FUNDS ON FRIDAY
by Glacier Research

glacier
by Sanlam

9 June 2023
Volume 1185

Investing in an uncertain economic environment

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In times of economic uncertainty, investors often turn to top-down investment strategies that attempt to predict the direction of the economy. While this approach may seem logical, it is not always the most effective way to achieve investment success. Bottom-up investing, while it downplays macro-factors, may counterintuitively be better than top-down investing when investing in uncertain times for a variety of reasons. These reasons include:

1. It is easier to develop conviction.
2. It provides an additional layer of diversification.
3. It does not attempt to time the market, so it reduces the risk that you are not invested in stocks when they are poised to deliver the best returns.
4. It enables the investor to profit from market drawdowns.

Bottom-up investing is an investment strategy that involves analysing individual companies, rather than focusing on macro-economic trends or broader market conditions. This approach involves analysing a company's financial statements, management team, competitive position, and other factors to determine whether it is a good investment opportunity. Unlike top-down investing, which is often influenced by macro-economic factors like interest rates and inflation, bottom-up investing focuses on the company's fundamentals.

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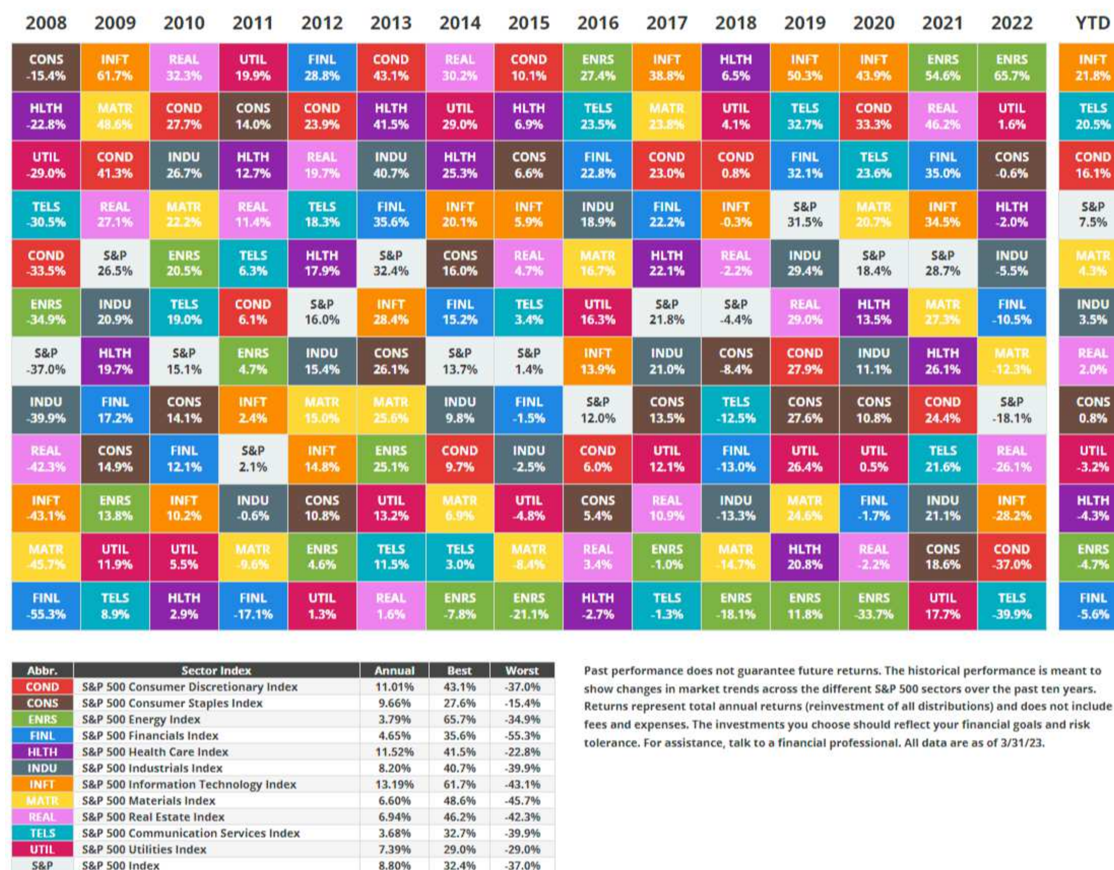
With bottom-up investing, it is easier to develop conviction.

In periods of economic turmoil, macro-economic factors can be highly unpredictable, making it difficult to make investment decisions based on these trends alone. It is also difficult to know which macro variables should guide one's decision-making, as different macro variables can lead one to draw different conclusions.

Delving a little bit deeper, to infer how a certain sector will perform in a certain economic climate is also difficult to do. There are multiple drivers to this: not only the economic climate, but other factors like valuation. A further complication is that the sector that performs best in a given year rarely does so more than once in a row. This means that investors trying to jump between sectors might end up missing the boat entirely. The dispersion in returns by owning the best vs. worst performing sector is wide and therefore the risk of underperformance to the investor is huge.



2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	YTD
CONS -15.4%	INFT 61.7%	REAL 32.3%	UTIL 19.9%	FINL 28.8%	COND 43.1%	REAL 30.2%	COND 10.1%	ENRS 27.4%	INFT 38.8%	HLTH 6.5%	INFT 50.3%	INFT 43.9%	ENRS 54.6%	ENRS 65.7%	INFT 21.8%
HLTH -22.8%	MATR 48.6%	COND 27.7%	CONS 14.0%	COND 23.9%	HLTH 41.5%	UTIL 29.0%	HLTH 6.9%	TELS 23.5%	MATR 23.8%	UTIL 4.1%	TELS 32.7%	COND 33.3%	REAL 46.2%	UTIL 1.6%	TELS 20.5%
UTIL -29.0%	COND 41.3%	INDU 26.7%	HLTH 12.7%	REAL 19.7%	INDU 40.7%	HLTH 25.3%	CONS 6.6%	FINL 22.8%	COND 23.0%	COND 0.8%	FINL 32.1%	TELS 23.6%	FINL 35.0%	CONS -0.6%	COND 16.1%
TELS -30.5%	REAL 27.1%	MATR 22.2%	REAL 11.4%	TELS 18.3%	FINL 35.6%	INFT 20.1%	INFT 5.9%	INDU 18.9%	FINL 22.2%	INFT -0.3%	S&P 31.5%	MATR 20.7%	INFT 34.5%	HLTH -2.0%	S&P 7.5%
COND -33.5%	S&P 26.5%	ENRS 20.5%	TELS 6.3%	HLTH 17.9%	S&P 32.4%	CONS 16.0%	REAL 4.7%	MATR 16.7%	HLTH 22.1%	REAL -2.2%	INDU 29.4%	S&P 18.4%	S&P 28.7%	INDU -5.5%	MATR 4.3%
ENRS -34.9%	INDU 20.9%	TELS 19.0%	COND 6.1%	S&P 16.0%	INFT 28.4%	FINL 15.2%	TELS 3.4%	UTIL 16.3%	S&P 21.8%	S&P -4.4%	REAL 29.0%	HLTH 13.5%	MATR 27.3%	FINL -10.5%	INDU 3.5%
S&P -37.0%	HLTH 19.7%	S&P 15.1%	ENRS 4.7%	INDU 15.4%	CONS 26.1%	S&P 13.7%	S&P 1.4%	INFT 13.9%	INDU 21.0%	CONS -8.4%	COND 27.9%	INDU 11.1%	HLTH 26.1%	MATR -12.3%	REAL 2.0%
INDU -39.9%	FINL 17.2%	CONS 14.1%	INFT 2.4%	MATR 15.0%	MATR 25.6%	INDU 9.8%	FINL -1.5%	S&P 12.0%	CONS 13.5%	TELS -12.5%	CONS 27.6%	CONS 10.8%	COND 24.4%	S&P -18.1%	CONS 0.8%
REAL -42.3%	CONS 14.9%	FINL 12.1%	S&P 2.1%	INFT 14.8%	ENRS 25.1%	COND 9.7%	INDU -2.5%	COND 6.0%	UTIL 12.1%	FINL -13.0%	UTIL 26.4%	UTIL 0.5%	TELS 21.6%	REAL -26.1%	UTIL -3.2%
INFT -43.1%	ENRS 13.8%	INFT 10.2%	INDU -0.6%	CONS 10.8%	UTIL 13.2%	MATR 6.9%	UTIL -4.8%	CONS 5.4%	REAL 10.9%	INDU -13.3%	MATR 24.6%	FINL -1.7%	INDU 21.1%	INFT -28.2%	HLTH -4.3%
MATR -45.7%	UTIL 11.9%	UTIL 5.5%	MATR -9.6%	ENRS 4.6%	TELS 11.5%	TELS 3.0%	MATR -8.4%	REAL 3.4%	ENRS -1.0%	MATR -14.7%	HLTH 20.8%	REAL -2.2%	CONS 18.6%	COND -37.0%	ENRS -4.7%
FINL -55.3%	TELS 8.9%	HLTH 2.9%	FINL -17.1%	UTIL 1.3%	REAL 1.6%	ENRS -7.8%	ENRS -21.1%	HLTH -2.7%	TELS -1.3%	ENRS -18.1%	ENRS 11.8%	ENRS -33.7%	UTIL 17.7%	TELS -39.9%	FINL -5.6%

Abbr.	Sector Index	Annual	Best	Worst
COND	S&P 500 Consumer Discretionary Index	11.01%	43.1%	-37.0%
CONS	S&P 500 Consumer Staples Index	9.66%	27.6%	-15.4%
ENRS	S&P 500 Energy Index	3.79%	65.7%	-34.9%
FINL	S&P 500 Financials Index	4.65%	35.6%	-55.3%
HLTH	S&P 500 Health Care Index	11.52%	41.5%	-22.8%
INDU	S&P 500 Industrials Index	8.20%	40.7%	-39.9%
INFT	S&P 500 Information Technology Index	13.19%	61.7%	-43.1%
MATR	S&P 500 Materials Index	6.60%	48.6%	-45.7%
REAL	S&P 500 Real Estate Index	6.94%	46.2%	-42.3%
TELS	S&P 500 Communication Services Index	3.68%	32.7%	-39.9%
UTIL	S&P 500 Utilities Index	7.39%	29.0%	-29.0%
S&P	S&P 500 Index	8.80%	32.4%	-37.0%

Past performance does not guarantee future returns. The historical performance is meant to show changes in market trends across the different S&P 500 sectors over the past ten years. Returns represent total annual returns (reinvestment of all distributions) and does not include fees and expenses. The investments you choose should reflect your financial goals and risk tolerance. For assistance, talk to a financial professional. All data are as of 3/31/23.

Figure 1: S&P 500 Sector performance

In contrast, by focusing on the fundamentals of individual companies, bottom-up investors can make investment decisions based on factors that are more certain and predictable.

Bottom-up investors can choose relative outperformers.

Another advantage of bottom-up investing is that it can provide greater diversification than top-down investing. Bottom-up investors can attempt to find the winners within a particular sector, which can help to ride out any underperformance by the sector itself.

Top-down investors are more easily swayed by market sentiment.

One often-quoted statistic, which shows how dangerous it is to time markets is what the impact on long-term returns would have been if you missed the 10 best days in the stock market. However, this knowledge does not prevent investors from being over-cautious or even selling stocks when volatility is high and market sentiment is at its worst. Top-down investors are prone to errors of this nature because they are more easily swayed by market sentiment. In contrast, bottom-up investors who have chosen stocks based on their fundamental characteristics are better equipped to look through this volatility (provided their time horizon is long enough), with the result that they get to pocket the long-term equity risk premium for “free”, because it is almost guaranteed that stocks will outperform bonds in the long-term.

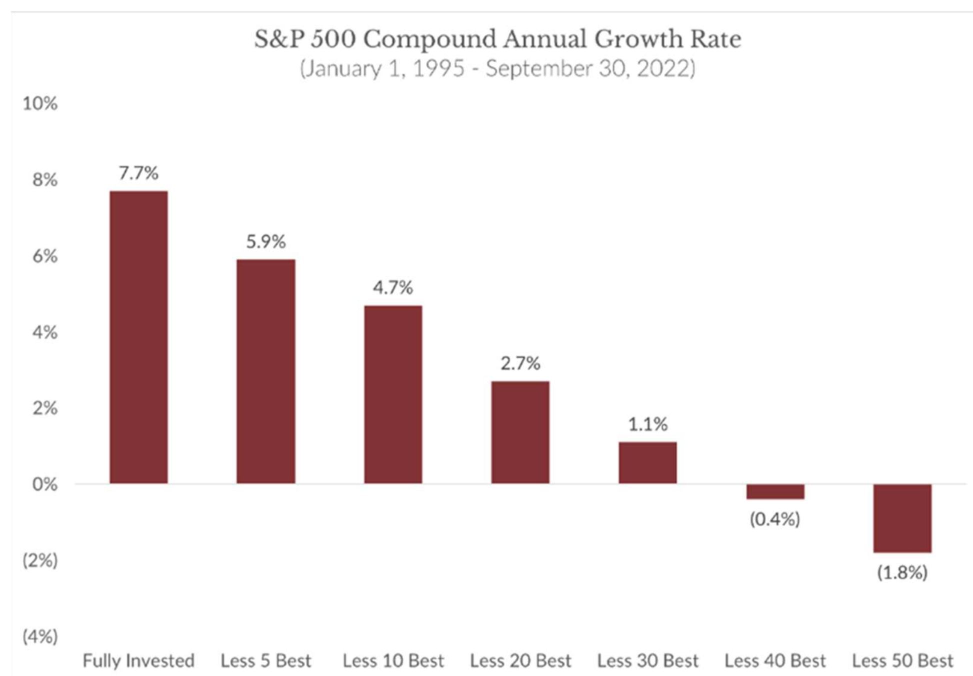


Figure 2: Best days in the market, Source: Strategas, Capital Investment Advisors

Volatility – friend or foe?

Downturns can lead to the undervaluation of companies, providing astute investors with a way to make money. Several factors can contribute to the undervaluation of a company, even amid certain economic conditions. Market reactions to economic uncertainty are often exaggerated, causing stock prices to plummet and undervalue otherwise fundamentally sound companies. This presents an opportunity to acquire shares at a discounted price.

Companies that operate in cyclical industries are usually more susceptible to economic fluctuations. During downturns, companies operating in these sectors may experience temporary headwinds, leading to undervaluation. Banks are one example of this. During a downturn, they usually sell off quite strongly in anticipation of burgeoning credit losses but if investors satisfy themselves as to the strengths of their balance sheets, they can weather the storm and rebound nicely. Construction companies are a second example of an industry that is exposed to cycles within the broader economy but will see a rebound when the economic climate improves.

Where do we stand today?

Presently, we find ourselves in a challenging investment landscape characterised by sticky core-CPI inflation and being at the tail end of a series of rate hikes which has broken records in terms of its steepness. The impact of this has been felt in many places and has even caused several banks to fail.

From a top-down perspective, market consensus is only for a small decline in the S&P's earnings this year and a recovery next year. We consequently believe in the likelihood of an earnings disappointment, and this combined with high valuations, makes equities unattractive in our view. However, given the fact that that equities outperform in the longer term being underweight equity is a "tactical" rather than a "strategic" position, and comes with large risks that are difficult to ignore.

By contrast, from a bottom-up perspective, there are abundant opportunities and while we have seen a large recovery in the market as a whole, this recovery has been skewed towards the big names and the smaller names have not really participated.

While both have their place, we believe in what bottom-up investing offers because it gives you the opportunity to make a profit even without taking the risk that you are not invested in equities when they are set to outperform.

Source 1: https://novelinvestor.com/sector-performance/

Source 2: https://www.wesmoss.com/news/money/the-perils-of-market-timing-missing-the-best-days-in-the-market/

Glacier Research thanks Gerhard Janse van Vuuren for his contribution to this week's *Funds on Friday*

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Gerhard is an equity analyst at Flagship Asset Management, a specialist global investment management boutique based in Cape Town, South Africa. Prior to joining Flagship in 2022, he completed several investment internships while completing his degree in Investment Management at the University of Stellenbosch. Gerhard has passed Level 1 of the CFA® exams and is currently furthering his studies with an Honours degree at the University of Cape Town.