Investment Insights

Growing a Client's Portfolio with High-Conviction Positioning

Morningstar Investment Management
December 2021

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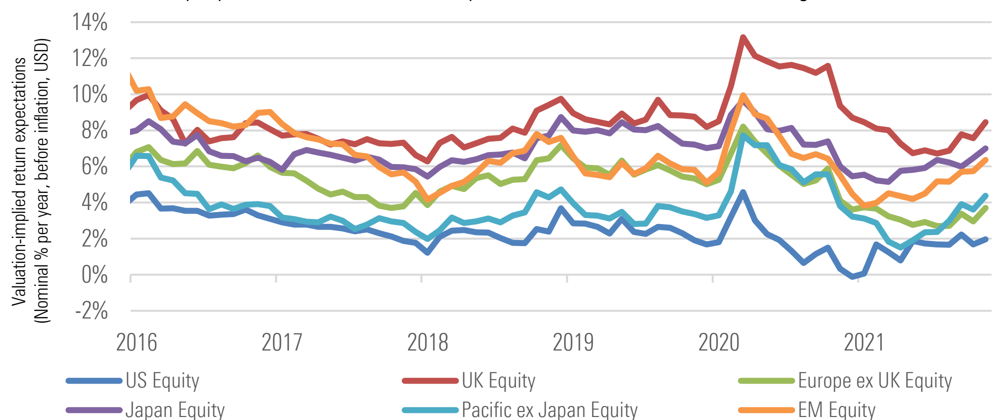
For Financial Advisers & Their Clients

Investors are entering 2022 with stocks at or near all-time highs—up over 100% from the market bottom in the U.S., for example. Kickstarted by an unprecedented fiscal and monetary stimulus and sustained by rising investor exuberance—e.g., special purpose acquisition company (SPACs), IPOs, and meme stocks—sharp gains across risk assets such as equity and credit have left investors with only a small number of investment opportunities. That requires an increasingly focused approach to portfolio construction.

Exhibit Global Equity Markets – Our Return Expectations Have Narrowed Entering 2022



Source: Morningstar Investment Management calculation, as of October 31, 2021. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index.

When assessing the number of attractive asset-class opportunities, we tend to look at the percentage of assets that trade above their fair return, which is the return we expect to realise when the asset is trading at fair value.

The number of assets that are fairly valued based on our valuation models has declined since last year. For instance, in March 2020, 57% of all country-equity markets that we track traded at a discount to their intrinsic value, and that has fallen to only 6% of all country markets as of the end of October (see exhibit presented below).

In this context, it is prudent to recall Warren Buffet's guidance: "Opportunities come infrequently. When it rains gold, put out the bucket, not the thimble." During the height of the pandemic-induced sell-off last March, we were in an environment where opportunities were plentiful, and a very targeted approach wasn't required. Today, the situation is different. Investors ought to take a more measured approach to constructing their portfolios: i.e., put out the thimble, and save the proverbial bucket for a period with heavier rain.

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Exhibit Number of opportunities has been dwindling (% of country with a valuation implied above fair return)

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Because of the scarcity in opportunity out there, the work that our global investment team does to uncover the opportunities presenting the best potential reward for risk becomes more critical. Looking ahead to 2022, we are highlighting three investment ideas for investors to consider in their portfolios.

1) The Recovery Play: Relative Value in Energy and Financials

While there are a number of headwinds on the horizon, not least uncertainty about inflation and the emergence of a resistant COVID-19 variant, the global economy is poised to continue its recovery, fueled by the normalisation of economic activity globally.

At current prices, global equities look expensive overall, according to our analysis, both in absolute terms and relative to international markets. However, there are pockets where we continue to see opportunity. These opportunities tend to cluster in more cyclical (or economically sensitive) areas of the market—including energy and financials, which have both done exceptionally well recently.

- **Energy Stocks:** Despite recent strength, we continue to believe integrated energy companies with diversified business models and strong balance sheets provide significant potential upside for investors. The global energy sector has survived its darkest days, which saw a negative oil price at one point. Additionally, the longer-term transition towards cleaner energy remains broadly on track despite some concerns about the profitability of clean energy. This development is particularly interesting when we consider climate-change risk, with European energy companies making a meaningful pivot toward renewables.

- **Banks:** Our research also leads us to believe that banks are still relatively attractive. Lower-than-expected loan losses and a potential acceleration of loan growth as we enter 2022 provide a favourable medium-term backdrop for the sector. For banks, we believe risks are skewed to the upside in the next year or two, driven by fundamental improvements that include solid economic growth, low loan losses, and a higher capital return. Our valuation models suggest that energy and financial stocks have the potential to outpace the broad global equity market by more than 2% over the next decade.

Energy stocks and financials also have attractive inflation-fighting properties, given their ability to pass on price increases to their clients. Inflation tends to boost interest rates and a steeper yield curve, which

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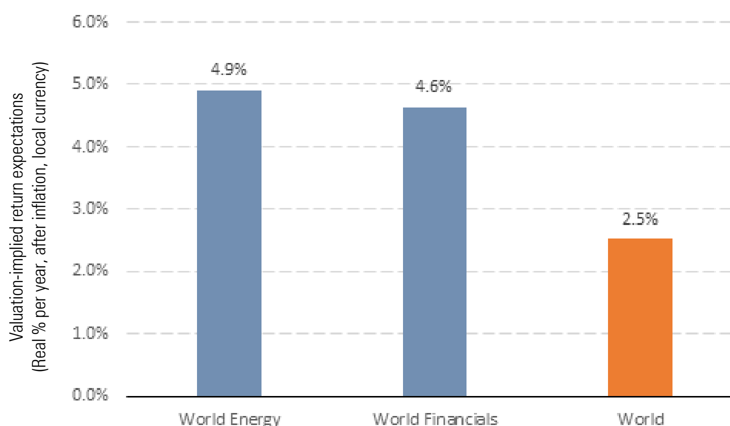
benefits banks. Oil is a commodity, and any price increases are passed on to consumers. In the event of a continued rise in inflation, energy and banks stand to benefit.

Exhibit Energy and financials offer higher potential returns than global equity market over the next decade



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2) Growth Companies at a Lower Price: The Case for China Tech

Investors have been bidding up prices of so-called "big tech" in recent years amid scarce growth elsewhere and falling interest rates, propelling an increase in stocks with the prospect of long-term growth. This run-up in prices, in addition to the risk of stretched valuations, has also increased concentration of the U.S. equity market in a handful of technology companies. As of September 2021, Meta Platforms (Facebook), Amazon, Apple, Netflix, Google (Alphabet) and Microsoft made up approximately 24% of the US market[1], creating a need for U.S. investors to diversify away from single stocks.

A sell-off in Chinese equities over the course of 2021, which was triggered by a regulatory crackdown, presents investors with an opportunity to purchase shares of big-tech companies at low valuations. At current prices, China appears to offer better absolute and relative value than any other major market, even after accounting for the potential impact that the regulatory crackdown may have on growth and profitability. Chinese stocks have an attractive growth profile and the major tech names have low financial leverage, which provides diversification against some of the cyclical stocks that are also trading cheap. Therefore, we think there is a growing case for investing in China.

3) Emerging-Market Debt in Local Currency: The Only Place for Positive Real Return in Fixed Income

With negative yields on government bonds (after adjusting for inflation) across developed government-bond markets and corporate credit spreads at multi-year lows, returns from the fixed income universe appear paltry over the next decade. Emerging-market debt in local currency (which we prefer over hard currency) continues to offer positive real yields and is a notable exception. Our view remains that emerging markets' sovereign fundamentals are broadly stronger than in the past. Improved current-account balances, enhanced reserves, movement to orthodox monetary policy, and a build-out of a local

[1] Originally sourced from Yardeni Research Stock Market Briefing: FAANGMs as at Sept 10th, 2021. Also validated by Morningstar Investment Management calculation against the Morningstar US Market Index, using data from Morningstar Direct to 08/31/2021.

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investor base allow for a shift to local-currency funding, though there are ongoing concerns surrounding an increase in debt levels and a lack of fiscal discipline in some countries.

In aggregate, emerging markets (EM) were slower out of the blocks in opening up their economy than developed markets (DM) were. That said, the majority of EM central banks have started increasing central-policy rates as inflation remains elevated. In addition, an aggregated view of EM currencies also looks undervalued and should be a tailwind over time. The area can be volatile, yet even allowing for some pessimistic assumptions, our research suggests that investors could earn a decent premium over similar-duration U.S. Treasuries if they're willing to risk short-term loss. Stated differently, we think investors are likely to be compensated for the risk of investing in emerging-markets bonds over time, especially for local-currency bonds.

Highlight of Our Convictions

Steering investors to our asset class convictions, our investment team monitors over 300+ markets across equities, fixed income, and currency. We highlight our conviction level across some core assets, including a micro-thesis on the key drivers.

Asset Class		Overall Conviction*	Key Long-Term Drivers
EQUITIES	United States	Low to Medium	Valuations are not as compelling as international markets. Investor optimism was bordering on excessive, which remains a concern to us.
	Europe ex-U.K.	Medium	We find the opportunity set in Europe to be diverse. The recovery continues to take shape, with sector selection important.
	U.K.	Medium to High	Investor sentiment has improved, following a long period of negativity. The reward for risk continues to appeal.
	Japan	Medium	We still cite structural reform, providing upside to earnings drivers. The relative appeal is moderate.
	Emerging Markets	Medium	Recent weakness has improved the opportunity set in emerging markets, although the overall appeal is still moderate. Risks need to be managed.
	Germany	Medium to High	German stocks offer solid balance sheets and upside to earnings—without the eyewatering valuations in some other markets.
	South Africa	Medium	While sensitive to cyclical earnings and concentration risk, valuations reflect these concerns. Our view has moderated though.
FIXED INCOME	Government Bonds – U.S.	Low to Medium	Yields are still incredibly low and no longer cover inflation risks. The defensive attributes are appealing, but unlikely to contribute to returns.
	Government Bonds – U.K. & Europe	Low	Gilts, Bunds and other EU Treasuries have terribly low yields. Longer-dated bonds are particularly sensitive to inflation risk with poor return prospects.
	Investment-Grade Corporate Bonds	Low to Medium	Yields are unattractive in an absolute sense, with a narrow spread to government bonds. We are wary of valuation risks if the recovery stutters.
	High Yield Credit	Low to Medium	Yields no longer compensate for the risk taken. Defaults remain low, but credit risk should not be ignored.
	Emerging-Markets Debt (Local)	Medium to High	Emerging market debt in local currency (which we prefer over hard currency) continues to offer healthy relative yields, even accounting for risk.
LISTED PROPERTY	U.S. REITs	Low to Medium	U.S. listed property remains broadly unattractive on an absolute basis, carrying high debt and concentrated exposure.
	Non-U.S. REITs	Low to Medium	Continues to rank behind other opportunities on both an absolute and relative basis, although South African REITs continue to stand out.

Source: Morningstar Investment Management, conviction levels confirmed at November 12th, 2021.

*Overall conviction is a long-term judgement built on a five-point scale from "Low" to "High". Typically judged on a 10-year horizon, a "Low" means that reward-for-risk is likely to be subdued, whereas a "High" means reward-for-risk is appealing. This incorporates our four pillars of conviction including 1) absolute valuations, 2) relative valuations, 3) fundamental risk and 4) a contrarian scorecard.

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