers. However, given most of these stocks still have major fundamental issues, most managers continue to remain confident in their underweights.

Back and forth on cannabis stocks

- The see-saw of cannabis stock performance continued. After alternating quarters over the past year, cannabis-related stocks underperformed in the second quarter. However, the level of underperformance was mild compared to past quarters (e.g. Q4 of 2018, where they underperformed over 40%).[3] While most managers still have concerns around valuation and management quality, some have started to add them to their portfolios for risk management purposes.

Emerging market equities

Hunting season for growth and market-oriented managers

- A dovish U.S. Federal Reserve (the Fed), continued China stimulus and trade-war normalization have seen managers looking beyond trade-war noise. Conviction has increased to exporters and high-growth technology sectors that lagged in China and Korea.

Fortune favors the bold

- Easing credit pressure saw managers review opportunities in weak fiscal countries. Some have renewed cautious interest in Turkey after its sell-off. Managers remain committed in Brazil despite its recent rally, with possible pension reforms sending a positive market signal.

Levering up the opportunity

- Policy reforms and data pointing to structural growth have been tailwinds for managers to increase value exposure in financials, such as Chinese insurers, Indian mortgage lenders and dividend-increasing Russian banks.

Europe and UK equities

Value is again historically *cheap* relative to growth

- In Europe and the UK, the value factor's valuation discount relative to growth continues to widen, and is now approaching historical highs last seen in 2000 and 2001.[4] Despite this, active managers remain largely cautious of the opportunity, and are waiting on the sidelines for more certainty around European Central Bank (ECB) policy and Brexit.

Fiscal stimulus turning positive

- On the back of elections in Italy and Germany as well as the *Gillet Jaune* movement in France, fiscal impulse has turned positive in all three countries for 2019. The UK could follow shortly under renewed conservative leadership. This should be beneficial to cyclical sectors.

[2] Source: S&P/TSX Global Gold Index

[3] Source: https://marijuanaindex.com/stock-quotes/canadian-marijuana-index/

[4] Source: MSCI World Value Index, MSCI World Growth Index. As of June 30, 2019.

Global and international equities

Growth and value managers in technology and financials

- Both types of managers are overweight, and with momentum performing well, we consider this indicative of a narrowing opportunity set and a potential overbought signal.

Growth managers remain committed to tech holdings

- Large-cap leaders and *cloud* stocks remain attractive on price-to-growth measures. We also believe *second generation* subscription-based models have rising appeal.

Value managers see financials as the *new utilities*

- Selected banks are regulated, but we believe they offer better growth and attractive dividend yields. Sensitivity to interest rates has fallen due to improved balance sheets.

Market-oriented managers

- Leadership changes in Q2 once again disadvantaged quantitative managers, with fundamental core managers faring better.

Japan equities

Growth managers confident in secular growers

- Many growth managers increased their conviction in high-growth stocks, due to rising expectations toward rate cuts, which usually lead to multiple expansion. Concerns around the economy and tariffs also brings additional attention to these types of opportunities.

Value managers looking for timing to add cyclicals

- Cyclicals plunged due to China-U.S. trade tensions and fears of an economic slowdown. Value managers sought good buying opportunities, expecting the economy would be supported by monetary policy easing.

Market-oriented managers have mixed views

- Transactions of market-oriented managers were mixed. Some made defensive shifts, particularly by reducing tech exposure, while others tried to chase momentum.

Real asset equities

Global property managers

- From a price-to-net asset value (NAV) perspective, Hong Kong property companies, Japanese developers and Singapore developers are trading at significant discounts vs. historical levels, while Australia and Japanese REITs look expensive.[5]
- Managers are tilting toward opportunities in the U.S. residential sector and niche segments including data centers, cloud storage, cold storage and gaming/leisure. They're avoiding U.S. malls and offices due to continuing weakness and higher capital expenditures to keep tenants.

Global infrastructure managers

- After a large run-up in valuations thus far in 2019, managers are positioning portfolios for late-cycle market conditions, with a preference for longer duration, less cyclical companies.
- The transport sectors (rail and airports) are being sold down, while allocations to utilities are increasing.

U.S. large cap equities

Healthcare as an emerging opportunity

- Managers with long-term investment horizons believe that the weak performance of healthcare stocks has presented a stock selection opportunity. While there is uncertainty in

[5] Russell Investments

the segment ahead of the 2020 election cycle, many believe that stock prices have become disconnected from long-term earnings power, resulting in a *throwing out the baby with the bathwater* problem.

Mixed signals in energy

- In contrast to the situation in healthcare, there doesn't appear to be a unified trade in energy, as managers are approaching the sector with more caution. While stock prices have become relatively more attractive, there doesn't appear to be consensus buying, as some managers are concerned about the demand side and commodity prices.

U.S. small cap equities

Growth managers show valuation discipline

- Most growth managers were active in trimming expensive areas of the market, particularly the top deciles of price-to-earnings ratio (P/E), price-to-book ratio (P/B) and price-to-cash flow ratio (P/CF). While some managers trimmed exposure, information technology continues to be a heavily favored sector where most growth strategies remain overweight.

Value managers leaning further into areas that struggled

- Sector positioning was mixed, but most strategies (including defensive value and deep value) pared back technology exposure during the period, and added to consumer discretionary and energy—areas that struggled most in the second quarter.

Small cap managers remain constructive

- Overall, managers recognize the late stage of the cycle and stretched valuations. However, most managers, including those who are more defensive, don't expect a recession in the near term and continue to be constructive.

The bottom line

With worries over an economic slowdown mounting and trade tensions still very much in play, uncertainty is likely to be the name of the game for markets in the months ahead. We believe that closely watching the thinking of specialist managers will be critical in order to identify potential opportunities for outperformance. Stay tuned as we continue to report on our observations from across the manager universe.

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Past performance does not guarantee future performance.

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The **S&P TSX Gold Index** consists of 68 precious metal mining companies traded on the Toronto Stock Exchange (TSX).

The **MSCI World Value Index** captures large and mid cap securities exhibiting overall value style characteristics across 23 Developed Markets (DM) countries*. The value investment style characteristics for index construction are defined using three variables: book value to price, 12-month forward earnings to price and dividend yield.

The **MSCI World Growth Index** captures large and mid cap securities exhibiting overall growth style characteristics across 23 Developed Markets (DM) countries*. The growth investment style characteristics for index construction are defined using five variables: long-term forward EPS growth rate, short-term forward EPS growth rate, current internal growth rate and long-term historical EPS growth trend and long-term historical sales per share growth trend.

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