SEI is Staying Calm
COVID-19 Crisis: Equity Review

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SEI New ways. New answers.®

- The COVID-19 crisis provided a massive exogenous shock to global capital markets.
- Almost nothing worked from an active management standpoint, even low-volatility equities struggled despite their typically more defensive nature.
- During this volatile and historically challenging time, we remain focused on the long-term view and continue to have confidence in our investment process and current positioning.

Equity Markets in Depth

Many equity markets declined approximately 30% peak-to-trough since the outbreak of the COVID-19 crisis. Equity portfolios have clearly been hit hard in absolute terms. Initially the selloff was primarily in the stocks of energy, commodity, airline and other companies where earnings were expected to suffer the most from a reduction in global travel. While we are not typically over overweight these sectors we have some exposure due to previously attractive valuations. Where this is the case, it detracted from relative performance. As the crisis has unfolded and whole countries have gone into lockdown, sharp falls have spread to the banks and other sectors as a global recession and widespread bankruptcies appear to be inevitable. On some of the worst days, selling has been almost indiscriminate. When stocks fall across the board, there's no hiding place for active managers who must remain fully invested.

This has been a challenging environment. Panicked selling has created a lot of volatility in the short term, and share price movements have not been reflective of the underlying fundamentals. This short-term pain creates opportunities in the longer run for those investors able to stay calm, measured and focused on their long-term objectives.

That said, we have not yet seen elevated turnover or wholesale changes in our portfolios. While markets have sold-off significantly, market leadership and the prevailing trends have not changed course materially. Sectors such as energy, financials and airlines had already been out of favour for some time, and were thus already viewed as attractively valued by our value-oriented managers. Conversely the higher quality, higher growth companies in consumer staples and technology that have proven more resilient were already in vogue and well represented in the portfolios of our momentum and stability-oriented managers. We expect these trends to reverse at some point.

Equity Active Positioning

Prior to the recent sell off, equity markets were looking somewhat richly priced, particularly in the U.S. Much of the market gains we saw in 2019 were a result of improved sentiment, and hence multiple expansion, rather than underlying earnings growth. With markets now trading at significantly lower levels, valuations are looking more attractive. This is particularly in light of central bank emergency rate cuts in March and the fact that this crisis is likely to be a temporary, albeit very painful, hit to earnings rather than anything more permanent. This has provided both investors and active managers with opportunities to start putting any surplus cash to work, although we believe it would be prudent to do so incrementally given volatility is likely to remain historically high. We acknowledge that this has been difficult for investors, but the best opportunities often arise when it feels most uncomfortable.

- In relative terms, our equity portfolios are strategically positioned to benefit from three systematic long-term sources of excess return or alpha sources, namely value, momentum and stability. Additionally we look to the stock specific insights of the underlying investment managers, to add value. Over the full cycle, stocks that are attractively valued, higher quality or lower risk, and enjoying positive change are expected to outperform.

- While our funds are well diversified across each of the three alpha sources, in recent times, extremely wide valuation dispersions have lead us to favour value, although the magnitude and nature of this tilt has varied across the portfolios, depending on potential opportunities in the different markets.

- The COVID-19 crisis has exacerbated this opportunity, with already out of favour stocks faring worse than more highly rated defensive and quality growth stocks, thus offering even better relative value in our view.

- The gap between the cheapest and most expensive stocks in the market is now as wide as it has been since the "Tech Bubble" 20 years ago. As this gap normalises and closes, we expect cheaper stocks to outperform more expensive stocks significantly.

- We are therefore maintaining our preference for value, and will use any fund flows to maintain and, where appropriate, reinforce this position. Although we would note that any shifts in the short term are likely to be very gradual given the ongoing volatility. Similarly, we are seeing some of our underlying investment managers make modest shifts, adding to or picking up oversold stocks (even airlines in some instances) where underlying long-term fundamentals remain robust.

Equity Performance Review

With our broad preference for value and a view that global growth would continue, it's unsurprising that our equity portfolios fared poorly due to the exogenous shock to markets from COVID-19.

- In our U.S. large-cap portfolios we maintained a strong preference for value via strategic allocations and a modest tactical tilt. This resulted in a preference for sectors such as financials, in particular banks, and underweight to richly valued technology companies. Although this positioning detracted, we remain confident and do not foresee any significant changes to it at this time.

- Global equity portfolios maintain the most significant value bias across our fund line up. Further they have a strong preference for a down in market capitalisation exposure, which is a hallmark of active management. Although this resulted in significant underperformance the potential for value to outperform remains incredibly strong.

- Like many of our other portfolios, our U.K. equity portfolio was positioned for continued global growth. As such it was underweight defensive mega caps in utilities and consumer discretionary in favour of positions in consumer discretionary and media companies. There have been no significant changes in positioning due to the COVID-19 crisis and we believe we are well positioned to benefit from an eventual rally.

- Managed volatility portfolios reduced volatility but not at the level we would have expected. Many of the stability-oriented stocks we own in these portfolios were indiscriminately sold by investors while correlations in equity markets were extremely high. No strategy can be expected to work as expected in every scenario and given the poor performance of low volatility as a factor we are not concerned about the underlying investment managers in our portfolios. While we understand investors are concerned about the lack of downside mitigation, we remind them that the efficacy of managed volatility cannot be measured during one brief market selloff. We believe that the long-term view of the potential for market-like returns with reduced volatility remains intact.

- Emerging-markets were among the hardest hit during the COVID-19 crisis. The benchmark index is now dominated by China and other Asian countries, and our underweight to China hurt as it has already started to reopen its economy as new reported COVID-19 cases and deaths have fallen dramatically. As oil importers, Asian countries also benefited from the oil price war which hurt our overweight position in Brazil.

Equities: Looking Ahead

We believe equity markets are likely to remain very volatile as the continuing pandemic unfolds and the economic impact becomes clearer. Markets could fall further from here despite the fairly swift bounce off of the bottom. Once the situation stabilises, we expect a sharp recovery just as we have seen after most other crises in the past. The precise timing of any potential recovery is difficult to predict. Recent actions taken by both governments and central banks around the world will hopefully be enough to fend off the worst-case economic outcomes. This should provide a solid floor under markets once rates of infection slow, and thus provide the foundation for a sustained rebound.

In the short term, market recovery phases are often driven by the most oversold "value stocks" in the market. Improved sentiment and expectations often lead to investors to rotate out of more expensive, defensive names in search of a bargain. As we've already noted, our funds are well diversified across each of our three alpha sources, but recently we have tended to favour value across nearly all of our equity portfolios. Our portfolios should, therefore, be well positioned for any short-term market recovery.

Longer term, the emergency stimulus measures that we have seen are likely to prove inflationary, an environment that tends to be more supportive of value investing, as the valuation of longer-duration growth stocks falls as a result of higher bond yields. If this trend does become established then we would expect our momentum bias to also benefit alongside our value tilt.

Active managers have had it tough in recent years as market returns have been narrowly concentrated in a small number of large, high growth (and often over valued) technology-related stocks (the so called FAANGs: Facebook, Amazon, Apple, Netflix and Google). In contrast, most active managers have tended to build more diversified portfolios, with holdings outside of the mega-cap market leaders. Usually this pays off, but not over the last few years. This trend has been driven in part by a prolonged period of favourable tailwinds from historically low interest rates and ample liquidity. Now that market conditions have turned more challenging, our view is that active managers will be able to outperform the market-cap weighted benchmarks.

We will of course continue to monitor market developments closely from here to ensure portfolios remain well positioned for the current environment without losing sight of our long-term strategy.

Glossary of Terms:

Alpha source: Our strategies are designed to capitalize on long-term drivers of market performance through exposure to persistent sources of returns such as mean reversion, trend-following and stability. We have refined our approach to identifying these alpha sources and the factor groups we employ as proxies to measure and capture their performance.

- **Momentum Alpha Source:** The investment manager seeks to benefit from investor under-reaction—due to anchoring. Such groups of stocks trend in price as perceptions change directionally and serially with incoming data, leading to herding behavior by investors.
- **Stability Alpha Source:** The investment manager seeks to benefit from investor tendency to undervalue lower-risk, higher-stability businesses—resulting from a focus on short time horizons and overconfidence in forecasts for momentum-driven stocks. Stability-oriented stocks have the power to exceed market expectations by consistently outperforming (rather than reverting to average market returns) and through the power of stable, long-term compounding.
- **Value Alpha Source**: The investment manager seeks to benefit from investor overreaction—resulting from aversion to loss. Such groups of stocks revert to the mean, as fear over the perception of the investment's risk dissipates.

Market-cap weighted: Market-cap weighted index is a stock market index whose components are weighted according to the total market value of their outstanding shares.

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