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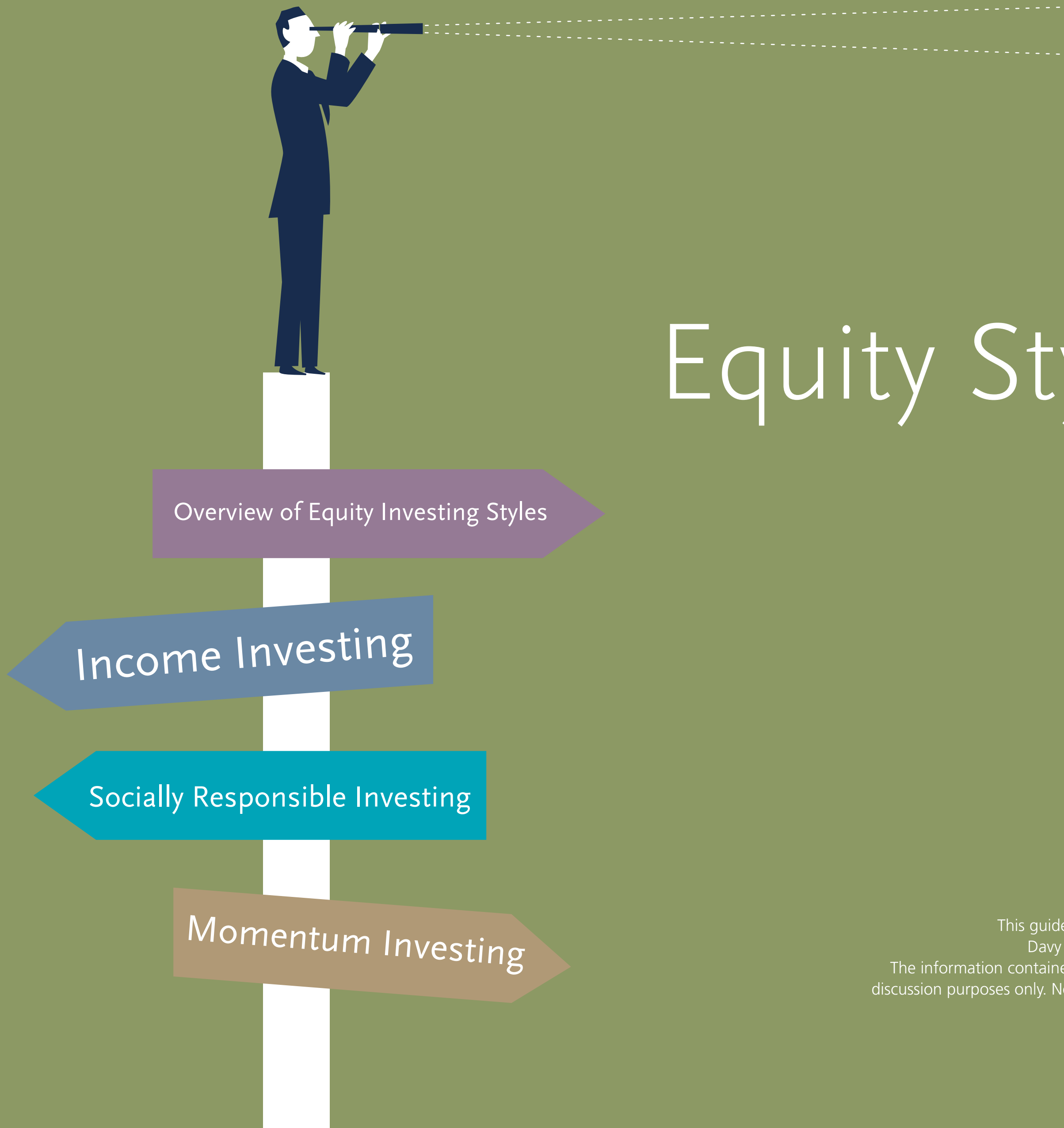
A Guide to Equity Style Investing



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Introduction

Investment managers that manage portfolios of stocks on behalf of pension funds, private clients, etc. tend to align themselves to a particular investment style. An investment style can be broadly defined by the emphasis a manager's investment process places on characteristics of the stocks purchased for portfolios. For example, growth investors seek to identify companies they believe will generate superior earnings growth over the long term.

In order to achieve diversification investors should focus not only on investing across different regions and market capitalisations (large-, mid- and small-cap stocks) but also on diversification across investment styles. Different points in the economic cycle are favourable to particular investing styles when the market places greater emphasis on certain characteristics of individual stocks.

Diversifying across different investment styles implicitly recognises that style returns will vary over time and ensures that portfolios are not overly exposed to one particular economic or market environment. A dynamic approach to style investing, where investors tilt exposure to particular styles depending on the prevailing market environment and risk appetite of investors, can also add value.

This guide will take you through the most commonly applied styles of equity investing and the types of market environment that are favourable to each. We hope you find the guide useful in considering your investment options.

Killian Buckley
Senior Investment Analyst - Equities
Global Investment Selection

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Overview of Equity Investing Styles

Overview of Equity Investing Styles

The investment styles listed below, while not a comprehensive list of all investment styles, represent a range of strategies widely applied by equity managers in constructing portfolios. Managing a portfolio in line with a particular investment style means that portfolios are constructed by selecting stocks with specific characteristics in common.

"I don't believe any of us have the pretension of believing that being very good analysts, or by going through very elaborate computations, we can be pretty sure of the correctness of our results. The only thing we can be pretty sure of, perhaps, is that we are acting reasonably and intelligently"

Benjamin Graham
Author of "The Intelligent Investor"

Investment Style	Focus
Growth	Identify companies they believe will generate superior long-term earnings growth higher than consensus growth rates implicit in the share price.
Value	Value managers seek to identify companies that are undervalued by the market and are trading at a discount to their intrinsic value.
GARP (Growth at a reasonable price)	This strategy combines both value and growth factors and seeks to gain exposure to growth stocks that are attractively priced.
Income	Emphasis on generating income by investing in companies that offer higher dividend yields than the overall market.
Thematic	Identify companies that will be beneficiaries of investment themes that will materialise over the long term, e.g. urbanisation, climate change solutions.
Defensive/Low Volatility	Construct a lower risk portfolio of companies with stable earnings profiles and less volatile share price movements that will provide greater capital preservation during periods of market declines.
Socially Responsible Investing	Invest in companies that have a positive impact on society and/or the environment while avoiding those companies from sectors considered to have a negative impact, e.g. tobacco, gambling.
Momentum	A strategy that seeks to benefit from short-term trends in pricing on the assumption that the trends will persist e.g. buying stocks whose share prices have risen and selling those whose prices have declined.

02

Growth versus Value Investing Styles

Growth versus Value Investing Styles

Value and Growth investing represent two distinct and complementary investing styles widely followed by equity investors.

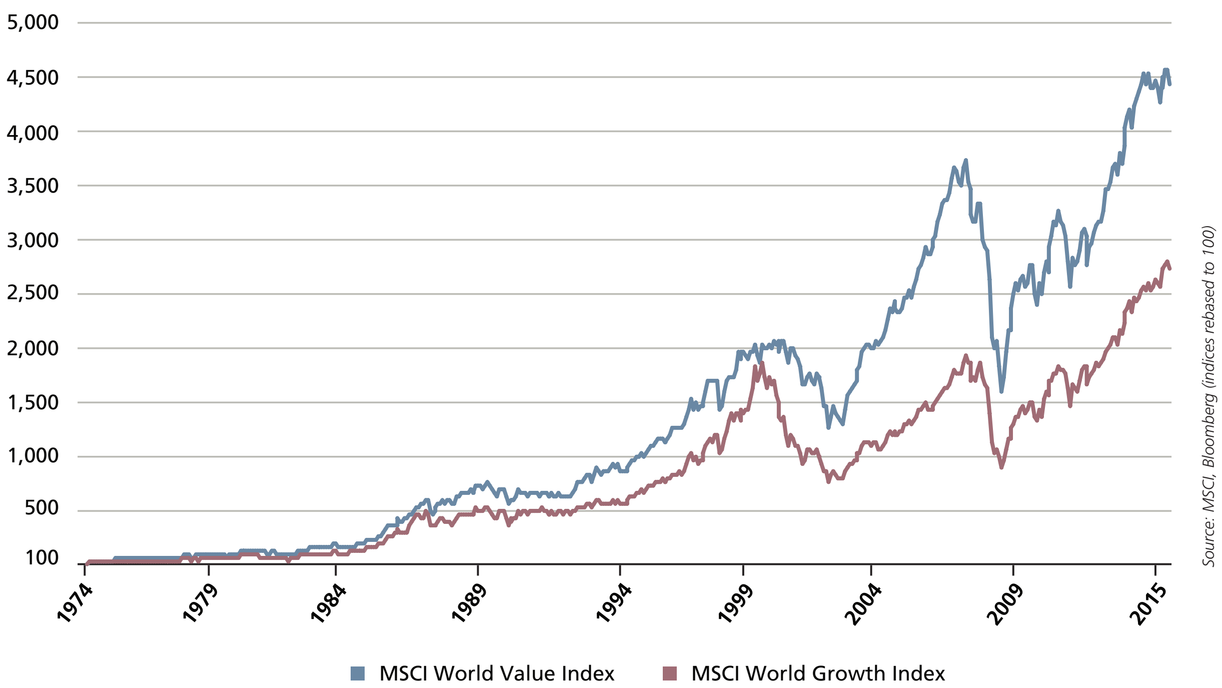
"The value investing philosophy eschews short-term considerations and gets you thinking most about fundamentals, as if you actually owned the business itself, not just its stock"

Charles Brandes
Chairman, Brandes Investment Partners

	Value	Growth
What do they buy?	Companies that are undervalued by the market and trading at a discount to their intrinsic value.	Companies they believe will generate superior long-term earnings growth, higher than the consensus growth rates implicit in their share price.
How do they identify opportunities?	Seek to identify companies that may have experienced a specific issue such as a decline in market share leading to negative market sentiment. This provides the opportunity for value investors to purchase shares at prices below their estimate of the companies' intrinsic value.	Place greater emphasis on projected growth rates in sales, earnings and market share. In many cases growth stocks have experienced high recent earnings growth which the market has extrapolated into the future on the basis that these high rates of growth can be sustained and expanded.
How are they valued?	Valuation metrics including price-to-earnings, sales and book value are lower than the market average. Share prices of value stocks are usually trading towards the lower end of their historical ranges and/or have experienced a recent decline in their price.	Valuation metrics are higher than the market average as the market is willing to pay more for higher growth potential. Growth stocks tend to trade at the higher end of their historical trading ranges.
Typical sector exposure	Operate in lower growth, more mature sectors such as Financials, Energy and Utilities.	Concentrated in higher growth sectors such as Technology and Biotech.
Source of returns	Value investors seek to benefit from the tendency of investors to overreact to negative news flow. Income via dividends tends to represent a significant component of overall returns.	Growth investors seek to invest in companies that will achieve rates of growth not fully appreciated by the market. Returns are primarily generated through price appreciation rather than income as any cash generated is reinvested to support the high rates of growth.

Growth versus Value Investing Styles

Figure 1: Value versus Growth: MSCI World Value Index versus MSCI World Growth Index, 1974-2015



Returns are based on gross dividends reinvested. Net returns will take into consideration tax rates that would apply on any dividends received which will vary depending on the investor's taxable rate. You should consult your tax adviser for the rules that apply in your individual circumstances.

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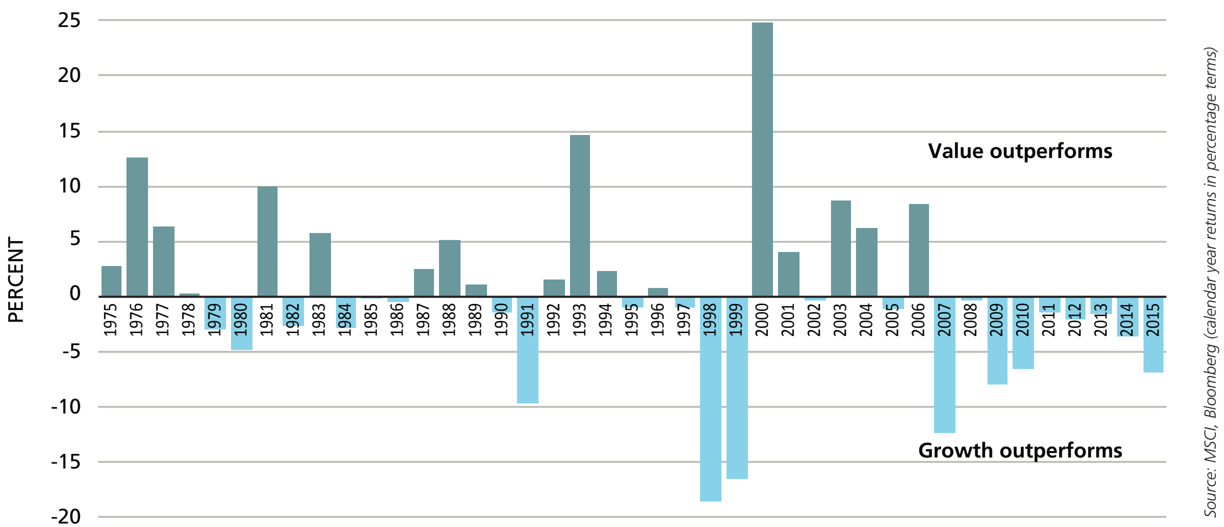
Numerous studies have demonstrated that over the long term, the Value style has outperformed the Growth style. This outperformance of value, referred to as the value premium, has been observed across regions and among both large-cap and small-cap stocks. The outperformance of the MSCI World Value Index compared with the MSCI World Growth Index is highlighted in Figure 1.

Growth versus Value Investing Styles

While over the long term Value has outperformed Growth, there are certain market environments that are more favourable to Growth, as well as cycles of Growth outperformance that can persist for several years.

Since the end of 2006 Growth has outperformed Value in each calendar year as shown in Figure 2. Applying a dynamic approach by tilting exposure to different styles depending on market conditions can add value.

Figure 2: MSCI World Value - Growth (annual returns 1975 to end September 2015)



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03

Income Investing

Income Investing

In order to avoid those companies in distress that have high dividends but which are unsustainable, income investors conduct in-depth fundamental analysis to assess the sustainability of dividends.

A stock with a high dividend may indicate that the market does not believe that the current dividend will be sustained. An income-focused strategy, therefore, should incorporate quality factors (return on equity, low leverage, etc.) to avoid those companies in financial distress that cannot sustain dividends at historical levels.

What do they buy?	Income-focused strategies seek to invest in companies offering a stable and growing income stream. In recent years the low yields offered by fixed income instruments have seen increased investor interest in high dividend paying stocks.
How do they identify opportunities?	Income managers screen for companies paying higher dividend yields than the market average that they believe can be sustained. Dividend paying stocks are typically concentrated in more mature industries where high levels of free cash flow generated can be returned to shareholders. In comparison, stocks experiencing high growth rates tend to reinvest cash in their businesses rather than return it to shareholders via buybacks or dividends.
How are they valued?	Income producing stocks tend to have lower valuation metrics such as price-to-earnings and price-to-book ratios than the overall market. This is due to the fact that higher growth companies which are more richly valued tend not to pay dividends.
Typical sector exposure	Compared with the broad market index, income portfolios have greater allocations to the more stable, mature industries such as Utilities, Telecoms, Energy and Consumer Staples. Stocks in these sectors tend to generate higher levels of free cash flow which can then be returned to shareholders.
Source of returns	Income managers believe that as well as providing an income stream, stocks with a history of paying dividends are more efficient in terms of allocating capital and managing their cash flow. Historically, approximately half of the total return generated from investing in stocks has been derived from the compounding effect of reinvesting dividends*.

**Source: Triumph of the Optimists: 101 Years of Global Investment Returns by Elroy Dimson, Paul March and Mike Staunton*

04

Thematic Investing

Thematic Investing

Case study

An example of a stock arising from a thematic investment process would be Novo Nordisk, the market leader in the production of insulin to treat diabetes. The company is positioned to benefit from the theme of rising Gross Domestic Product (GDP) in developing countries leading to increased healthcare spending. As countries get wealthier they tend to invest more in healthcare.

Novo Nordisk is also positioned to address the sharp rise in diabetes, particularly in developing countries. Increases in disposable income have led to greater spending on convenience foods causing a sharp rise in diabetes. With a 50% share of the global insulin market and an innovative product pipeline, Novo Nordisk is an example of a stock with the potential to benefit from these long-term secular trends.

What do they buy?	A thematic investment style seeks to identify long-term secular investment themes that will persist into the future and to identify the companies that are best-positioned to benefit from those themes.
How do they identify opportunities?	Firstly, by identifying long-term secular investment themes (e.g. changes in demographics, urbanisation, climate change solutions) and secondly, by conducting in-depth fundamental research with the aim of identifying companies that will benefit from a particular theme.
How are they valued?	Portfolios tend to be biased towards segments of the market where industry changes are more dynamic, e.g. growth in clean energy. Stocks from stable, mature industries tend to be less represented in a thematic portfolio with the result that thematic portfolios often trade on higher valuations than the overall market.
Typical sector exposure	Thematic managers typically identify a small number of investment themes they believe will materialise over the long term. As a result, their portfolios tend to be relatively concentrated in certain sectors. Portfolios tend to have lower exposure in more mature industries or those in secular decline.
Source of returns	Many secular themes are inherently predictable but thematic managers seek to exploit the markets' excessive focus on shorter term issues while failing to fully recognise changes in long-term competitive dynamics. Managers with a thematic approach tend to have low turnover of stocks within their portfolios due to their long-term investment horizon.

05

Defensive/Low Volatility Investing

Defensive/Low Volatility Investing

The risk profile of a stock can change over time. Therefore, relying on historical, quantitative measures of risk alone may not be sufficient in constructing lower risk portfolios.

Changes in market dynamics or in the regulatory environment may change the risk profile of a stock. As an example, following the Deepwater Horizon oil spill in 2010, energy company British Petroleum moved from being a stable, low-risk stock to one experiencing very volatile movements in its share price.

An approach that assesses risk from both qualitative and quantitative perspectives should be applied in constructing defensive/low volatility portfolios.

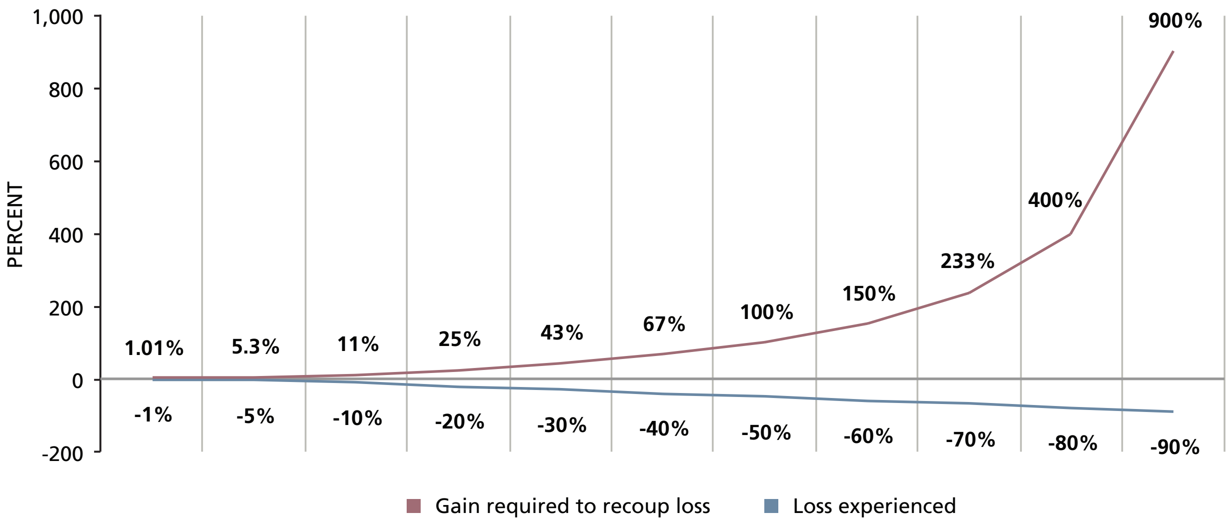
What do they buy?	Defensive/low volatility managers select stocks that are less volatile in terms of their share price movements. They seek to construct portfolios that capture the market return over the long term but with lower than market risk.
How do they identify opportunities?	Defensive/low volatility managers identify stocks which tend to have more predictable sources of revenue, operate in stable industries and are less vulnerable to large swings in their share price. Managers take into account the volatility of stocks, as well as the correlations between them in constructing lower risk portfolios.
How are they valued?	These strategies have a lower allocation to the higher growth, more volatile segments of the market. By excluding these stocks, defensive/low volatility portfolios tend to be more attractively priced than the broad market index.
Typical sector exposure	Defensive/low volatility strategies tend to have a value tilt with an overweight allocation to defensive sectors such as Consumer Staples, Utilities, Health Care and an underweight allocation to IT, Energy and Materials. At a regional level, countries where defensive sectors have a higher representation tend to have larger allocations within defensive/low volatility portfolios e.g. Japan and Switzerland.
Source of returns	Traditional finance theory suggests that higher risk is rewarded with higher returns. However, evidence has shown that high-risk stocks, as measured by the volatility of their share prices, have substantially underperformed lower risk stocks.

Defensive/Low Volatility Investing

The performance of low risk stocks is helped by their focus on minimising drawdowns. This is due to the fact that the higher the loss experienced, the greater the percentage increase required to recoup the loss.

Figure 3 highlights the benefit of minimising drawdowns over the longer term. For example, a loss of 40% requires a subsequent gain of 67% to get back to the initial level. In comparison, a loss of 20% requires just a 25% gain to get back to the initial level.

Figure 3: Impact of minimising drawdowns



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Warning: This graph is for illustrative purposes only.

The US technology focused NASDAQ index peaked in March 2000 at 5,048 before declining by 78% to 1,114 in September 2002. To get back its previous high required a return of 355% and this was not achieved until April 2015.*

This illustrates the fact that the greater the percentage loss experienced the higher the return required to get back to the initial level.

**Source: Nasdaq*

Defensive/Low Volatility Investing

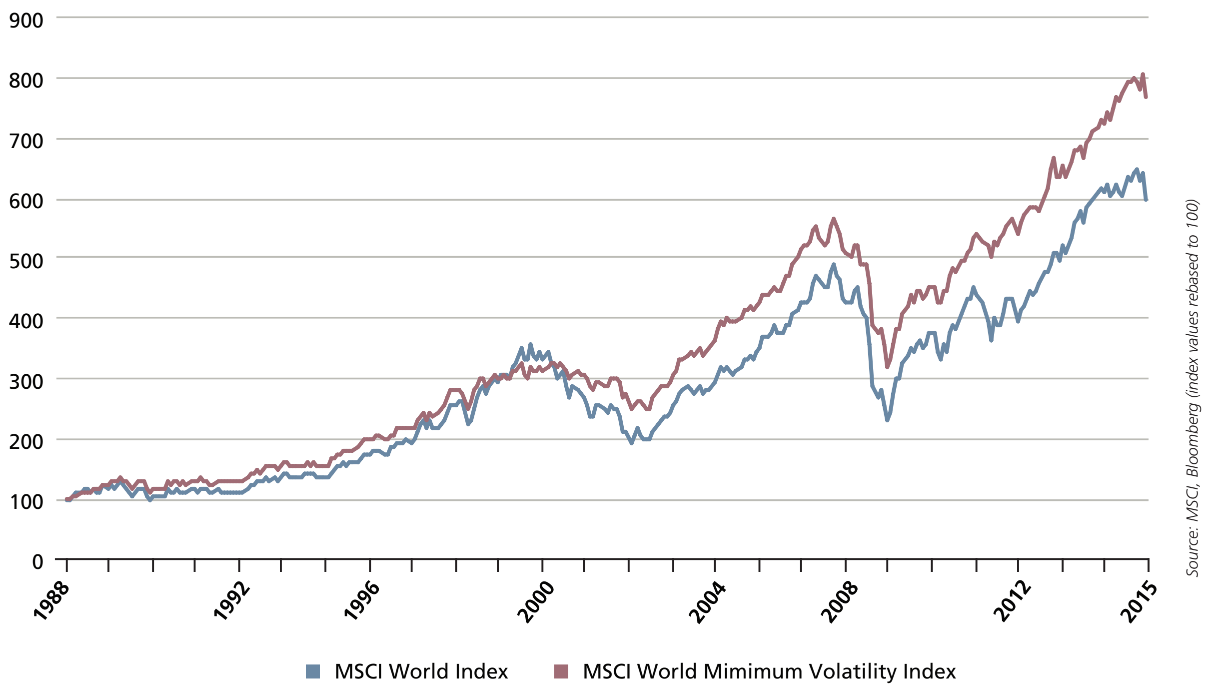
The *'Low-Volatility Anomaly'* refers to the tendency for lower risk stocks as measured by share price volatility to outperform higher risk stocks that experience greater fluctuations in price. The persistent outperformance of low risk stocks has been proven across markets and over the long term*. It is referred to as an anomaly as it contradicts traditional finance theory which states that only by taking higher risks can investors realise above average returns.

Theories that seek to explain the persistence of this anomaly include the preference of many investors for higher risk stocks in the hope of experiencing returns that represent multiples of the initial investment. This behavioural bias can cause the riskiest stocks to become overpriced, leading to lower returns compared with low-volatility stocks.

"Benchmarks as a Limit to Arbitrage: Understanding the Low-Volatility Anomaly"
by Baker, Bradley and Wurgler.
Financial Analysts Journal, January/February 2011

The MSCI World Minimum Volatility Index is constructed to represent the lowest risk portfolio of the MSCI World Index. Since its inception in 1988 it has outperformed the broader MSCI World Index as shown in Figure 4.

Figure 4: MSCI World Minimum Volatility Index versus MSCI World Index



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Socially Responsible Investing

Socially Responsible Investing

Many SRI strategies avoid fossil fuel-based energy companies in the belief that social costs arising from global warming will result in changes in consumer behaviour favouring clean energy producers. Stricter environmental regulations focused on reducing carbon dioxide emissions are also likely to negatively impact on the growth of fossil fuel-based energy producers.

What do they buy?	Socially Responsible Investing (SRI) considers the social and environmental consequences of investments in constructing portfolios. Portfolios constructed by SRI managers tend to screen out stocks in sectors such as tobacco, gambling, alcohol and weapons manufacturing.
How do they identify opportunities?	SRI managers take a subjective view in determining whether or not a particular sector or stock is compatible with an SRI approach. As an example, SRI managers may exclude companies that produce components which are used in the manufacture of weapons, even if the component is widely used for other purposes. In general, SRI managers exclude companies in the tobacco, gambling and weapons industries.
How are they valued?	The stocks and sectors excluded by SRI strategies tend to be more defensive with stable sources of revenue. SRI portfolios generally attempt to structure portfolios with broadly similar exposures and valuation metrics despite the fact that they exclude parts of the market with low valuations.
Typical sector exposure	In order to ensure that portfolios are diversified, many SRI strategies will seek to gain broad representation across sectors to ensure that they are not overly concentrated in particular sectors. In general, portfolios tend to have lower exposures to sectors such as defence, tobacco and alcohol.
Source of returns	SRI managers believe that integrating environmental, social and governance factors into their investment process will result in superior long-term results. Over the long term those companies which have a negative impact in areas such as the environment, human rights and consumer protection will be constrained in their ability to gain market share due to increased regulations and changes in consumer behaviour.

07

Momentum Investing

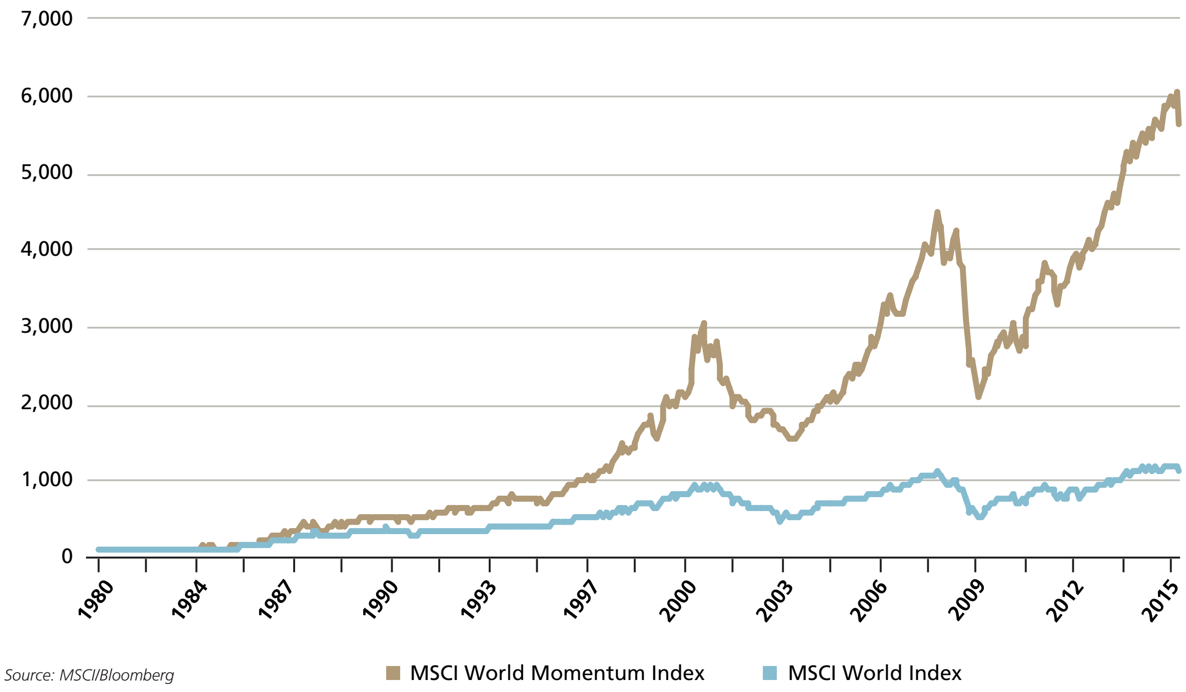
Momentum Investing

The MSCI World Momentum Index is constructed to replicate the performance of an equity momentum strategy by emphasising stocks with high price momentum. Over the long term, this has outperformed the broad market index, as shown by the relative performance of both since 1980 (see Figure 5).

What do they buy?	The momentum effect refers to the tendency for stocks that have performed well in the recent past to continue to appreciate and for stocks that have performed poorly to continue to do so. Momentum investors follow a relatively simple strategy that involves purchasing stocks that have risen in value and selling those stocks that have experienced recent price declines.
How do they identify opportunities?	Opportunities are identified by examining patterns of recent price movements and by constructing portfolios in favour of those stocks that have risen in price.
How are they valued?	Momentum strategies tend to have higher valuations compared with the broader market given they buy stocks that have risen in price. They seek to buy high and sell higher.
Typical sector exposure	Momentum strategies tend to have relatively high turnover as portfolios are positioned in favour of stocks that have risen in price. Sector exposures are not persistent and vary depending on which sectors have experienced recent price appreciation.
Source of returns	The performance of a momentum strategy can be explained by the under-reaction of investors to new information and the herding behaviour of investors. Momentum strategies focus less on the underlying fundamentals of a stock, and instead seek to take advantage of behavioural characteristics of market participants (‘following the crowd’).

Momentum Investing

Figure 5: Relative performance of the MSCI World Index and the MSCI World Momentum Index



Source: MSCI/Bloomberg

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08

Summary

Summary

The performance of each style of equity investing is cyclical and will vary depending on the economic cycle and the market's appetite to risk. The table below sets out the type of market environment favourable to each investing style.

Investment Style	Description
Growth	Growth tends to outperform in recessionary environments when investors are willing to pay a premium for stocks with the ability to generate earnings independent of the underlying economy. Growth also performs well in periods which, in retrospect, are considered speculative bubbles with prices driven by the "irrational exuberance" of market participants, e.g. late 1990s.
Value	Value stocks tend to outperform during the early stages of an economic recovery as the market revises upwards estimates of intrinsic value. The outperformance of value in this type of environment was observed in the early 1980s, 1990s and 2000s.
GARP **(Growth at a reasonable price)**	This strategy seeks to combine both value and growth styles with the objective of performing well in all market environments. Historically, however, it tends to perform more in line with market environments that are supportive of the growth style of investing.
Income	Income strategies tend to have a value bias and perform well in the early stages of a recovery. The investing style performs well in low interest rate environments when investors place a greater emphasis on dividend income as a source of return and stocks with attractive yields are substituted for lower yielding fixed income instruments.
Thematic	There is no particular market environment that is more or less favourable to a thematic investing style. It can, however, often result in more concentrated portfolios biased towards particular sectors.
Defensive/Low Volatility	Defensive/Low volatility strategies perform best when the market is risk averse and investors are attracted to stocks with lower risk profiles. This investment style tends to lag in rising markets but provides greater downside protection in declining market environments.
Socially Responsible Investing (SRI)	Most SRI managers seek to maintain diversified portfolios therefore, portfolios tend to perform in line with the broader market. The optimal environment for SRI portfolios is when markets place a greater emphasis on avoiding companies whose activities have negative social effects in areas such as the environment, public health and consumer protection.
Momentum	This strategy works best when markets are trending upwards, when there is significant liquidity and an excess of buyers over sellers. It can exhibit large negative returns at turning points in the market when stocks that have underperformed experience a recovery as was the case in March 2009. The manager's ability to identify inflection points is therefore critical to success.

Summary

- Equity managers tend to align themselves to a specific style of investing in constructing diversified portfolios of stocks. In this guide we described a number of different investment strategies or styles. While the list is not exhaustive, the styles described include those strategies that are widely applied by investment managers in managing portfolios of stocks. Market conditions and the risk appetite of investors will be favourable for different strategies at different times.

- An approach that gains exposure to a number of different equity investing styles will provide greater diversification than diversifying solely across regions, sectors, and market capitalisations (small-, mid- and large-cap stocks).

- While investors should seek to gain exposure to a diversified range of strategies at all times, an approach that tilts exposure in favour of certain styles through taking into account the market environment and risk appetite of investors can add value.

All investments contain risk. Potential investors should ensure they understand all the risks associated with any investment prior to making a decision to invest.

Summary

Calendar year performance for the indices quoted throughout this guide:

Table 1: Calendar year performance, in %

	2014	2013	2012	2011	2010
MSCI World Index	5.5	27.3	16.6	-5.1	12.4
MSCI World Value Index	1.1	23.3	12.1	-8.3	6.3
MSCI World Growth Index	4.7	24.9	14.2	-6.9	12.9
MSCI World Momentum Index	5.9	27.5	12.1	2.5	14.6
MSCI World Minimum Volatility Index	11.4	18.6	8.1	7.3	12.0
NASDAQ	14.8	40.2	17.7	-0.8	18.1

Source: Bloomberg, all US dollar terms

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