Oakmark Funds

Today's equity market: aligning expectations

September, 2023

The 2023 Natixis global investor survey shows that today's investor struggles to reset expectations in the current market environment.[1] While the investment environment has been strong over the past 10 years with low interest rates and high equity returns, it was inevitable that a shift would occur—and investors have taken notice. We've identified a few topics and trends to consider when looking at equity investments.

Key takeaways:

- **Index funds aren't as "low risk" as some may think**: Steady market returns between 2012–2021 and increased flows into passive strategies have driven misconceptions about index funds being "less risky."[1]
- **Volatility can create opportunity**: While many investors define risk as volatility and say it is a top three concern[1] – it's a little more involved than that; there are other factors to take into consideration.
- **Patience is key**: Using a long-term approach to investing helps navigate through multiple market cycles. Working with an investment professional can help investors put this into perspective.

What's changed?

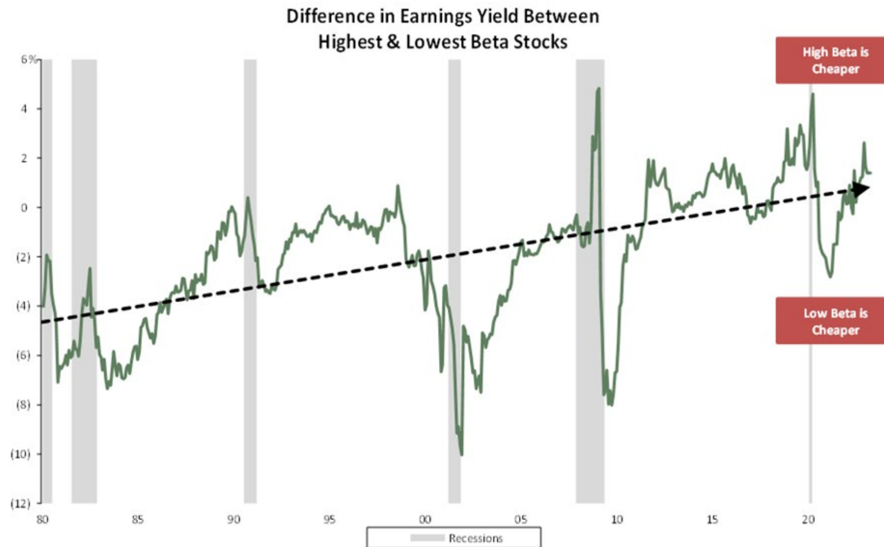
Today's investment landscape has changed dramatically from 20 years ago. Passive investing was just beginning to gain traction. Today, total passive fund assets in the U.S. are approaching parity with total active fund assets. Quantitative funds can capture and react to new information nearly instantaneously, while ubiquitous financial data has allowed quantitative measures of volatility to be broadly incorporated into investment decision making.

Higher correlations: The result of these shifts has been higher correlation across stocks as passive flows have a greater impact on stock price movements. Over the past three decades, the average correlation among S&P 500 stocks has increased and are well above historic averages in recent years. Research suggests this is related to the prevalence of ETFs, with greater ETF ownership of constituent stocks leading to greater correlation between those stocks.

Premiums on "low beta stocks:" Today it seems there is an increased premium placed on low beta stocks as investors now broadly incorporate such metrics into their assessment of risk. In fact, the lowest beta quintile of the S&P 500 is trading at a historically large premium to the highest beta quintile in recent years (see chart 1).

[1] 2023 Natixis Global Survey of Individual Investors, available at https://www.im.natixis.com/us/research/2023-individual-investor-survey; Natixis Investment Managers, Global Survey of Individual Investors conducted by CoreData Research in March and April 2023. Survey included 8,550 individual investors in 23 countries.

Chart 1: Difference in earnings yield between highest & lowest beta stocks



Large-capitalization stocks. Top vs. bottom beta quintile. Equal-weighted.
Source: National Bureau of Economic Research, Empirical Research Partners analysis;
Large-capitalization stocks: top vs. bottom beta quintile; equal weighted.
Date range: January 1980 through mid-April 2023

Do index funds provide “shelter” from the storm?

In a word, no. As the Natixis investor survey notes: “*After a decade of big market returns amplified by good press, investors have established a confirmation bias in which they believe passive investments have superpowers that simply don’t exist; 61% wrongly assume that index funds are less risky than other investments. By their very design, index funds have no built-in risk management. They just buy all securities within an index.*[1]”

Despite views of index funds being lower risk, some of them now require the “non-diversified” risk alert. A portfolio tracking the NASDAQ 100 Index might be considered diversified, but a closer look shows that since the weightings are based on market capitalization, its five largest positions account for 47% of assets, and its largest, Microsoft, accounts for 13%. Further, the technology sector accounts for 51% of the NASDAQ 100, and the total of positions each over 5% of a NASDAQ 100 index fund is 47%. Tesla and Meta are each just below the 5% threshold; should either of those companies pass 5%, the SEC would not allow the fund to invest new capital at the same weightings as the index. IRS rules also prohibit any Registered Investment Company from purchasing any position that is over 5% of assets if the total of those positions crosses 50%. That means the index fund would lose its pass-through status and be taxed as a typical corporation.

Similarly, the Russell 1000 Growth Index also requires the “non-diversified” warning because 36% of its assets are invested in stocks that each account for over 5% of its portfolio. The 10 largest holdings account for over half the portfolio, with the technology sector being 43% of assets (see table 1).

Table 1. Number of holdings doesn't always mean less risk. Concentration leads to less diversification.

	S&P 500	Nasdaq 100	Russell 1000 Growth	Russell 1000 Value
% in >5% holdings	15%	47%	36%	0%
% in Top 10 holdings	31%	61%	53%	17%
Top holding weight	7.7%	13%	12.6%	3.2%
# of holdings	503	100	1000	1000

As of June 30, 2023; source: Factset

The Natixis global investor survey results reveal that nearly six in ten investors (59%) look at the broad exposure these funds provide and assume that index funds give them access to the best opportunities in the market. They may provide exposure to the best opportunities, but since they invest in every company in an index, these funds also may give them exposure to the worst opportunities in the market.[1] In contrast, an active manager will do the fundamental analysis to try to identify the best opportunities while trying to avoid the worst—rather than just buying everything.

Is low volatility worth the price?

The Natixis survey results demonstrate that investors say all the right things about volatility, including the two-thirds who think it creates opportunity to grow their wealth. However, they may be much more concerned about it than they let on as volatility ranks as their #3 investment concern in 2023. Volatility is also a fundamental part of how investors define risk.[1]

"Risk" could be the word that investment professionals most disagree about. In general, there is agreement that an investment with higher risk requires higher return, but we don't agree on how to measure risk. Business owners say risk is the chance their business is worth less in the future than it is today. Academics get frustrated by that definition because it isn't easily quantified. They measure daily stock price changes and use risk metrics like beta, standard deviation and correlation. Many portfolio managers measure risk through tracking error, or how much their portfolio return differs from their benchmark index.

We've noted that the market is currently placing premiums on "low beta stocks" as investors now broadly incorporate such metrics into their assessment of risk. We looked at stocks with a more than $1 billion market cap that have been less volatile than the S&P 500. We didn't find one we thought was as attractive as the stocks we own. We

found that these stocks are mostly below-average growth businesses with above-average P/E ratios. But as a group, their standard deviation has declined by 23% compared to 20 years ago. Not owning them increases our relative volatility. When faced with the choice of buying businesses we believe are attractively priced but have high day-to-day volatility or businesses we deem more expensive but have lower volatility, we will always pick the former.

Where do we see opportunity today?

Whenever we see such a disconnect between stock prices and business fundamentals, it gets our attention. After all, in the long term, stock prices should converge with business values. When prices and values become untethered, it creates opportunity.

To be clear, we are (and always have been) bottom-up value investors. We don't form a macro view and then search for ideas that fit our narrative. Instead, we spend our days scouring the investable universe for opportunities to buy businesses at a discount. This bottom-up process manifests itself in different ways over time. Thirty years ago it led to large holdings in low-beta stocks like H.J. Heinz and Lockheed Martin; today it is unearthing ideas that take advantage of very different trends in the market.

We see four areas of opportunity in the current environment:

1) Undervalued, high beta stocks – with long-term earnings power

When the market values high beta stocks at a discount, there is opportunity to buy those businesses that are being overly penalized. For example, a financial sector stock that has a competitive advantage and strong growth outlook versus its peers, but trades at a discount because of cyclical fears – can be an opportunity.

2) Industries labeled with a stale perception of risk

In a market that relies on quantitative measures of price volatility to gauge risk, there is opportunity to identify businesses where fundamentals have evolved—but market perception of risk is stale. For example, during the 2008 global financial crisis the big banks needed to be saved. Since then, they have improved their balance sheets, and in the recent banking crisis they helped save the collapsed banks. Yet, the stocks trade at substantially lower multiples today than before the global financial crisis.

3) Opportunity to buy quality emerges from lock-step price changes

When the market paints with an overly broad brush–treating all stocks in an industry similarly despite fundamental differences–there is opportunity to identify the highest quality companies that are being inappropriately penalized. The energy sector is an example; recent oil price weakness has weighed on the shares of most oil producers—and the market doesn't seem to have sufficiently differentiated between low-cost producers with plentiful inventory and high-cost producers with minimal inventory.

4) Hard-to-quantify datapoints matter most

When every numerical datapoint about a business is being captured in a quantitative model, there is opportunity to focus on attributes that are hard to quantify, like management quality and capital allocation. Through research, we've been able to identify businesses with quality management teams and track records of excellent capital allocation – that may have otherwise been overlooked.

Keeping a long-term focus

We avoid letting the short-term "noise" distract us from our investment philosophy—and still focus on identifying the most undervalued investments in the market, waiting patiently for the gap between price and value to close. If this process takes a little longer than it did in the past, we won't get antsy. By investing in businesses with growing per share value and aligned management teams, time is on our side. We're also willing to take on volatility when we see opportunity for outsized returns, even as the world moves in the opposite direction.

We would rather take on short-term price risk than fail to achieve our primary goal—the same goal we had 47 years ago at our inception: build wealth for our clients over the long term. Markets may change and shift, but we remain committed to our investment approach.

Similarly, staying focused on the long term and working with an investment professional can help investors understand market dynamics, put the "noise" into perspective and navigate through multiple market cycles.

Sources:

- 2023 Natixis Global Survey of Individual Investors
- The High Price of Low Volatility | U.S. Equity market commentary 2Q23
- Staying the Course: Value Investing in an Evolving World

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The NASDAQ-100 Index includes 100 of the largest domestic and international non-financial companies listed on The NASDAQ Stock Market based on market capitalization. The Index reflects companies across major industry groups including computer hardware and software, telecommunications, retail/wholesale trade and biotechnology. It does not contain securities of financial companies including investment companies.

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