

Frontier International – Perspectives from Europe – Equities (Part one)

August 2024

We recently completed a research trip across London, Edinburgh and Copenhagen, engaging with 23 fund managers covering 29 strategies. Additionally, we held separate discussions with asset owners and our London-based research partner, Lane Clark & Peacock (LCP). The focus of the trip was on rated and client-held strategies, while also progressing onsite due diligence for potential new ratings, including a listed impact strategy and a core strategy.

In the first part of this two-part paper, we address the challenges faced by active management in concentrated markets, specifically focussing on the underperformance of a broad group of quality growth managers. These managers typically concentrate on stable, long-term compounders trading at reasonable valuations. During our trip, this underperforming group was notably overrepresented, making it a significant theme.

The quality growth style has faced considerable challenges in recent years. This includes the outperformance of value cyclicals and a major de-rating of growth stock multiples in 2022, and then the ensuing outperformance of the expensive 'magnificent seven' and GLP-1 weight loss stocks. Against this backdrop, the underperformance of the quality growth cohort is not entirely unexpected given the drivers of the market over this period. More adaptable or rotational strategies have generally fared better due to higher exposures to these high-performing sectors.

Nevertheless, quality is broadly expressed, highlighting the importance of understanding the specific quantitative and qualitative attributes of individual managers who focus on quality. For some managers, quality reveals itself over time and must be reasonably priced, while for others it tends to be a more forward-looking concept. Despite recent challenges, it is important to recognise the attributes of quality-focussed strategies, which will typically be targeting lower downside capture but also lower starting valuations relative to higher growth strategies

In our detailed paper, we delve into the nuances of quality growth strategies, examining both stronger and weaker performers. We also reflect on how these managers are navigating the difficulties of aligning valuation with growth and provide insights into their evolving approaches to identifying enduring quality.

The final word

Ultimately, our discussions with European global equities managers have provided valuable insights into the underperformance of many quality growth managers. It is evident that quality indices have become increasingly skewed towards high-growth, mega-cap tech stocks, which explains why many traditional quality-focussed managers, who tend to favour more stable compounders and moderate valuations have struggled. Although the current market environment of high valuations and increased concentration poses challenges, quality growth strategies have historically been effective in preserving capital and will continue to play an important role in a style-balanced, multi-manager equity portfolio.

At the same time, investors should critically assess quality growth managers who focus too heavily on recent year headwinds in explaining longer-term underperformance. This is especially important when there has been a failure to recognise long-term value creation due to an overly simplistic or rigid approach to the quantitative characteristics of a compounder. It isn't about being an early investor in Nvidia but there have been opportunities to identify some of the magnificent seven stocks earlier in the piece as durable compounders. Whether these stocks still represent good value at current valuations is a more complex question.

Stay tuned for the second part of our paper, which will look at geopolitical considerations from a European manager perspective.

Want to learn more?

If you are interested in learning more, please reach out to your consultant or a member of the Equities Team. Clients can access the comprehensive research paper on Partners Platform.