Insights

Active Quantitative Equity

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Applying Lessons of a Volatile 2022 for 2023

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A close review of important topics from 2022 helps to inform our views on key themes investors should be focused on in equity portfolios in 2023.

Across global markets, 2022 acutely challenged investors across asset classes. In looking back at 2022, inflation, monetary policy, and geopolitics topped the list of key topics and risks. For active quantitative equity investing, the topics that captured the Active Quantitative Equity (AQE) team's attention most in 2022 were the following:

- Macroeconomic conditions and credit risk
- Drawdowns, volatility, and equity risk
- The many dimensions of investor sentiment

Let's examine each of these topics in greater detail.

Macroeconomic Conditions

At the start of 2022, we started observing inflation and interest rates, and assessing the impact that both have on growth stocks. During our analysis we were reminded of the importance of examining fundamentals and expected earnings. In the growth stock universe there were still strong performers despite the challenging discount rate headwinds.

Over the course of last year we also commented on the inflation sensitivity of different parts of the market, and the relationship between our signals and investment grade corporate bond spreads. Additional analysis on the relative valuation of stocks with resilient credit risk sensitivity reassured our team and underscored the primary goal of our investment process, namely to find attractive high quality companies at reasonable prices.

Drawdowns, Volatility, and Equity Risk

Over the course of 2022, the AQE team had plenty of opportunity to analyze sharp drops in the equity market, and shape different views of volatility and equity risk. Broadly, the team was reminded that traditional high risk segments do not always underperform in market drawdowns. This concept was notably demonstrated when Energy stocks outperformed the rest of the market even when the market was down sharply.

Furthermore, we sought to highlight nuances associated with our preference for "low risk" stocks during the year. In 2022 our cornerstone thematic signals — Value, Quality, and Sentiment — pointed toward lower risk names more than was typical in other years. Yet throughout the prior year, we also had a strong preference for Energy stocks (high risk), and generally a negative view on the Real Estate sector.

Our team also reflected on the lack of cushion that traditionally lower risk segments like Real Estate, Utilities, and Telecommunications had during last September's sell-off. The events of September stood out as an unusual drawdown because the relative pay-off to low-volatility stocks was notably lower than is usually the case. Our explanation of why these events played out the way they did is because of the importance of the dimensions that we specified above in predicting stock returns — Value, Quality, and Sentiment measures.

Multiple Ways to View Investor Sentiment

Investor sentiment was an important topic that our team focused on during the course of 2022. Measures of investor sentiment experienced not only the widest variability in returns during 2022, but also a significant number of leadership changes during the year.

Our analysis of supply chain linkages pointed to a divergence between a measure of customer sentiment versus a direct measure of investor sentiment mid-way through the year. Semi-conductors were a prime example of this disconnect, particularly through supply bottlenecks.

Additionally, our analysis of language used in earnings calls carried important insights about relative attractiveness of defensive versus cyclical industries, and the confidence in the outlook by company management in those segments.

Experiencing a dramatic market pivot in November, price momentum declined sharply, as can happen periodically for this fat-tailed, negatively-skewed signal. (Refer to December 2022's commentary, "Price Momentum Crashes — Should We Worry?") The market conditions reminded us of the importance of combining price momentum and other signals with complementary payoff profiles in order to produce a more resilient predictor of stock returns through different market twists and turns.

Looking Forward

As we look out to 2023, fundamentals, diversification of factor exposures, and retaining high quality or defensive exposures are the themes investors should be focused on in equity portfolios.

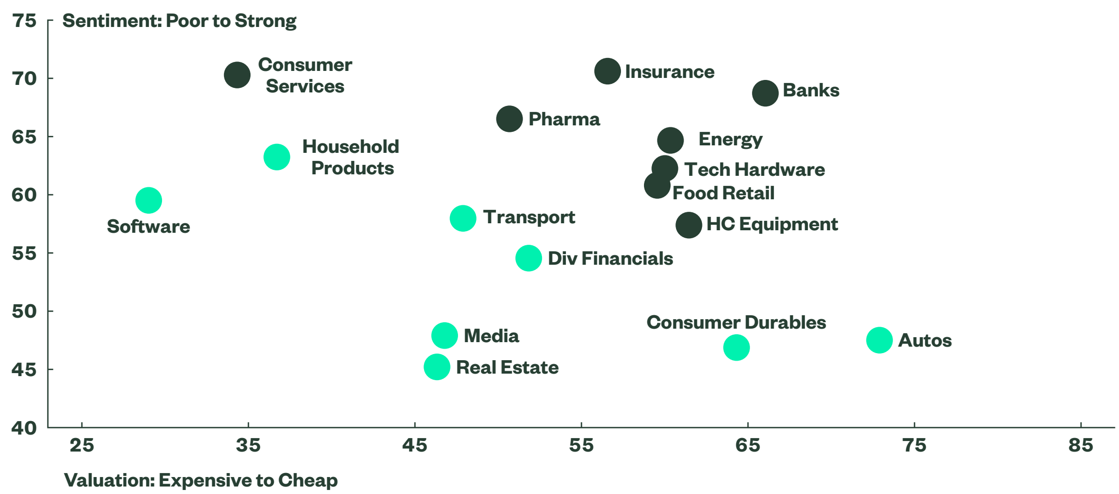
The equity market drawdown in 2022 creates a valuation cushion as compared to the end of 2021; however, other risks, and the macroeconomic and market conditions that were prevalent last year still abound. Although we may have passed peak inflation, the outcomes of the fine balancing act for central banks globally between inflation, interest rates, and growth risks still need to play out.

With that uncertainty we expect elevated levels of market volatility to persist and Sentiment reversals to be common. We therefore believe it is important to balance exposures within a portfolio — for example marrying Sentiment exposure with Quality and Value factors. Similarly, we favor balancing investments in traditionally low risk sectors with more cyclical exposures rather than betting on one very specific path for the economy. Importantly, this balanced approach enables fundamentals and diversification to guide our stock selection.

At the start of 2023, our equity industry preferences are summarized below — with most preferred in dark green, and least preferred in light green. See Figure 1 and Figure 2.

Figure 1
Developed Markets: Most- and Least-Preferred Segments Overall, with Average Valuation and Sentiment Measures per Segment

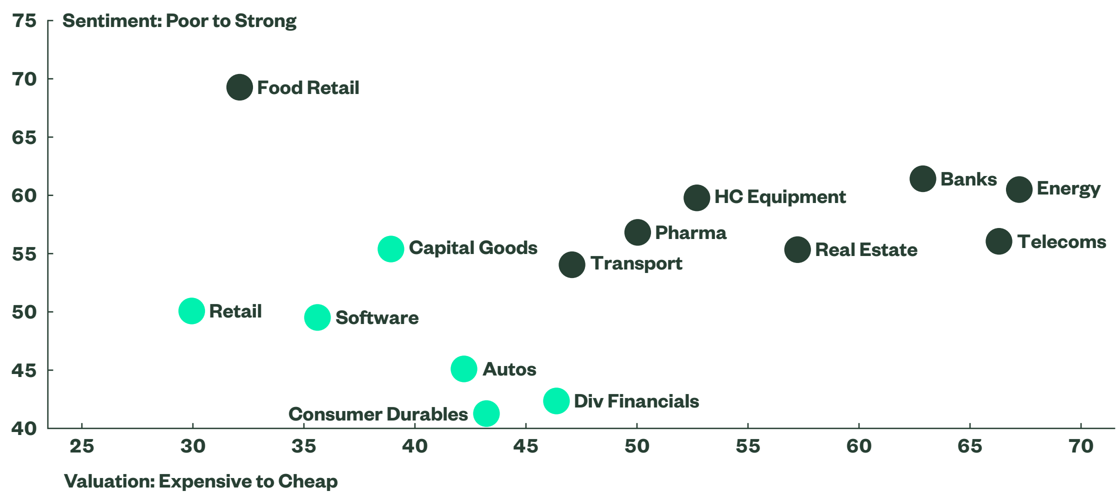
Most Preferred
Least Preferred



Source: State Street Global Advisors, as of 31 December 2022.

Figure 2
Emerging Markets: Most- and Least-Preferred Segments Overall, with Average Valuation and Sentiment Measures per Segment

Most Preferred
Least Preferred



Source: State Street Global Advisors, as of 31 December 2022.

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