



Equity Market Factors in 2022

NOTWITHSTANDING the short but very sharp fall at the start of Covid-19, investors in equities had enjoyed a glorious run in the years up to the end of 2021; the MSCI World index had returned an annualised 9.3% over five years and 11.1% over ten years. Clearly the good times came to a halt in 2022 with the MSCI World index falling 13.4% over the nine months to September 30. But to put the nine months in perspective: a) intra-year falls of 15% or more are quite common and b) it only gave back the gains of the previous 18 months. What has made this year feel a lot worse was the large and simultaneous falls in bond markets, which particularly weighed on investors in lower-risk funds/portfolios.

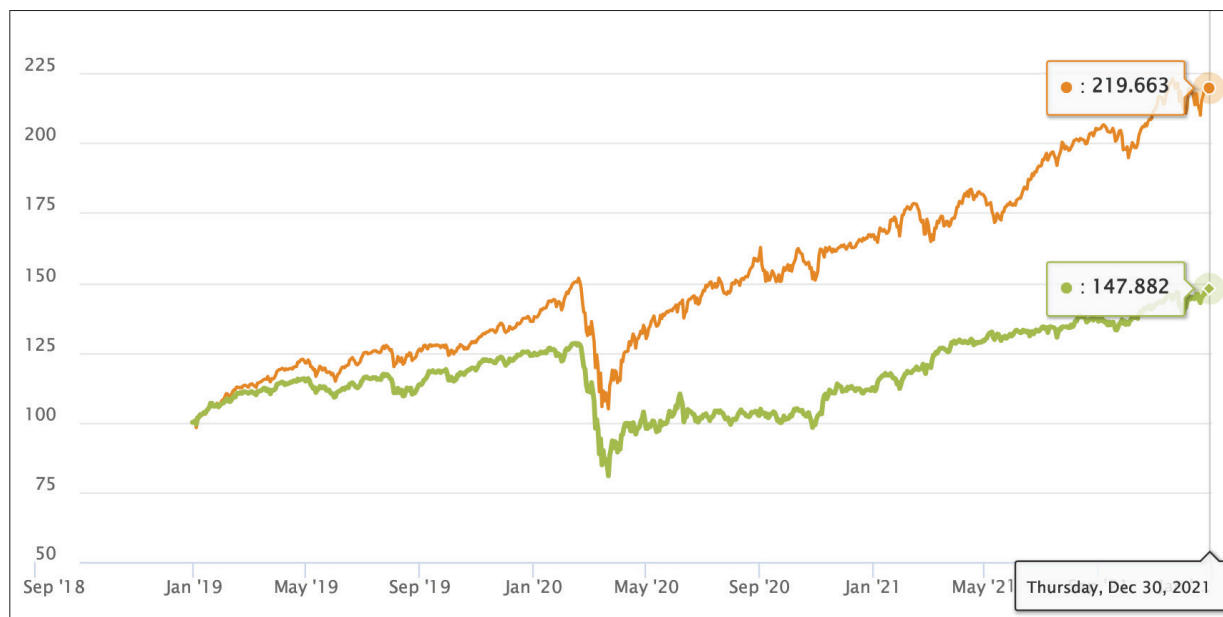
Most passively-managed funds tackle equities on a global basis and here the big divergence in 2022 was between hedged and unhedged approaches. Mainly because of the exceptional strength of the USD over the nine months, hedged global equity returns were 9% worse than those which were unhedged. In general, actively-managed funds are underweight in the US market (and USD) with the major overweighting being towards Eurozone/Europe. Had currencies not moved, that positioning would have been marginally beneficial but to unhedged € investors it was substantially negative over the nine months. In as much as funds were exposed to Emerging Markets or Small Cap rather than Developed Markets, the impact was marginally negative.

The biggest influence on equity returns was not geography, but investment style. Perhaps the most

important dimension of investment style is the distinction between Value and Growth. The value approach emphasises stocks with cheaper-than-average valuations (dividend yield, price-to-book ratio and so on) even if that indicates lower-than-average expectations of profits growth. Growth investors look to emphasise companies with faster long-term growth prospects, even where that means paying higher valuation multiples. To convey their essential difference, the MSCI World Growth index has a much higher exposure to sectors like Information Technology, Consumer Discretionary and Communication Services whereas the MSCI World Value index's three largest sectoral weightings are to Financials, Healthcare and Industrials. The latter also has a substantially bigger position in the Energy sector.

The two indices have delivered very different outcomes over the nine months; the Value index fell by 5% whereas its Growth counterpart tumbled 22%. Clearly the substantially different weightings in sectors like Energy (outperformed by 34%) and I.T. (underperformed by 17%) would have given the Value index a big advantage over that period.

Funds managed with a 'value' style - including those favouring higher dividends - have performed much better than others year-to-date. This would have come as a welcome respite after a long period in which 'growth' had the whip hand – the chart below shows the scale of divergence between the MSCI World Growth and Value indices in the three years to end-2021.



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Basic financial mathematics explains a lot of the above; 'growth' prospered as interest rates headed to zero; the discounted values of their (believed to be) better earnings prospects out into the future were more valuable. The rise in interest rates has clearly reversed this. In effect, growth equities are a longer duration asset than value equities, and so the latter is likely to be more resilient when long-term interest rates are rising.

The sector which drove the 'growth' outperformance more than any other was I.T. which outperformed the broad market by 47% over the three years shown in the chart above; the Energy sector underperformed by 70%, but as a smaller sector, had less impact.

As an aside – and given its topicality - the scale of outperformance of I.T. and the underperformance of Energy over 2019-2021, (and the reversal of same in 2022) are likely to have been material factors impacting the relative performance of 'ESG' funds over recent years. Such funds are typically overweight I.T. and underweight Energy.

The resurgence of the 'value' factor has only regained a fraction of the ground lost in the preceding years and the big question is whether it has further to go. In attempting to answer that question the starting point is the valuation metrics and where they sit in a long-term context. As of September 30, 2022 the key statistics were:

	Dividend Yield (%)	Trailing Price/Earnings Ratio
MSCI World Growth	1.1	25.2x
MSCI World Value	3.5	12.1x
MSCI World	2.3	16.3x

Source: MSCI.COM

The relative valuation metrics as between 'growth' and 'value' have come from the very outer extremes of history a year or so ago and, notwithstanding the recovery already made, any sort of reversion to the mean leaves considerable scope for further outperformance by 'value'. Depending on mean reversion has impoverished many investors, but in the same way that financial mathematics supported growth, sustained higher interest rates/ bond yields would be likely to provide continuing support for 'value'. The probability of inflation continuing to overshoot consensus expectations is high and having 'value'- tilted equities (especially in balanced portfolios holding nominal bonds) strikes us as a better way to be positioned. In practice, the number of funds managed with an explicit 'value' style is quite small; although an imperfect expression of 'value', those managed with a dividend orientation are more widely available and may be the next best way of gaining exposure to the 'value' factor.

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