IMAP Independent Thought Podcast
Episode 29: Headwinds in the Global Equity Markets

Hosted by **Emily Barlow (Perpetual Private)**, joined by **Rowan Stewart (Aequitas) and Ben Drury (Baillie Gifford)**

- Are equities overvalued and should investors be repositioning their portfolios?
- Does Growth face headwinds in a higher for longer interest rate environment?
- Is the magnificent 7 a bubble that's about to burst?

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Emily Barlow - Perpetual Private (00:15):

Hello and welcome to Episode 29 of the IMAP Independent Thought Series podcast.

My name is Emily Barlow. I'm an investment director within Perpetuals Wealth Business, and I will be your podcast host for the next six episodes.

Today I'm joined by Ben Drury and Rowan Stewart.

Ben is a client service director and investment specialist at Bailey Gifford, working within Bailey Gifford's Global, Al Global Alpha Strategy.

And Rowan is the Joint Chief Investment Officer of Equitas Investment Partners, a professional asset consultant and portfolio manager.

Good morning, Ben Rowan. Today on the podcast we will be jumping into the growth value debate and our guest's views on whether now is a better time for growth or value investing.

Let's start by looking backwards. 2023 was a much better year for equities than most investors would've anticipated. However, the drivers of return were fairly narrow and in international equities largely driven by those magnificent seven tech stocks. I'd like to ask you both if you think that this is a trend that's set to continue or is it a bubble that's likely to burst? Rowan, perhaps we'll start with you.

Rowan Stewart - Aequitas (01:34):

Well is it a trend that's likely to continue to, I think certainly some of the advances in technology can be really important for the world at large. What we struggle with is the valuations of some of these companies and the breadth of it. This idea that in many markets, all of the technology stocks are priced for continued high growth. We find it difficult to see that everybody will win and that shareholders will get good returns from all of those stocks. That's the conundrum that we face, that the fundamentals are good, but the valuations are challenging

Emily Barlow - Perpetual Private (02:16):

And bubbles can keep going for a while right?

Rowan Stewart - Aequitas (02:18):

"Far longer than you can remain solvent" is the saying

Emily Barlow - Perpetual Private (02:22):

Ben, what are your thoughts on that?

Ben Drury - Baillie Gifford (02:24):

I think taking a slightly different angle, and we can say that it probably won't continue in the sense that it has already seen a real divergence of performance of those magnificent seven stocks.

At the start of this year, we saw the Magnificent seven become the magnificent forum pretty quickly. You could call it the magnificent one and a half with Nvidia continuing to perform very strongly up by about 75% this year. Meta about adding another 50%. And then in contrast, Tesla and Apple declining from the highs that they've previously made.

So I think that this, since seven, it's been helpful. In terms of thinking about market dynamics for this year, I don't think it's helpful in looking at the grouping as any sort of coherent opportunity set. I think you need to look at each of the opportunities for those companies and look at the investment cases for each of them individually.

Ben Drury - Baillie Gifford (03:14):

In terms of whether it's a bubble, I think those two companies that I mentioned that have performed delivered the most significant share price performance in Nvidia in a matter in both those cases that share price appreciation has been incredibly well underpinned by operational progress.

I think you look at the price of NVIDIA, it's in the mid thirties, which isn't cheap, but I think the growth of that company is delivering, that looks pretty reasonable and Meta actually even cheaper. So more or less a market or slightly above a market multiple.

Emily Barlow - Perpetual Private (03:45):

Okay, that's interesting. So if we look a little bit at portfolio construction, Rowan, are you recommending overweight to growth or values when you are talking to clients about portfolios?

Rowan Stewart - Aequitas (03:57):

For the most part, we're focusing on value and value. What that means for portfolios can vary a lot depending on our clients' different investment philosophies, and the way they construct their portfolios.

I think very broadly speaking, those client groups that are more concerned about absolute performance and income are concerned with the high valuations of some of these stocks and the fact that they could see big drawdowns and are leaning more into the valuation and income side of the portfolios.

Whereas some of the other groups with a more of a long-term growth perspective are thinking about it more along the lines of we'll just have less growth would have. We certainly don't want to have no exposure to those kinds of assets.

Emily Barlow - Perpetual Private (04:54):

And that's because of the concern of that sector being a bit overvalued?

Rowan Stewart - Aequitas (04:59):

Yes, absolutely. I mean it's almost entirely into earnings expectations and particularly for the broad market.

One interesting trend that we've got from a few clients recently is they're starting to look at the index exposure to go, gee, we're getting a lot of the magnificent seven coming through in our international equity core exposure. Is that really how we want our portfolios to be positioned?

So we're actually seeing a little bit of a swing back to active from some of our clients.

Emily Barlow - Perpetual Private (05:33):

So with that in mind, some investors would say that that high interest rate, lower growth environment provides better conditions for value investing. Ben, would you say anything different to those investors clearly as coming from a growth investor background? You must have a differing view to that?

Ben Drury - Baillie Gifford (05:51):

I think that's right. You probably expect to hear this from a growth investor, but I think maybe counterintuitively, I don't know, but higher interest rates are good for growth.

I think that clearly there's been a shock, particularly over 2022 when we started to see that evidence that inflation was entrenched. Central banks were going to have to ramp interest rates significantly in response to this. And I think as much as anything it was the speed of that ramp and that adjustment phase that that cause growth assets to have a very difficult period in 2022.

In a reaction to that actually where we are now, I think we're in a much more normalised environment. I think in any sort of longer term historical context rates are not particularly high. Rates being more normalized means that you're less likely to get unhelpful behavior in markets in terms of investors chasing yield or certain parts of the market becoming very crowded.

Ben Drury - Baillie Gifford (06:43):

And I think what you've also seen as a result of capital becoming scarcer than it was, is a greater discipline being seen from growth companies or companies across the market. And I think this is very helpful for returns.

I think what we've seen is companies looking harder at their cost base, I think companies are therefore focusing, not just on growth, but they are making sure they can evidence the value of that growth and see that coming through in terms of profitability.

And I think companies that have the financial flexibility to react the strategic flexibility to that, and the cultural adaptability, are actually better placed now than probably they were certainly in a relative basis two or three years ago.

Rowan Stewart - Aequitas (07:25):

One of the things too think if you're thinking about growth equities on a really long term view, the stats show that it is a very small proportion of companies that are responsible for almost all of the earnings growth.

And that's, I think related to structural change and economies and society and the way everything works. So in that sense, it's probably interest rates are kind of relevant on that very long term framing. It's whether some great new idea comes through.

The challenge is of course capturing that, and not getting all the ideas that seem great, but to now not to be. So I think you can definitely make a case for having an allocation to all of those sorts of companies on a long term basis. The skill is getting more hit's than misses.

Ben Drury - Baillie Gifford (08:24):

Yes

Emily Barlow - Perpetual Private (08:25):

So with that in mind, you know, as you mentioned, it is a more normalised interest rate, but we have been through a very long period of low interest rates and different companies have set themselves up differently over the past 10 years. So do you see more opportunities than risks given, you know, looking backwards versus looking forwards?

Ben Drury - Baillie Gifford (08:44):

I think in terms of risks, I mean you can always identify, if we're looking across the portfolio, you could say, what are the risks we see? You could talk about China, talk about US elections.

And I think actually, you know, we probably wouldn't say anything particularly insightful in terms of the risks that that, you know, any cross section of the investment community would, would raise.

I think you can manage those in terms of position sizing, portfolio construction. I think for us, building on, on what we've heard from Rowan, I think it's actually about making sure we identify where we see the most attractive opportunities.

That's where your time and attention needs to be focused because the opportunity set is much, much broader than just the magnificent seven.

I think we see an increasing breadth to where the sorts of areas where we might be able to identify and gain access to really interesting growth companies.

And I think that making sure we're focused on identifying those opportunities, bringing them into the portfolio, particularly coming have a period where growth investing has been through, you know, a very difficult period it's actually biasing our research, our mental bandwidth towards identifying those opportunities as much as it is to identifying risks that we should be worrying about.

Emily Barlow - Perpetual Private (09:47):

So going back to those magnificent seven or magnificent four or magnificent one and a half, are you now seeing that as an opportunity to invest? Do you still have those stocks in your portfolio?

Ben Drury - Baillie Gifford (09:59):

Not all of them, no, we don't own Apple. And I think again, it just comes back to the sheer diversity of criteria that are represented within that magnificent seven.

NVIDIA's delivering revenue growth incredibly profitably at well over 200% a year. You compare that to Apple, which is barely growing at all, and some of the other companies like Microsoft, which is a fantastic business, but again, completely different in terms of the speed of growth and the sorts of opportunities ahead of it.

So I think you'd look at each of them individually and you wouldn't look at them any differently to any of the other opportunities we may be able to get in the market.

I think focusing to any degree with any sense of exclusivity on those magnificent seven is really to, to completely miss, you know, the, the entire rest of the market where the kind of the next magnificent seven may emerge from, if you will.

Emily Barlow - Perpetual Private (10:45):

So you are looking much more broadly.

Ben Drury - Baillie Gifford (10:47):

Yes.

Emily Barlow - Perpetual Private (10:47):

Absolutely. Yes. Rowan, we've talked a bit about looking forward. So in terms of outlook, how are you thinking about portfolios and what is it that's keeping you and some of your clients awake at night?

Rowan Stewart - Aequitas (11:02):

We always tell clients, start with your asset allocation. That's the most important thing. Vary that according to market conditions, and then find investments that provide the exposures that we want. And that is going to vary depending on our client's investment philosophies and what they're offering to their clients in turn.

So the short answer is it varies a lot, but we talked about a tendency to value over growth. We shouldn't buy extreme dispersions in valuations in some markets.

We're in an odd environment where if we look forward and say on a 10 year basis, there's lots of things to feel really happy about. You can get good companies at reasonable valuations.

There are some companies that gold moves really well, there are themes to support that and touched on AI, but energy transition, emerging markets, et cetera. There's loads of reasons to be positive on that long timeframe.

And even on the defensive side of the portfolio, interest rates are much higher than they were a few years ago. That's pretty good for most people if you're investing. But on a six month to one year timeframe, there's all sorts of things that we can worry about.

Rowan Stewart - Aequitas (12:30):

Interest rates not coming down as fast as people want, geo risk, et cetera, et cetera. I don't think we have any special insider ability to predict what China's going to do or what the Federal Reserve is going to do. So the way we deal with that is to diversify the portfolio across assets across different styles. It might not be exciting, but it works,

Emily Barlow - Perpetual Private (12:59):

So you're maintaining a fairly neutral position

Rowan Stewart - Aequitas (13:02):

For most of the portfolios. We are slightly defensive. We're coming back from very defensive to slightly defensive, and we are quite interested in a lot of assets that have underperformed.

We've been advising many of our clients to add positions in global small caps getting back into emerging markets. So in many cases that's getting back from zero to about strategic weight not making a big push into that space. And much of that is just, we've seen one part of the equity market run really hard and other parts not.

And so on that simple basis, I think you have to be more interested in those segments of the market than you were a year or two ago.

Similarly, with fixed interests you can get government bonds at in the bank 4% and change if you are willing to invest in government bonds on that 2%. Surely you should like them more now when they're paying you twice as much. That's the kind of thing that we're talking to now

Emily Barlow - Perpetual Private (14:19):

That will very much make sense. And we would agree with a lot of those thoughts at Perpetual. Then if we delve into a little bit more of the detail in terms of sectors and geographies, is there anything that you are particularly liking or not liking at the moment?

Ben Drury - Baillie Gifford (14:38):

I think broadly to answer that question, I think what we're really excited about is if you look back over the last decade, where have the really big winners have emerge?

Where have the sort of the darlings of the growth investment community emerged from? And it's been fairly narrow opportunity set in some senses. It's been really a very heavy exposure to Silicon Valley West Coast, US kind of under that tech umbrella.

I think actually what we see now is having spent the last decade really building out these tools, we see the impact of these tools actually emerging in a much greater areas of the world in, in a wide range of different sectors.

I think AI is really interesting, perhaps the most obvious area of enthusiasm for growth investors to be talking about, but I think the winners or potential winners of this revolution go well, well beyond NVIDIA, which is where most of the excitement is focused so far.

Ben Drury - Baillie Gifford (15:25):

You are looking at the other areas of hardware, you're looking at how that plays out in terms of the build out of data centers, how these models are incorporated in industry specific ways across a whole variety of industries and parts of the economy.

I think you can look at healthcare as an area that's been under intense pressure now at multi-decade lows on a relative basis in terms of valuation versus the market. But the long term drivers of return in terms of the opportunity and the pressures on healthcare systems around the world and the technologies that are now being brought to bear to address those challenges look like a really fertile hunting ground for us.

I think we're excited about some of those points that Rowan mentioned earlier in terms of the incorporation of a much greater focus on renewables in our electricity grids, the electrification of broad parts of our economy, particularly maybe automobiles, but well beyond that.

Ben Drury - Baillie Gifford (16:13):

And I think we're another sort of area of focus for us at the moment is where we can see scarcity, whether that's scarcity of capital, whether that's the impact of scarcity of labor, whether that's scarcity of key resources like semiconductors or other key materials and where are the companies which are benefiting from that scarcity, which are sitting on those points of scarcity and able to earn a really attractive return.

I think when you look at the qualities and characteristics of those businesses that represent a much greater diversity of growth opportunities that maybe would've been represented in portfolios five, or six years ago,

Rowan Stewart - Aequitas (16:49):

I think we are seeing a lot of more industrials and what traditionally called manufacturing coming into growth portfolios. And I think that's a very interesting dynamic. I mean, given my background in engineering, I guess I would be interested in that, but you're seeing high tech manufacturers solving particular niches and often with an ESG sort of theme as well.

A lot of interesting companies after we've had a decade or more of manufacturing being looked on very negatively because China could do it cheaper that trend seems to be turning around in industries. There's a lot of that heavy industrial white industrial flavor coming into many growth style portfolios, which really wasn't there for a long time healthcare and tech. Maybe with a side or of consumer discretionary names. But yes, certainly that diversity is coming through portfolios.

Emily Barlow - Perpetual Private (18:04):

So to pick up on that point around ESG, it is certainly a theme that we are starting and certainly increasingly seeing from clients. They're asking more questions.

Gone are the days of just looking at screening, you've got multiple different tools.

So is that something that your clients are asking you more about or is it something you are paying more attention to from a portfolio construction perspective?

Rowan Stewart - Aequitas (18:28):

Yes, they are asking more, but it's probably from zero to a small amount. And that's driven by their client base as well. So some of that is becoming more mainstream.

Our experience is more in that sort of private wealth and financial advice area. So dealing with clients directly, which I think is a little bit different from the institutional space where there is an element of you want to do it so that you can put it in your name report when you are dealing with the end investor directly, it's much more personal.

And I'm sure you've probably experienced this as well, you know, what particular things are people sensitive to what are the thresholds that are important for them?

And it's complex. It requires a lot of thought and discussion. So yes, we are seeing more, but it, it's not so much a product based conversation, does this product have the green tick? It's what do we care about and how do we measure that and change, it's an overused word now, but how do we influence that change?

How does it change what we would do in terms of our portfolios and is that meaningful to the world? It's certainly a long conversation and it involves a lot of thought on both the client's behalf as well as ours.

Emily Barlow - Perpetual Private (20:12):

Yes. So that more values based investing and that more monitoring and measuring of impact, perhaps that more stewardship shareholder activism perhaps type approach and just really getting an understanding for that. We're certainly seeing a lot more of that. It's not just about the screening, it's about what's in the portfolio, what does that mean and what positive changes being impacted rather than specifically looking to invest in ESG funds. It's looking at what is the impact of that strategy. Do you have any thoughts on that? Is that questions that you are hearing from some of your clients? Ben?

Ben Drury - Baillie Gifford (20:47):

I think what we see in different parts of the world is the conversation being at very different points. So whether you're talking to someone in North America or the US in particular, you get a very different conversation to that in other parts of the world.

I think what I would add is that even outside of a portfolio with the badge itself, ESG or positioning a portfolio for clients that really care about ESG, I think we say the view that you need to think about some of these issues even from a purely financial point of view.

So if you're looking at a company that we invest in, a cement manufacturer in Europe, if you look forward a few years to a world which will probably be much more explicit in putting a carbon price on emissions, thinking about how that would affect competitive advantage in that industry particularly and how that company is positioned relative to its peers in that world.

Ben Drury - Baillie Gifford (21:33):

We've been investing in an airline for many years.

The attitude to unionisation, there was actually the change in their attitude becoming more constructive, actually unlocked a number of new markets for them where they were then allowed to operate much more freely than previously.

So I think we think about it in terms of how does this affect the growth opportunity for companies?

How does this affect their competitive advantage?

And then for clients that have more of a values forward approach, it's actually quite easy to then put a, a portfolio that then meets that just by using restrictions to ensure that you, you're not putting anything in that portfolio that would make them uncomfortable.

Emily Barlow - Perpetual Private (22:05):

Great. So to wrap up, is there anything that you'd like to leave our listeners with front of mind as we finish the podcast?

Rowan Stewart - Aequitas (22:17):

I think for us, we talked a lot about investment markets, investment selection, and touched on asset allocation. What we find with our client base dealing with advisors is that's actually the implementation and operations that are the biggest challenge.

So yes, we can absolutely think about which markets look attractive, but having a set of products in your portfolio that enables your portfolio to work or a portfolio structure that helps you manage that is just as important as forming those views in first place. It's the operations that carry, it's not the investment markets,

Emily Barlow - Perpetual Private (23:02):

The unexciting stuff. <Laugh>. Ben, what about you?

Ben Drury - Baillie Gifford (23:05):

I think the comment I would leave you with is that the drumbeats of change of progress continue. and actually periods immediately after very difficult periods for great investing can often be the most productive times to invest.

If you look back to the GFC companies, which were under significant pressure, then the likes of Amazon and Microsoft and Alphabet and so on, with then some of the most fantastic investments that people could get exposure to in the next decade.

And I think we see a similar type of situation emerging now where companies which have been under significant impression, which have been through this difficult period, have adapted, are now emerging stronger.

And as I say, having been through this kind of cleansing period where a lot of excess has come out of the market, certainly the kind of excess we saw towards the end of the pandemic, this feels much more sustainable and a much more productive time for a growth investor to go to work.

Emily Barlow - Perpetual Private (23:59):

Well, thank you so much for your time, Rowan and Ben. It's been a great discussion, which I'm sure has left our listeners with some food for thought. And to our listeners, we hope you can join us next month when we'll have another fascinating topic lined up for you.

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