Equity Market Risks and Opportunities:

Four Independent Views

VALUE EQUITIES

Q: What is the biggest risk that equity investors face today?

BRYANT VANCRONKHITE, CFA
+ Managing Director, Senior Portfolio Manager, and Co-Team Leader, Special Global Equity

A: In my view, the most underappreciated development for equity markets today is the paradigm shift that has taken place in monetary policy following the pandemic. The Federal Reserve has a dual mandate of supporting price stability and full employment. Other central banks have similar competing objectives. The fundamental challenge today is that pursuing both goals will require increasingly different policy prescriptions going forward. Something will have to give, and I think this fact is still dawning on markets.

What changed? In the decades leading up to the pandemic, inflationary pressures created by massive liquidity injections and ultra-low interest rates were offset by deflationary megatrends, including the offshoring of production to low-cost centers, productivity improvements from technology and automation, and relatively cheap and flexible energy supplies. Today, some of the deflationary trends related to globalization have been reversed by ongoing supply chain disruptions, reduced exploration and development of traditional energy supplies, and emerging geopolitical tensions, and it looks like these changes may be long lasting. Markets are now coming to terms with structurally higher prices and a growing recognition that central banks may be unwilling or unable to step in and spur growth as they had in the past. Everyone is talking about this now, but I think few have fully comprehended the end game.

Q: So how does this shake out? What are the longer-term implications?

A: The decades of policy experimentation I described above have "papered over" the weakness of business models that rely on an artificially cheap cost of capital. There are many zombies masquerading as viable businesses that will soon be exposed as growth inevitably slows into 2023. To see why, consider that the prescription for survival in this environment is the ability to relocate supply chains, secure scarce energy supplies, and invest in further automation and efficiency solutions that can sustain production. These are all costly investments that only companies with financial strength can make. Second, companies will need to raise prices to protect margins and sustain free cash flows, and only companies that hold a strong competitive position for their products and services will have the ability to do so. This means that companies that cannot invest will slowly harvest their degrading productive asset base, and those that cannot protect their margins will see progressively lower earnings guidance. The upshot is that, sooner rather than later, you will likely see a growing stratification of markets into winners and losers.

Q: How should equity investors respond?

A: Active approaches will likely present a much stronger value proposition to investors going forward. If you think about it, many of the factors that allowed weak companies to keep pace with better-run companies in the years leading up to the pandemic also allowed broad index-tracking strategies to flourish. Everyone won in that environment, which diminished the importance of individual stock selection. Today, that dynamic has flipped. As fundamentals take the leading role in driving return dispersion, I think investors can respond by allocating to investment strategies that actively exploit divergence in fundamentals.

As for our brand of active management, we have long discussed how balance sheet strength foretells the level of flexibility a company has to react to change—to make accretive acquisitions and capital expenditures, invest in research and development, or generate yield by returning cash to shareholders. I think that proactive and smart investment into an asset base gives a company the right to earn cash flow in the future. We use our process to gain confidence in a company's competitive advantage; to ensure it has the willingness and ability to raise prices to offset increased investment needs; and to determine it is making the right investments that will allow success and separation from the pack over the next one, three, or five years. This focus has served us well in prior cyclical downturns, and I think it will do so again in the face of the structural challenges I described.

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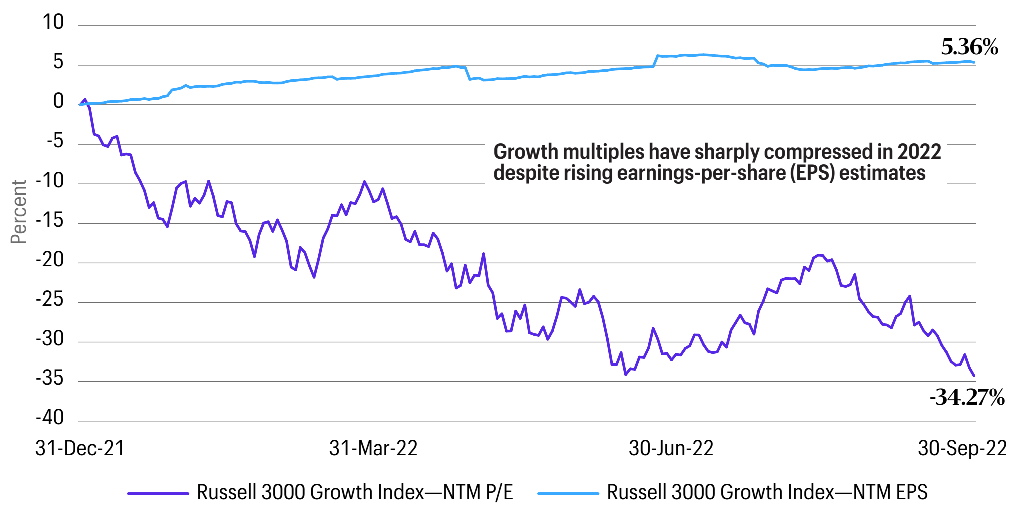
GROWTH EQUITIES

Q: What happened in U.S. growth equities in 2022, and what concerns are top of mind for investors in 2023?

MICHAEL SMITH, CFA
+ Managing Director and Senior Portfolio Manager, Discovery Growth Equity

A: It's no secret that U.S. growth stocks had a dismal year last year, underperforming value stocks and broad equity markets. A main contributor to this outcome was sharply rising interest rates throughout the year. The effect of higher rates on growth stocks has been outsized because a greater proportion of their value is tied to distant earnings that are now subject to significantly higher discount rates. This has brought growth valuations down considerably. However, growth company earnings estimates have shown impressive resiliency and, in some cases, have even *risen* over the course of the year. This suggests to us that multiple compression has been responsible for most of the growth equity declines in 2022. Against this backdrop, the most common concern investors have looking into 2023 is whether the coast is clear to reallocate to growth equities or whether fears of a recession should keep investors on the sidelines for now.

MULTIPLE COMPRESSION WAS THE STORY OF 2022



Sources: Allspring and FactSet; NTM stands for next 12 months

Q: Can you expand on that? Is the coast clear for investing in growth equities?

A: I believe there is a rather compelling case for investing in growth equities today. Relative valuations to the broad market are near their long-term average and have likely completed the bulk of their de-rating in this cycle. If higher rates have the intended effect of slowing economic growth, inflation and interest rates should eventually moderate this year. Our research of past cycles has shown that declines in market valuations initially dominate performance during downturns. As a cycle matures, company fundamentals such as earnings growth, profit margins, and free cash flow take on much greater importance in return generation. I think we are entering that phase in 2023 as many of the headwinds for growth stocks are subsiding.

DRIVERS OF STOCK PRICES OVER TIME

Stock price returns = EPS × Valuation multiple + Cash returns (dividends, shares buybacks)

Source: Allspring

> "... investing in companies on the "right side of change" is central to our philosophy.

Q: How are you finding the best companies to own in 2023?

A: We target innovative companies that can sustain profitability from superior fundamentals. Some of the hallmarks of superior fundamentals in this environment are durable pricing power, more effective cost control, and execution of greater operational efficiencies. Strong earnings fundamentals are often supported by secular drivers that help insulate a company from cyclical factors that may hamstring its weaker competitors. Beyond this, investing in companies on the "right side of change" is central to our philosophy. We are always looking for visionary management teams that can position their company to benefit from structural changes in the economy. Because technology often defines the cutting edge of change, it is natural for us to find true innovators in the information technology sector. However, the influence of technology today is broadening out. The most innovative companies in every sector are running ahead of change and are extracting the most out of new technologies to run a more sustainable and resilient business. This is where I think we can compound wealth for our investors over the long term.

As I mentioned above, changes in valuations tend to lead the market cycle. If we continue to see slowing economic activity and a preference for companies that can grow through a downturn, I expect growth equities would be the first to enjoy a rapid improvement in sentiment—much like a coiled spring. Until then, high-growth companies with resilient fundamentals will be increasingly scarce and will be sustained by attracting capital from cyclical corners of equity markets that are more exposed to the sluggish economic backdrop.

EMERGING MARKET EQUITIES

Q: What risks are top of mind for investors in emerging market equities today?

ALISON SHIMADA
+ Senior Portfolio Manager and Head, Total Emerging Markets Equity

A: Two headline risks preoccupied investors for much of 2022. One of these was the conflict in Ukraine. It's not clear yet what the end game looks like, but the war has upset global markets for agricultural and energy commodities and is shifting longstanding trade and political alignments. Another concern was China, which always looms large on investors' minds. We are encouraged by China's recent policies to support its property sector, its pivot away from zero-COVID-19 policies, and the improved potential for reopening. However, the lockdowns have created further impetus for corporate managers to rethink supply chains. Moreover, President Xi has solidified political control and challenged regional competitors over its Taiwan reunification and "Belt and Road" ambitions. All of these geopolitical risks have weighed on global growth.

In fact, the International Monetary Fund downgraded its 2023 global growth forecast from 3.8% to 2.7% in October. Emerging market growth expectations have been downgraded from 4.7% to 3.7%, but developed market growth expectations have been hit harder, falling from 2.6% to 1.1%. Emerging markets have been more resilient in sustaining growth—historically, a rising growth differential between emerging and developed markets has led to emerging market outperformance.

Emerging market currencies have held up better than major developed market currencies against a strengthening U.S. dollar. Some countries were proactive in managing monetary policy against rising inflation expectations back in 2021, which is paying off now. The Brazilian real, Mexican peso, and Peruvian sol appreciated against the U.S. dollar in 2022, and certain Latin American countries are well positioned to capture a greater share of global agricultural trade and investment from realignment of supply chains. So, overall, emerging markets present a mixed bag of risks and opportunities.

Q: How should investors respond?

A: The way historical trading relationships are being rapidly redrawn is creating winners and losers that I think investors can exploit. I also believe it is a mistake to think about emerging markets as a homogeneous group with a common set of return drivers—there is a chasm of diversity among countries. The MSCI Emerging Markets Index is composed of 24 countries at widely varying stages of economic development. Some countries have high per-capita income (Qatar, for example), while others remain quite low (such as India). There are autocracies and democracies, technological leaders and commodity exporters, pegged and free-floating currencies, etc. The list of variables goes on and on. Successful investing in this asset class involves a deep understanding of country dynamics and of the multitude of companies that comprise their investable asset base. Only active management will be able to exploit these differences.

One can get a sense of the historical value of active management by looking at how the MSCI Emerging Markets Index ranks among the universe of active emerging market strategies within the eVestment Alliance Global Emerging Markets Equity universe. For more than 20 years, the index ranked below the median manager return in 99% of rolling five-year periods. The consistent outperformance of active managers in this asset class is remarkable.

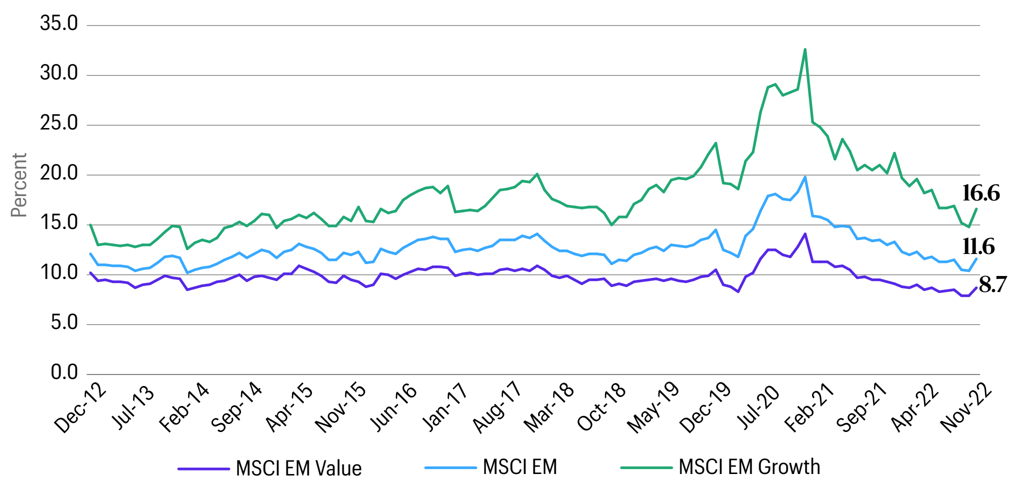
Q: Why is now a good time to invest?

A: I mentioned how emerging markets tend to outperform developed markets when growth expectations widen. In addition, earnings multiples are near their 10-year trough of 10.4x, and a variety of valuation multiples are at a 30% to 50% discount to developed markets. Valuation cheapness does not usually provide a strong signal for timing market inflections, but it can give a good indication of the length of the runway for multiple expansion in the next cycle.

Our style tends to have a value-oriented bias and a preference for higher dividend yields. The chart below shows the past 10 years of earnings multiples of the flagship index and of the growth and value variants. The value index is priced at 8.7x forward earnings estimates as of the end of November, presenting an attractive entry point from a historical perspective.

> “In emerging markets, it is generally the environmental profile that is most financially relevant.

HISTORICAL PRICE/EARNINGS MULTIPLES OF MSCI EMERGING MARKETS STYLE INDEXES



Source: Bloomberg

Moreover, individual companies that have developed well-rounded environmental, social, and governance profiles are positioned to stay ahead of sustainability trends that have become important selection criteria for investors in recent years. In emerging markets, it is generally the environmental profile that is most financially relevant. We look at carbon-intensity metrics (tons of CO_2/\$1M revenue) of all companies we evaluate for our portfolios. Longer term, I think some of these companies have the potential to lead the world in reducing emissions. With major new infrastructure slated to come online over the next several years, there is a great opportunity for these companies to leap ahead of developed market counterparts that are harvesting and upgrading costly legacy infrastructure.

SYSTEMATIC EQUITIES

Q: Given equity market turmoil, how can Systematic Edge help investors face these challenges?

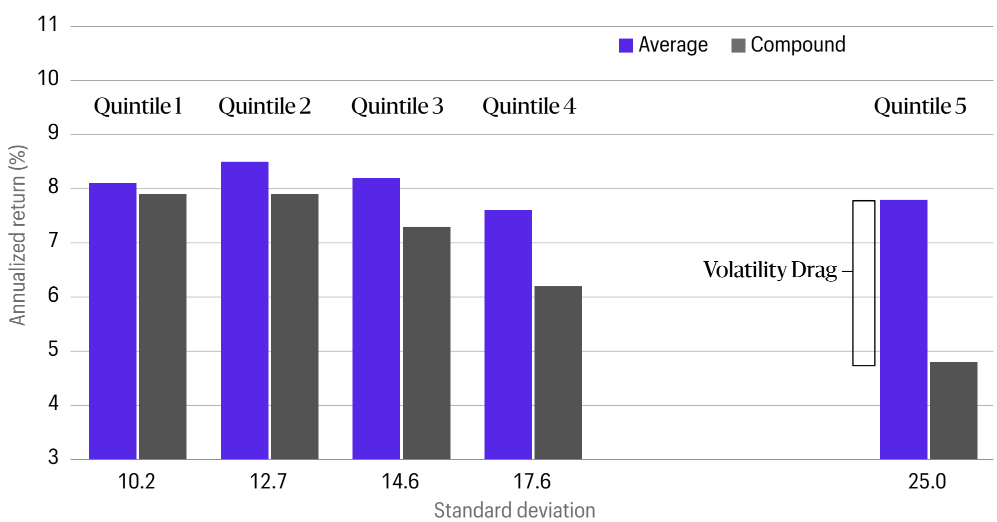
PETER WEIDNER
+ Portfolio Manager and Head, Systematic Edge Equity

A: The sharp and simultaneous drawdown in equities and fixed income in 2022 led to significant losses across investors' broad portfolios—all at a time when inflation has been climbing. There are two elements at play: seeking return in the face of market headwinds and delivering income to meet investor needs. Fortunately, technology has made targeting these attributes simpler, cheaper, and more accessible to nearly any investor. We've done a lot of work in this area.

When equities and bonds both sell off, it can feel like there's nowhere to hide. But liquid alternatives strategies can help generate return with less exposure to these asset classes. Our approach is to build portfolios that are designed to harness some of these dynamics to the benefit of our clients. For instance, high beta, or highly market-sensitive assets, are often darlings in bull markets. Their riskiness can be beneficial when all assets are rising together. However, they come with significant volatility. This may not be an earth-shattering observation, but consider that high volatility reduces one of the most powerful effects in investing: compounding. The chart below shows average and compound returns of market beta quintiles of the MSCI World Index since January 1997. Over the long run, more volatile assets have generated similar average returns but much lower compound returns. The compound return of the highest-beta stocks is up to 40% lower than peers!

HIGH BETA TENDS TO UNDERPERFORM OVER TIME

VOLATILITY QUINTILES WITHIN MSCI WORLD | JAN-97 TO SEP-22



Source: Bloomberg

We see this as an opportunity to harness this effect in a way that can benefit our portfolios in periods of market distress. We have designed quantitative strategies using our established investment process to short high-volatility stocks and deploy proceeds to names with better fundamentals and risk profiles. The result is an asymmetric expected return profile. This means that these strategies should reduce downside exposure in difficult environments, thereby adding some needed defensive attributes to investors' overall asset base while still maintaining market exposure for when markets rally.

At the same time, there are investors who need reliable income and more expected return than bonds can offer. Another strategy we manage seeks to enhance equity portfolios by selling call options, which generate premiums that, for all intents and purposes, can be construed as income. We dynamically select options that we believe have the strongest reward/risk profile—the risk being that a rapid market rally would cause the portfolio to achieve less than full participation. The trade-off for giving up part of the upside is significant option premium that supplements income and total returns in normal-to-down markets.

Q: Why not target high-dividend payers? Isn't that a more direct way to get income?

A: It can and should be, but only in moderation. Stretching too far for dividends drives portfolios toward the dreaded value trap—a term that I'll explain below. This is driven by incentives. The market tends to punish companies that cut their dividend. This motivates management to maintain or grow their dividends even after the fundamentals of the company deteriorate and the market has devalued their shares. The net result of stale dividends and fallen prices is high yields, which can "trap" unwitting investors. Any number of catalysts, including an economic shock, could abruptly force a dividend cut, sending a signal to the market confirming that the company may be in serious trouble. Investors lose in two ways: one is by the loss of income and the other is by *further* punishment of the share price. Don't get me wrong. I love dividends. But we are very selective in including only companies with stable-to-improving business fundamentals and that we believe have a dividend policy that can withstand some level of distress.

We use a quantamental investment process to seek out these companies. This means we make full use of quantitative tools to efficiently zero in on companies that have favorable fundamental attributes. We then apply a fundamental review to help us deepen our understanding of a dividend policy or any other fundamental characteristic identified by our model. This gut check allows us to build conviction that each of the components of a portfolio presents a favorable risk/reward contribution across any stage of the market cycle.

Different investors require different solutions. The defensive- and income-focused strategies I outlined above can help investors face headwinds they haven't seen in the past several decades.

For further information

We want to help clients build for successful outcomes, defend portfolios against uncertainty, and create long-term financial well-being. To learn more, investment professionals can contact us.

Contact details

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The Morgan Stanley Capital International (MSCI) Emerging Markets (EM) Index (Net) is a free-float-adjusted market-capitalization-weighted index that is designed to measure equity market performance of emerging markets. You cannot invest directly in an index.

The MSCI Emerging Markets Value Index captures large- and mid-cap securities exhibiting overall value style characteristics across 27 emerging markets (EM) 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. EM countries include: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Kuwait, Malaysia, Mexico, Pakistan, Peru, Philippines, Poland, Qatar, Russia, Saudi Arabia, South Africa, Taiwan, Thailand, Turkey, and United Arab Emirates. You cannot invest directly in an index.

The MSCI Emerging Markets Growth Index captures large- and mid-cap securities exhibiting overall growth style characteristics across 27 emerging markets (EM) countries. The growth investment style characteristics for index construction are defined using five variables: long-term forward earnings per share (EPS) growth rate, short-term forward EPS growth rate, current internal growth rate, long-term historical EPS growth trend, and long-term historical sales per share growth trend. EM countries include: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Kuwait, Malaysia, Mexico, Pakistan, Peru, Philippines, Poland, Qatar, Russia, Saudi Arabia, South Africa, Taiwan, Thailand, Turkey, and United Arab Emirates. You cannot invest directly in an index.

The MSCI World Index is a broad global equity index that represents large- and mid-cap equity performance across 23 developed market countries. It covers approximately 85% of the free-float-adjusted market capitalization in each country and the MSCI World Index does not offer exposure to emerging markets.

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