



Investment Insights

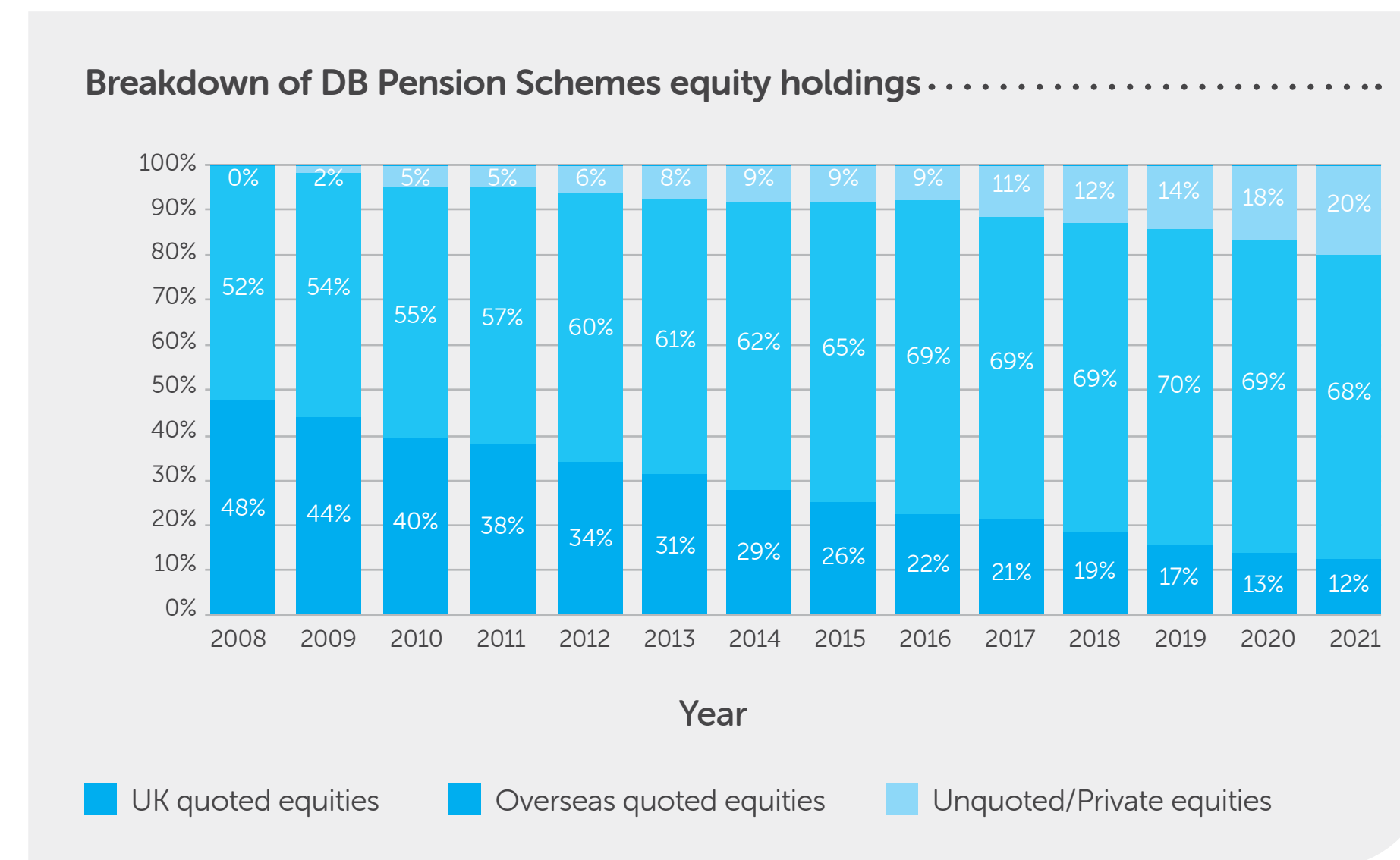
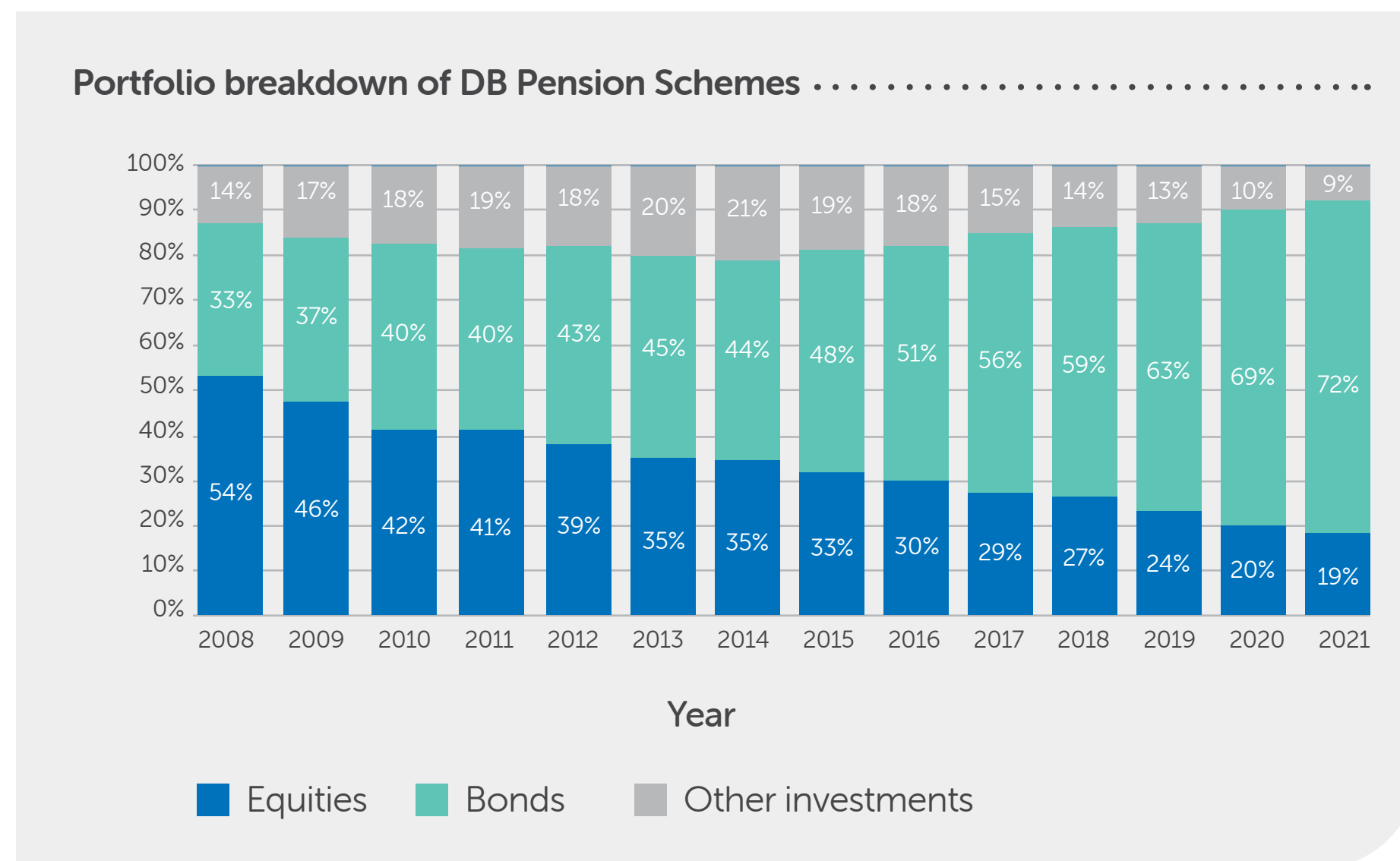
Equities - what is the right approach for you?





Introduction

For the past decade investors have been removing a home-town bias within their equity portfolios. At the same time, many have been moving away from equity risk as the major, often only, source of return generation. This has been most acute in UK Defined Benefit Pension Schemes as shown in the charts below, but has been a consistent theme across all investors:



Source: PPF Purple Book



Firstly, we note the significant rise in private equity and unquoted equity exposure. There have been many reasons for this, but one issue is the falling number of listings on the public market. This has led to concerns over whether public markets remain truly representative of global growth, and hence whether investors are able to generate returns that come from global growth. We feel this is an important consideration, but outside of the scope of this particular paper.

But what lessons can be learnt from the shift away from UK and towards overseas equities, and what does it mean for equity portfolio construction today? Whilst home-town biases have been reduced, are others being retained within portfolios? Now that we have moved from a position of a rising tide lifting all boats, are those biases emerging and how should equity investors react to potentially structural market shifts?

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We consider four key themes in this paper:

1. Does a regional approach have merit?
2. What has driven regional equity performance and what will drive performance going forwards?
3. Has sustainability changed the investment thesis?
4. What should investors be doing?

1. Does a regional approach have merit?

Major market events in recent years, from the US-China trade war to the COVID pandemic and the Russian invasion of Ukraine, have highlighted the different risks faced by different geographical regions. However, regional equities differ by more than geography. Each region has a different exposure to sectors of the economy, revenue sources and equity factors that mean they can perform very differently under different market conditions.

In our view, the starting point for an equity portfolio should be a global market capitalisation approach. This involves investing in each individual company in proportion to its total listed value, and removing the “home bias” many investors have historically had towards their own domestic markets. This approach is both simple and cheap.

However, for some investors, global market cap might not be the best answer, as illustrated in the below case study, “Bubbles and US tech stocks”

In summary, we do think a regional approach has merit for some investors, and in many circumstances, an allocation that differs to the global market-cap is very sensible. However, investors choosing to deviate from global market cap should be aware that their performance is likely to differ too. In the next section we explore the main drivers of performance.





2. What has driven regional equity performance?

By taking a market-cap approach, you will be heavily weighted towards the largest companies, regions and sectors. Companies that have performed well in the past will take up a larger share of the index and those that have underperformed will shrink as a proportion of the index. As such, for a global investor, the regions to which you are exposed may have developed significantly since the portfolio was first established. The same is true of sectoral exposure, as evidenced by the growth in the technology sector over the past twenty years.





Regional outperformance

In decades past the differences in returns between regional equity markets were very significant but the rise of globalisation has led both markets and economies to become increasingly interlinked.

However, as can be seen in Figure 5, the differences in regional performance are sufficiently large that this approach can be justified, and with the right weightings to different regions this method has the potential to outperform the global market cap approach. The wrong selection can also significantly underperform the global index. For example, many UK investors have historically been over-exposed to UK equities, which have been among the worst regional performers over the past 20 years. While Emerging Markets, the strongest performing region over the same period, are often avoided by investors due to the higher degree of risk involved.

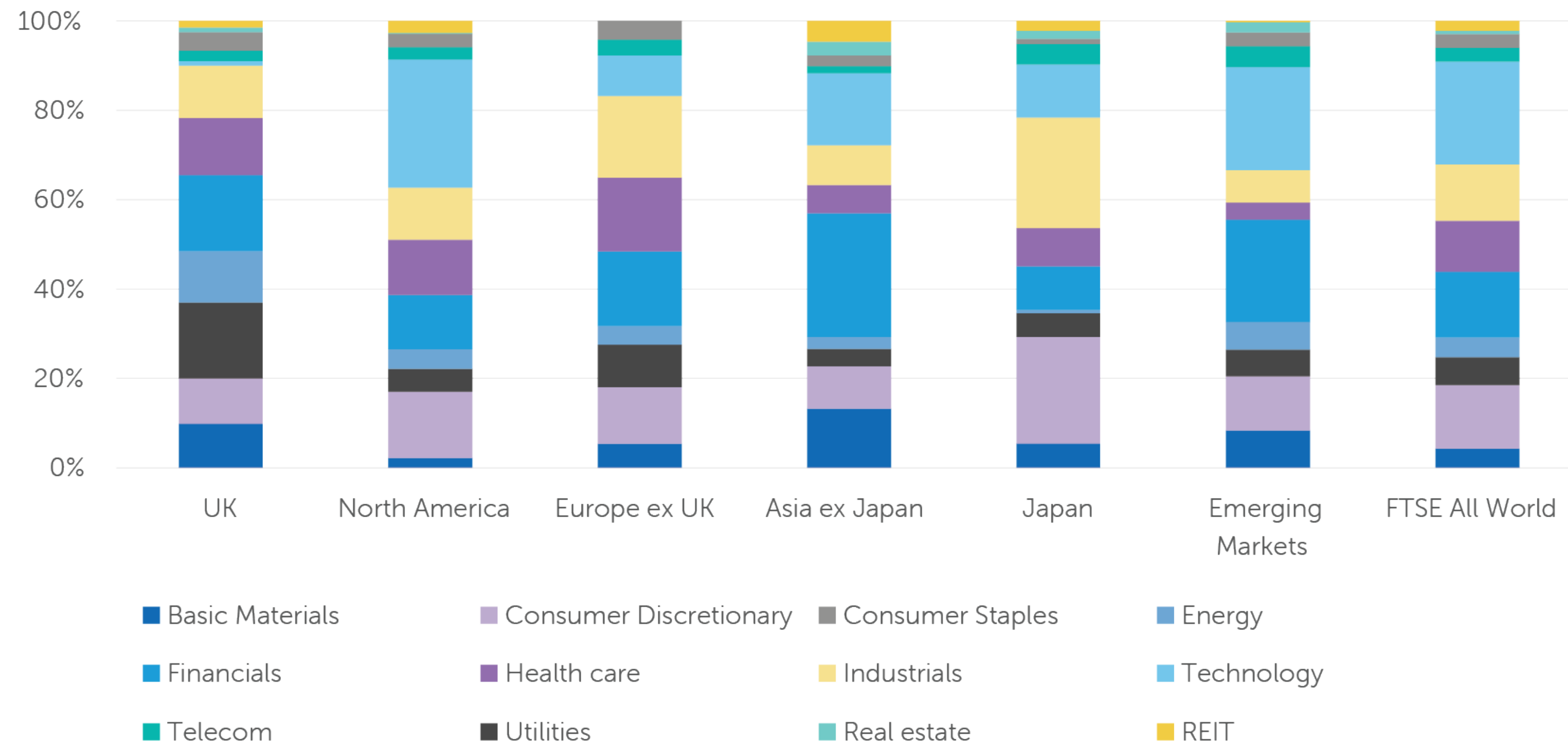
2017	2018	2019	2020	2021	H1 2022	10 - year ann. Return (to end of 2021)
N. America 27.0%	N. America -5.1%	N. America 31.5%	N. America 20.2%	N. America 27.0%	UK -11.2%	N. America 16.0%
All World 24.6%	All World -9.1%	All World 27.2%	Asia 18.8%	All World 18.9%	EM -14.8%	All World 12.4%
Asia 24.3%	Japan -13.0%	Europe 25.3%	All World 16.6%	UK 17.3%	Asia -15.8%	Europe 10.4%
UK 17.3%	EM -13.0%	UK 22.8%	EM 15.5%	Europe 16.5%	Japan -19.3%	Japan 8.7%
EM 1.6%	Asia -14.0%	EM 20.6%	Japan 14.6%	Japan 1.5%	All World -19.8%	Asia 7.3%
Europe 0.3%	Europe -14.4%	Japan 19.5%	Europe 12.3%	Asia 1.4%	N. America -20.6%	EM 6.0%
Japan -13.0%	UK -14.5%	Asia 17.4%	UK -8.9%	EM 0.1%	Europe -23.9%	UK 5.4%

Figure 5: Performance of regional equity markets over time. Source FTSE

Therefore, investors should be aware that they are taking responsibility for this decision and be able to monitor and rethink their regional weightings as necessary. This requires a detailed understanding of the underlying exposures of each equity region, in particular, the exposure to different sectors.

Sector exposure

The sectoral composition of each region is in Figure 6.



The UK's sector split is more evenly spread than other regions, but is quite different to the global market cap (represented by FTSE All World in the figure above). North America, however, more closely resembles the market cap. But which was the best sector to be overweight to?

Figure 6: Sector bias of each equity region. Source: FTSE



Figure 7 illustrates the performance of each sector over each of the past five years together with the annualised performance over the past decade. As you can see, the ranking of performance between these sectors is rarely consistent on a year-to-year basis, emphasising the benefit of having diversified exposure across sectors. Moreover, the FTSE All World, which will hold the sectors relative to their market cap, shows less volatility in returns over the periods shown.

Other observations can be drawn from this data in the context of other economic factors. For example, the price of oil is similar today as it was twenty years ago, yet the energy sector has significantly underperformed the tech sector and reduced its share of the global market during that period. We also see that Health care for example, seen as a defensive sector, has outperformed the wider market in periods of poor performance, but underperformed when markets are thriving.

As demonstrated by the charts earlier in this report, an investor's sector exposure is constantly changing and will most likely not be the same as when the investor first set up their portfolios. For example, over the last 10 years technology has been the best performing sector by a comfortable margin, resulting in the sector now taking up the largest proportion of the world index. It is therefore no surprise that North America has followed a similar trend as technology stocks take up a large proportion of North American equities.

So what has driven North America's strong performance? An overweight to technology.

Why has the UK underperformed all other regions? An overweight to energy and an underweight to technology.

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**We can now answer the question at the start of this section.
What has driven regional equity performance? Differences in sectoral allocations.**



One thing that stands out from these sectoral differences is that they often do not reflect the underlying economy of their region. For example:

The UK market and overseas companies

The UK economy only has a relatively small domestic production of energy and basic materials. However, this was not always the case and several companies such as the oil company BP and the mining company Anglo-American remain listed in the UK despite most of their operations being conducted overseas and most of their revenue being generated in US dollars. This was one of the reasons why the UK stock market performed well after the Brexit referendum. A fall in the value of sterling meant that US dollar revenues were worth more in sterling terms. This issue is not unique to the UK market, as many large multinational companies generate revenues from across the globe that may not reflect their home markets, and investors need a clear understanding of the source of revenue before making allocation decisions.

Emerging markets and basic materials

Emerging market economies also have a mismatch between the sectors that dominate their economy and those that dominate their markets. Emerging markets are much more exposed to basic materials and energy than other regions, but many of the leading companies are nationalised or not publicly available to trade. For example, Saudi Aramco, an oil company, would be one of the largest single stocks in the global index at current valuations, but only 1.5% of its total value is fully tradable and so is the weight represented in global indices.

China and Germany

One notable example is China, where index providers have only recently begun to incorporate the domestically listed “A-shares” into emerging market indices. As such that market is underrepresented in global market cap indices. Germany is also underrepresented in global equities relative to the size of its economy because a much higher proportion of its economy (in comparison to similarly sized countries) is made up of “Mittelstand” companies, which are medium sized privately-owned businesses.

It therefore follows that **if an investor believes that a particular sector will outperform, they can gain exposure to this sector by tilting towards certain regions**, but investors should not assume that markets reflect the underlying economies. In any case, regional investors should take this into account when selecting their weightings.

Factor exposures

Exposures to different regions will not just expose investors to different sectors, but also expose investors to “factors” to different extents. Each region will have its own biases towards different factor tilts. Equally, if an investor chooses to invest in a factor-based approach, it follows that there will be geographical biases within their portfolio relative to the market cap too. For example:

Growth and value stocks

There is high relative exposure to growth stocks in the US market (led primarily by the big-tech stocks). By contrast, the European market has a higher proportion of value stocks.

Figure 8, shows the relative performance of the developed market “growth” stocks, which are expected to have high earnings growth over the long-term, relative to “value” stocks, which are considered good value relative to current and short-term earnings.

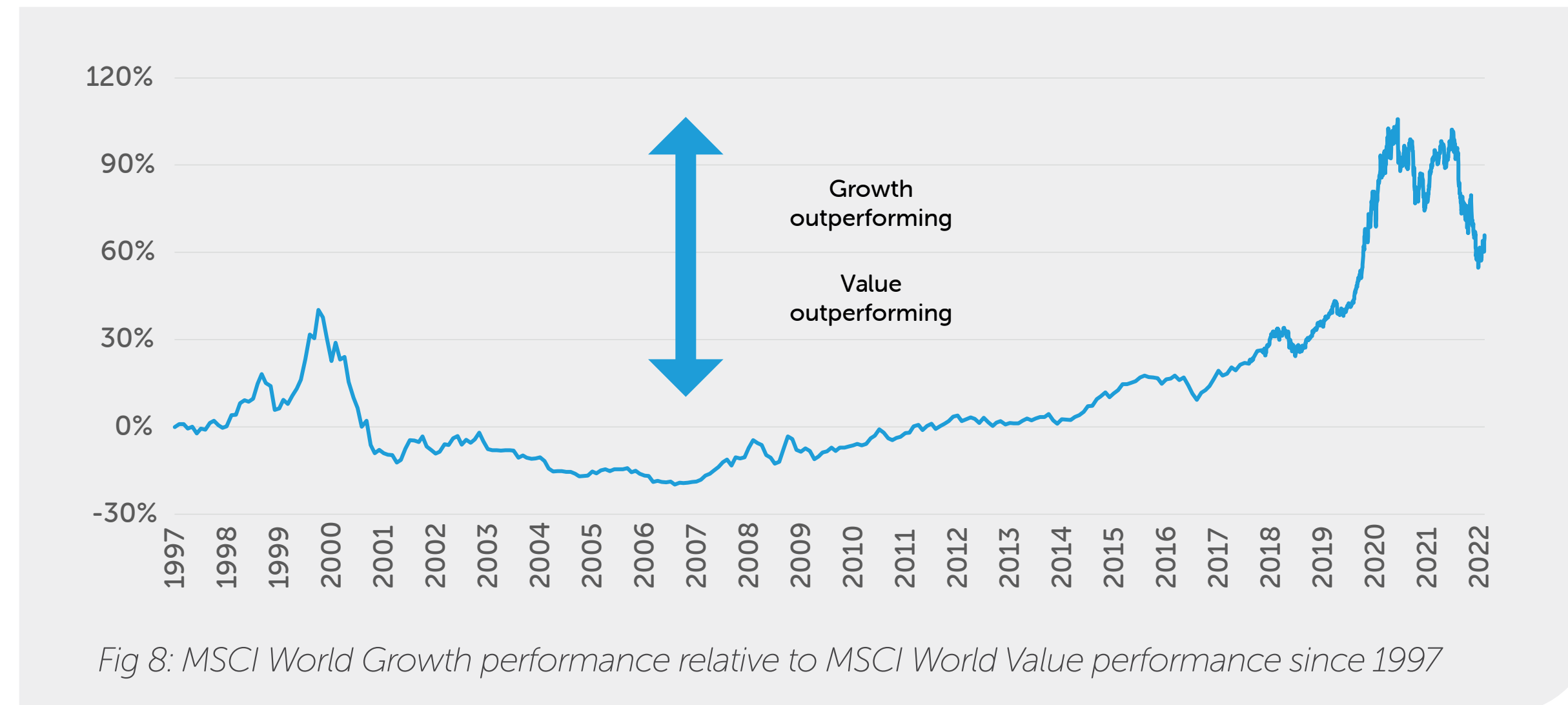


Fig 8: MSCI World Growth performance relative to MSCI World Value performance since 1997

The long period of outperformance in growth stocks relative to value stocks between 2014 and 2021 coincides with strong performance from both the Technology sector, and from North America. More recently, the rotation into value stocks has coincided with strong performance from the Energy sector.

There are a number of other factors, such as momentum, quality, size, and many more, that we have not analysed in this particular note. These factors will correlate with regional (and sectoral) performance more closely for some regions (and sectors) than for others. **Investors should be aware of factor exposures within their portfolio, and consider how these link back to performance.**

3. Has sustainability changed the investment thesis?

So, the performance of certain sectors has driven regional equity performance in the past. Should this be the only consideration when building an equity portfolio in the future? In short, no.

In recent years, Environmental, Social and Governance (ESG) and sustainability issues have become more prominent in portfolio construction. Whether that be with investors striving to satisfy new regulations, taking the view that improving sustainability is the right thing to do or investors increasingly holding the view that sustainable stocks (including those helping the move to a low carbon economy) have a tailwind that will help them outperform in the long term, it cannot be denied that ESG and sustainability have become major considerations.

To cater for this change there is a proliferation of ESG and sustainability focused index funds. These can be market weighted funds, with tilts and/or exclusions applied to move away from companies that perform poorly on ESG metrics, and towards those that are ahead of the game. Factor-based funds are also becoming increasingly popular.





Though the starting point is often market cap, this still represents a departure from our default case, as tilts and exclusions can shape your underlying exposure. While there is a lot of variation between different approaches, examples of some of the changes could include:

- Greater concentration due to exclusions – the proportion of excluded companies can reach higher than 10% depending on the scope of exclusions.
- Higher allocations to technology and financials, and lower exposures to carbon-emitting sectors like energy, industrials, utilities and materials in climate-focused indices. An active manager may also be able to capture opportunities in biases present in the construction of some climate-focused indices (such as the way Scope 3 emissions are included or the current lack of standardisation in ESG scoring systems).
- A greater allocation to Developed markets due to poorer ESG governance and ESG data availability in Emerging markets. This will tend to lead to a “quality” factor bias within ESG-tilted indices.

We note that, due in part to the strong performance of the Energy sector which will be underweight in ESG-tilted funds and indices, many have lagged global market cap year to date. Is this a concern? We do not think so. These are short term deviations, and do not necessarily reflect what will happen over the longer term.

The case for inclusion of ESG and sustainability factors is strong (not least due to the focus on climate change and its management by regulatory bodies such as the Pensions Regulator), and many investors are already setting themselves a net zero target for carbon emissions. For more information on how you as an investor might start on that particular journey, see our briefing note here. **In summary, we do think that sustainability has changed the investment thesis, and we believe that all investors should be incorporating ESG and sustainability into their equity portfolios.** Investors should be comfortable that performance may differ to global market cap in the short term as differences in sectors play out, but we have no doubt that portfolios constructed through a sustainable lens are the future of equity investing.

4. What can investors do?

What are you trying to achieve?

This is the first question that you need to ask yourself.

If it is to achieve a return in line with the global equity market, then investing in line with the global market cap should be your starting point. Any other decision taken will lead to the possibility of underperformance against this benchmark.

If you are concerned about bubbles forming within any particular region or sector, then consider a regional approach which seeks to address these concerns. For example, if you believe that the technology sector is overvalued then consider an underweight position to the US.

Similarly, if you wish to include sector views that are linked to ESG and sustainability, such as an underweight to Energy and Basic Materials as high carbon-emitting sectors, then you might consider an underweight to the UK.



Consider everything together

If investors do choose to move away from the global market cap approach then it is important that they understand how interconnected each approach is.

As we have seen, holding a regional bias in your portfolio can lead to indirect biases towards specific market sectors, but each region also has different exposures to the other approaches discussed in this note.

Say, for example, you decide to depart from the market-cap in order to increase your exposure to European equity at the expense of US equity. This may have additional implications for your exposure:

- **Sector exposure:** This tilt would lower your exposure to the technology sector, while increasing your exposure to other sectors such as health care, financials, consumer staples and industrials. This may in turn increase exposure to the performance drivers behind these sectors.
- **Factor exposure:** This tilt would increase your relative exposure to value stocks over growth stocks. Do you expect the outperformance of growth stocks in recent decades to continue, or do you believe the value outperformance in 2022 may indicate the tide is turning?

- **ESG:** Europe has emerged as one of the leaders when it comes to ESG metrics, owing to state guidelines and the regulatory environment, while Federal US is lagging behind (noting some states are every bit as advanced as Europe). Tilting towards Europe may therefore improve the ESG credentials of the portfolio.
- **Performance drivers:** Together, the above factors mean that you are adjusting the drivers of performance in your portfolio. For example, defensive sectors such as healthcare and consumer staples typically fare better during recessionary periods, while the same is typically true of value stocks relative to growth.

The points raised above highlight some indirect consequences of holding regional biases. The reverse is also true however, with some investors who favour an ESG or Factor based approach indirectly altering their regional and sectoral exposure. Investors should take care to understand their exposure along all of these axes when deciding to adjust their allocation to equities.

Overview and conclusion

We believe that global market cap equities should be the starting point for all investors when considering their equity allocations, but that does not mean that it is the best approach to take in every circumstance. Other approaches offer the ability to meet other goals, whether that is aiming for higher returns, lower volatility or sustainability goals. Investors need to carefully consider and understand their underlying exposures when making an allocation and should be aware that these other options may require a tolerance for higher fees and higher governance requirements.

If you would like to know more please get in touch with your usual Barnett Waddingham contact and we would be happy to provide more information.



Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively get in touch via the following:



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