

Our global equity manager is underperforming – should we worry?

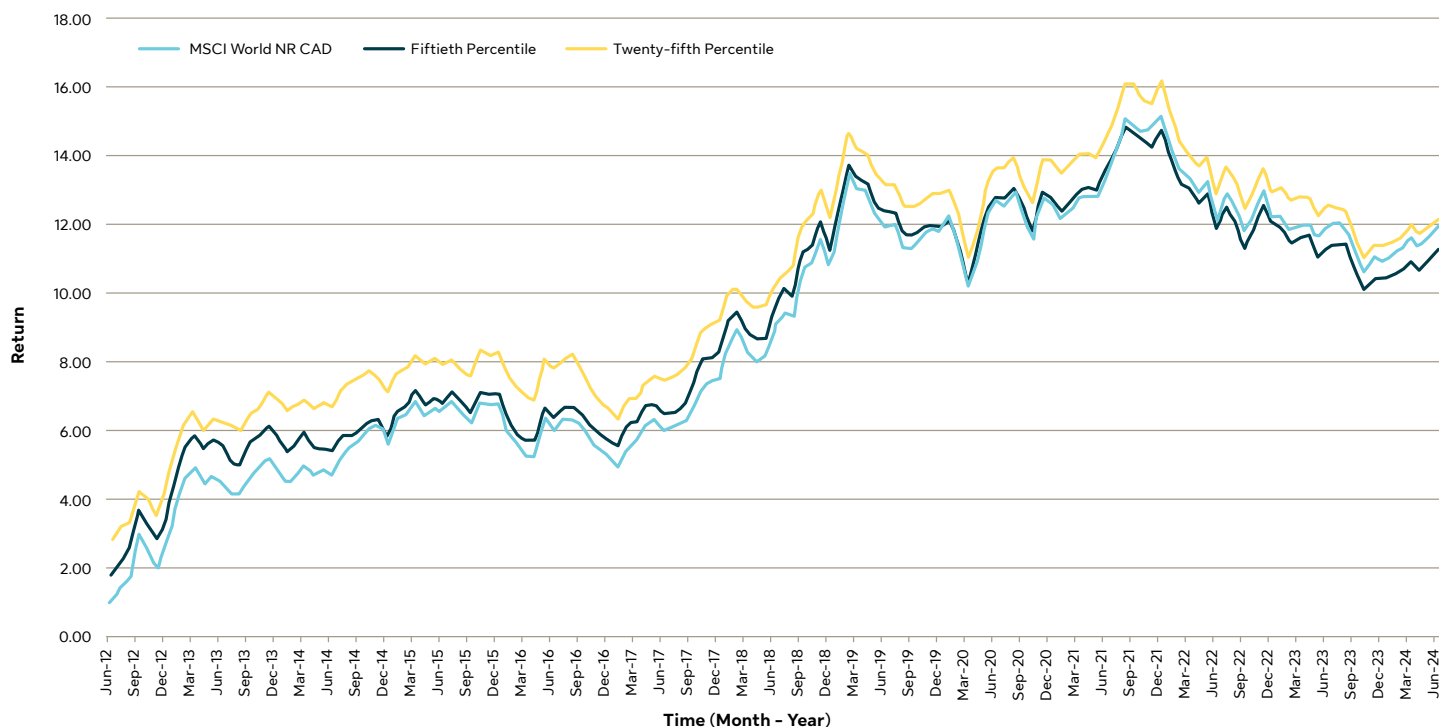


Look to the U.S. component for clues

The past two to three years have been challenging for many global equity managers, with the magnitude of underperformance in this period being meaningful enough to impact longer term periods as well. This lagging performance by a plurality of active global foreign equity managers has sparked new discussions among pension committee members and fiduciaries about their manager selections, and more broadly, whether there is value in active management.

Historical data has generally supported the use of active management in the global equity asset class over longer periods, until June 2021. As can be seen in the following chart, when looking at rolling ten-year periods starting in 2012, we can see that the median manager (black line) has outperformed the benchmark (blue line) until June 2021, when the median manager began to underperform the benchmark.

Global Equity Median Manager (active) vs. Benchmark (passive), 10 year returns June 2012 to June 2024



Data source: Morningstar Direct. Pooled Fund Universe, Global Equity Morningstar Category vs. MSCI World NR benchmark. 10-year time periods as of month end until 06/30/2024.

We see a significant margin of outperformance from managers at the top quartile, suggesting the importance of identifying manager skill, style dominance or some combination of those over time, albeit it being very difficult to do.

But a closer look at the drivers of underperformance may lead to a new appreciation for your manager's philosophy and process, and possibly support a more patient approach.

Over the past two decades, the U.S. equity component of global equity markets¹ has risen from roughly half to over 70%, driven largely by outperformance of U.S. stocks.

In addition, the number of stocks contributing to this outperformance has become increasingly narrow and concentrated in a handful of mega-cap 'darlings', commonly referred to as the Magnificent 7, or Mag 7.

Tech and tech-adjacent companies Microsoft, Apple, NVIDIA, Amazon, Meta and Alphabet comprise 21.5% of the MSCI World Index and 31.1% of the S&P 500 Index. If you add Tesla, the Magnificent 7, have had an outsized impact on U.S. and global equity market returns.

¹ Represented by the MSCI World Index (C\$)

Here is how the Magnificent 7 stocks performed in a one-year period ending June 30, 2024 (in US dollar terms):

- Nvidia: +192%
- Meta Platforms: +76%
- Alphabet: +52%
- Amazon: +48%
- Microsoft: +31%
- Apple: +9%
- Tesla: -24%

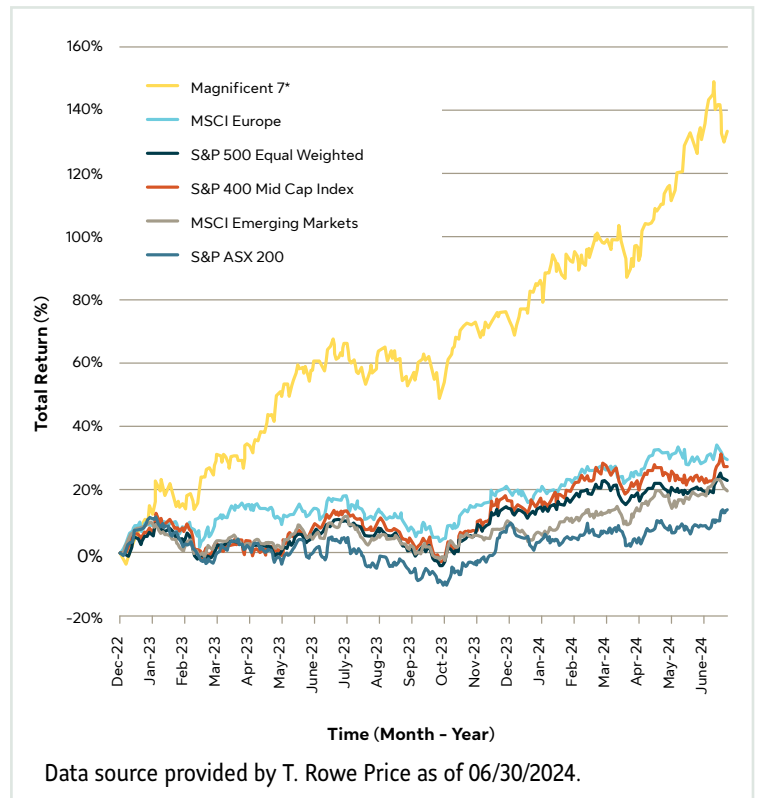
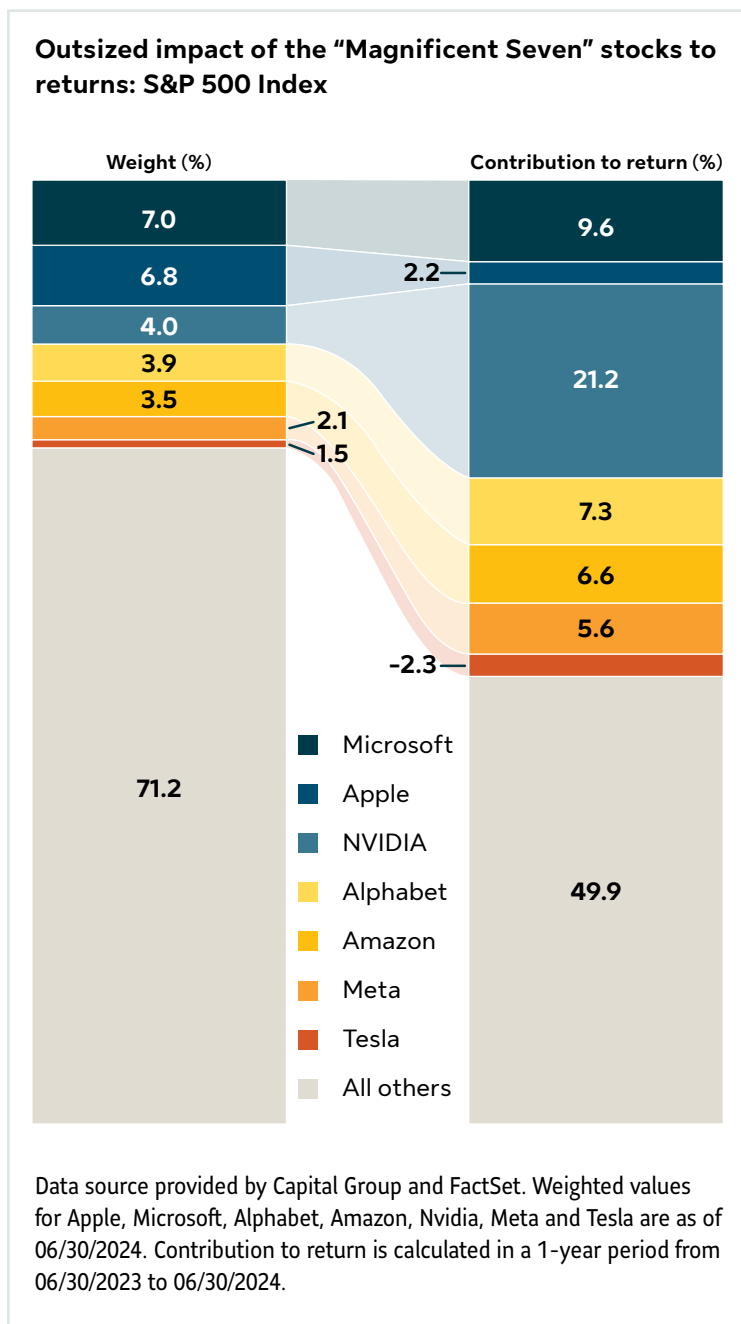
As a group they generated an average return of 54.9%. This can be compared to a return of 22.7% for the overall S&P 500 Index and 18.4% for the MSCI World Index. These seven stocks contributed more to returns than all the rest of the stocks in the S&P 500 Index, combined:

We can see a similar story over longer time periods. Over the last ten years ending June 30, 2024, here are the total cumulative returns for each of the Mag 7 stocks:

- Nvidia: +26,554%
- Tesla: +1,136%
- Amazon: +1,090%
- Microsoft: +972%
- Apple: +807%
- Meta Platforms: +649%
- Alphabet: +523%

This compares to an overall cumulative return over ten years of 178.6% for the S&P 500 Index and 101.4% for the MSCI World Index.

This categorical performance differential is apparent when comparing to other regional markets as well:



Market- capitalization-based benchmarks like the S&P 500 Index and MSCI World Index are intrinsically momentum-biased. Stocks with higher returns will comprise a larger proportion of these indices over time. Over the past decade, an equal weighted version of the S&P 500 Index (which is not affected by momentum), has underperformed the market-capitalization based S&P 500 Index by 2.4% annualized (as of September 4, 2024). As a direct result, the S&P 500 Index and MSCI World Index have become much more concentrated. It's fair to conclude that these seven stocks are distorting the benchmarks that active managers are being compared to, and the valuation metrics they use to value markets and portfolios.

Some managers are adapting their fundamental research processes to accommodate for this distortion in various ways, such as thinking of the Mag 7 stocks as a sector and defining risk controls around weightings for it, or by looking to get indirect Mag 7 exposure by investing in stocks that that may benefit from Mag 7 tailwinds. Other managers, particularly those with a Value or Low Volatility approach may choose to reject the higher valuations of the Mag 7 entirely. So, it is particularly important to evaluate performance in the context of the manager's approach, investment style and the market environment.

Mathematically, it is impossible for this outsized growth experienced by the Mag 7 to continue indefinitely. The S&P 500 cannot become the S&P 7. But while market participants wait for the inevitable correction and/or sector rotation to occur, it is natural to be frustrated by relative underperformance of an actively managed global equity fund.

We also know that style-related headwinds or tailwinds can have a big impact on performance, particularly during market extremes. While there have been periods where value has outperformed growth, overall, growth stocks have outperformed value stocks by over 5% annualized over the last five- and ten-year periods, as of the end of 2023.

With perfect hindsight, we know that if you had replaced your Value manager back in 1999 with a Growth manager, you would have made a bad situation worse. Value style managers benefited from the predominant market environment of low and stable interest rates, as well as the Global Financial Crisis, when Growth struggled. The following decade (2009 to 2019) saw a reversal of that style dominance, as Growth began a long period of outperformance.

And while any stock market period may have dramatic winners and losers, what differentiates the current period is its concentration in Technology and related stocks, with very high Price to Earnings (P/E) ratios. In some ways, this is reminiscent of the internet bubble of the late 1990's. Similar to the internet bubble, the P/E ratios of these companies are very high. The forward P/E ratio for the Magnificent 7 was about 35 at the start of 2024. This compares to 15.5 for the rest of the S&P 500. But unlike the 1990's, these stocks are generating significant revenues, and managers who own them generally make a strong case for their inclusion in portfolios.

Taking a broader approach to performance evaluation might include considering the member perspective, and absolute returns, rather than relative. For the ten- year period ending June 30, 2024, 15 out of 21 of the active managers on the Sun Life core platform have annualized returns greater than 10%, and most of those that are below that benchmark have markedly lower risk characteristics. Returns of this magnitude undoubtedly contribute meaningfully to the retirement outcomes of members.

So, if recent performance of your global equity manager is causing you to lose sleep, the GRS Investment Solutions team is here to support you with a comprehensive review of investment options available. Being patient (doing nothing) and making a change are both active decisions that need to be supported by a thorough review and a good understanding of your managers' process, positioning and results.

Active or passive? Value or Growth? Large or Small Capitalization? Developed only or Emerging Markets?

Your Investment Solutions Executive can help to navigate the complexities of line-up design and manager selection across asset classes, while keeping in mind how plan members view successful investment outcomes.

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