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Growing capital as market distortions unwind, will require a differentiated approach

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We have been arguing for some time that global markets have become characterised by severe distortions over the past decade. As at 27 September, the S&P 500 Index found itself 23% lower than when it started the year and investors in US 10-year government bonds, lost 18% over the same period, making this the worst year, thus far, for bond investors in decades. This followed after a less-than-auspicious start to the year, when global markets, represented by the MSCI World Index, recorded their worst half-year performance since its inception 50 years ago.

Significant fear is building that the hawkish US Federal Reserve and other central banks will continue to aggressively raise rates in their attempt to stem rampant inflation and tip the global economy into recession in the process. The prices of cyclical sectors and commodities have fallen sharply in recent months, suggesting that markets are increasingly pricing the likelihood of a sharp global contraction. We have already seen volatile market reactions to news feeds and new developments, and in an environment marked by multiple crises (as we argue in **this article** by Anet Ahern), it will be easy for investors to panic. It is therefore important to take a step back from the short-term noise and consider the bigger picture.

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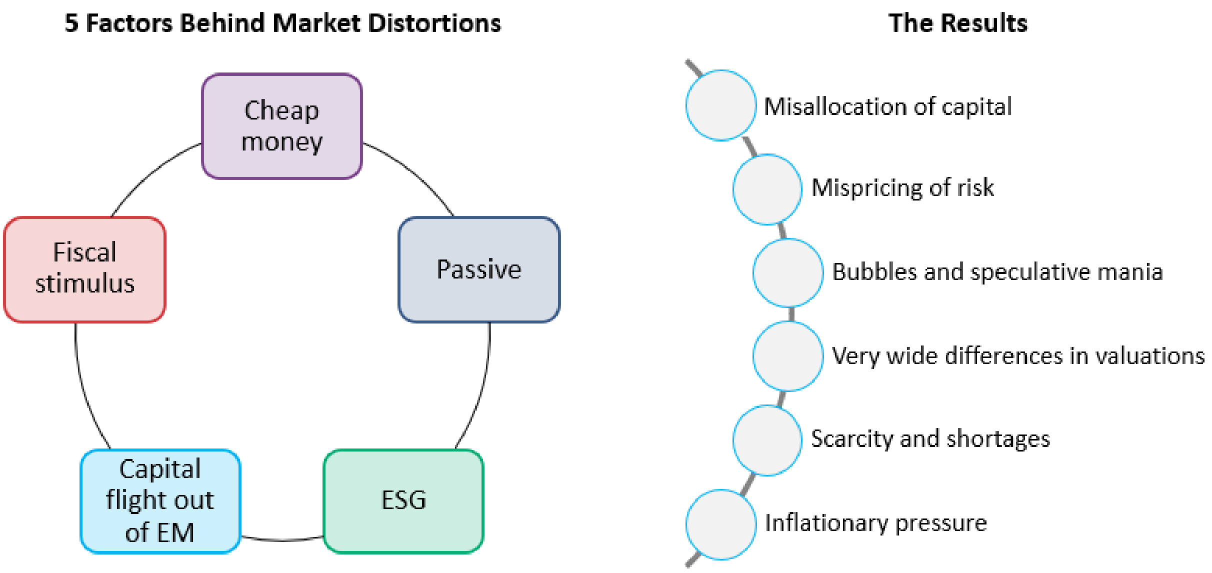
As the distortions of the past decade or so continue to unwind, it is important to acknowledge the effect that this will have on asset class returns over the medium to long term, and construct portfolios with this in mind. As always, we believe there are opportunities for astute investors, but we also believe that investors will have to look beyond the consensus view in order to unlock these successfully and grow their capital in the years ahead.

A quick reminder on five of the key factors contributing to asset price distortions

These are:

1. **Very cheap money** – the extremely low cost of capital and negative real rates in the developed world have supported high prices of financial assets.
2. **The rise of passive investing** – a fundamental reallocation of funds towards the winners of the past at the expense of the losers. Notably, most portfolios have materially drifted closer to benchmark indices, upweighting winning funds and stocks at the expense of poorer performers.
3. **The environmental, social and governance investing (ESG) movement** – capital has been redirected away from perceived 'bad' industries to 'good' industries, in most cases with limited consideration of the unintended consequences.
4. **Capital flight from emerging markets (such as South Africa)** – global investors have reduced exposure to emerging markets in recent years, in favour of some of the beneficiaries of global market conditions.
5. **Fiscal stimulus** – initially in the form of tax cuts, but more recently via vast cash payments to counter the impact of COVID. Historically, fiscal spending has been focused on expanding productive capacity and infrastructure. This time, the injections primarily funded private consumption and savings.

Figure 1:



Source: PSG Asset Management

The result has been profoundly distortionary effects on financial markets

Some of the effects we have seen play out include:

- **Misallocation of capital** away from productive parts of the economy towards the perceived beneficiaries of this environment, including 'hot' areas such as tech and renewables.

- **A severe mispricing of risk** where a vast array of financial assets that derive much of their value from negative real rates had seen their valuations soar (long duration assets).
- **Rampant speculation** fuelled by high levels of liquidity stimulus cheques, and zero commission trading for retail investors. Bubbles or manias developed in various pockets including cryptocurrencies, unprofitable tech, special purpose acquisition companies (SPACs), meme and story stocks like Gamestop and Tesla.
- **Extraordinarily wide divergences** in valuations between the winners of this environment and the assets where capital was exiting.
- **Underinvestment in many productive parts of the global economy** including infrastructure, supply chains, most of the energy complex, and raw material capacity.
- **The emergence of strong and pervasive inflationary pressure** due to the misallocation of capital and aggressive expansion of the monetary base giving rise to 'too much money chasing too few goods'.

Following consensus views is unlikely to reward investors in the future

Distortions of this magnitude will not unwind in a matter of months. The resulting multi-year trends that are already underway will strongly favour certain assets, and the beneficiaries of the market distortions (the winners of the past) are less likely to produce satisfactory returns and will be riskier than is commonly perceived.

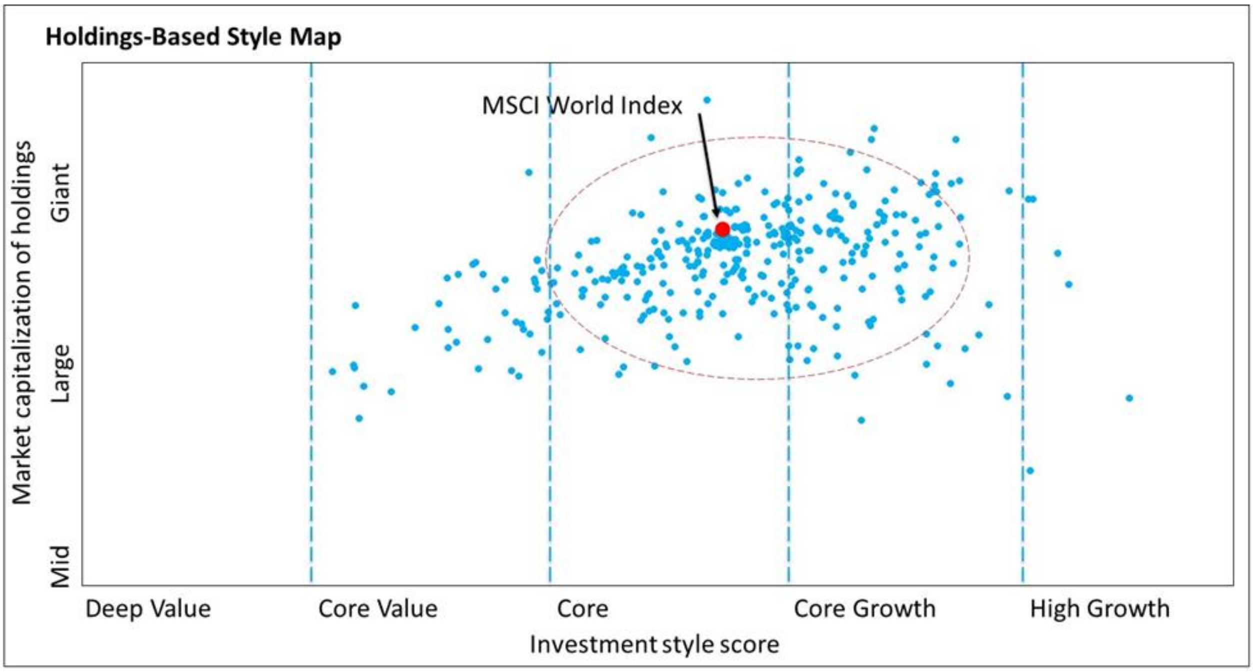
Many may view the potential of an imminent recession as confirming previously held views that the global economy will revert to its post-Global Financial Crisis (GFC) period of below-trend economic growth, and that the stocks to own going forward will likely be the same as those of the past. However, we would caution against this view and would argue that using the playbook of the past over the coming decade will set investors up for poor returns. Areas of the market that will deliver for investors and which will be perceived as 'quality' in the future, will likely be different from those of the past.

Given the expected unwinding of several major market distortions described above and weaker returns expected from major index constituents, differentiated positioning will become critically important going forward. However, finding truly differentiated managers may be more of a challenge than many investors realise.

Unpacking manager concentration in the market

To this end, it is interesting to observe the positioning of major global equity funds. The chart below shows over 400 of the world's largest global equity funds available on the Morningstar database and maps them according to investment style (from value to growth) and the size of companies held by each fund.

Figure 2:



Source: Morningstar, PSG Asset Management, fund data as at 30 June 2022

The bulk of funds are invested in the largest global companies and ranked as core and core growth (as illustrated above), with only a small minority of funds scoring as value funds and investing outside the mega-cap counters. While these results shouldn't be surprising (given people are drawn to what has worked in the past), it is highly indicative that the vast majority of funds appear to be positioned close to the index, which would benefit from a continuation of the investment environment witnessed over the past decade.

Also, the rise of passive investing, coupled with the increased index concentration of growth stocks (such as technology stocks and companies that have benefitted from unsustainably low interest rates) has seen global indices skew significantly towards large cap growth companies. By implication, most funds have a likely bias to large cap growth.

Differentiated managers have a valuable role to play in this challenging environment

Considering the current setup of the market, some of the key questions investors in global equity unit trusts should ask themselves are whether their active managers are just hugging the index, and how they would perform, if the next decade were to look substantially different to that of the past, as we continue to see distortions unwind. We would argue that the environment ahead makes a compelling case for investing with truly differentiated managers.

Glacier Research would like to thank Philipp Wörz for his contribution to this week's *Funds on Friday*

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