ETF INSIDER

NOVEMBER 2024 • EUROPE'S LEADING ETF MAGAZINE FOR PROFESSIONAL INVESTORS

Small cap ETFs: Stage set for the return of size?

Investors rebuild allocations

ETF STREAM

Opener

Mini is mighty after large cap domination

Welcome to the November edition of *ETF Insider*, the first ETF magazine dedicated to professional investors across Europe. Each month, we produce analysis on a specific area of the market, be that fixed income, emerging markets or factors while also providing expert insights into the latest on asset allocation and portfolio construction, always through an ETF lens.

This issue focuses on factor ETFs. With fund selectors wary of market overconcentration but eyeing central bank rate cutting cycles, smart beta strategies provide avenues for moving away from market cap-weighted indices to target companies representing different investment styles.

With the Federal Reserve expected to continue cutting its Funds Rate to as low as 3% in 12 months' time, *ETF Stream* senior reporter Toby Lawes examines how investors are eyeing a potential recovery in small cap earnings (p.28).

"This narrowing gap in profit makes the valuation premium of large caps versus small caps incredibly unsustainable," said Stephan Kemper, chief investment strategist at BNP Paribas. "The starting point for small caps is much more appealing from a valuation perspective," he added.

However, this view is not consensus, with Jaisal Pastakia, investment director at Handelsbanken Wealth & Asset Management, contending small cap outperformance comes in "fits and starts" and now is not the right time to remove an underweight position.

Elsewhere, Lauren Gibbons, reporter at *ETF Stream*, explores potential overlaps between trending systematic active, 'index-plus' ETFs which have enjoyed strong traction and the well-established suite of factor ETFs (p.24).

Yvan Roduit, head of investment advisory at Raiffeisen, suggested low tracking error active ETF are the "modern version of smart beta", but said "they are smarter and with limitless potential for evolution".

Other deep dives see Peter Taberner investigate which factor ETFs will perform in the current rate cutting cycle (p.26), while Justin Reynolds unwraps shareholder democracy and the arrival of passthrough voting within European ETFs (p.18).

Finally, keep an eye out for the usual segments 'ETF of the month' (p.13) and 'Fund Fights', where *ETF Stream* compares the strengths and weaknesses of similar ETFs (p.15). Finally, I want to highlight our Expert Investors series where ETF fund selectors about their asset allocation and ETF usage (p.11).

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ETF Insider is published by

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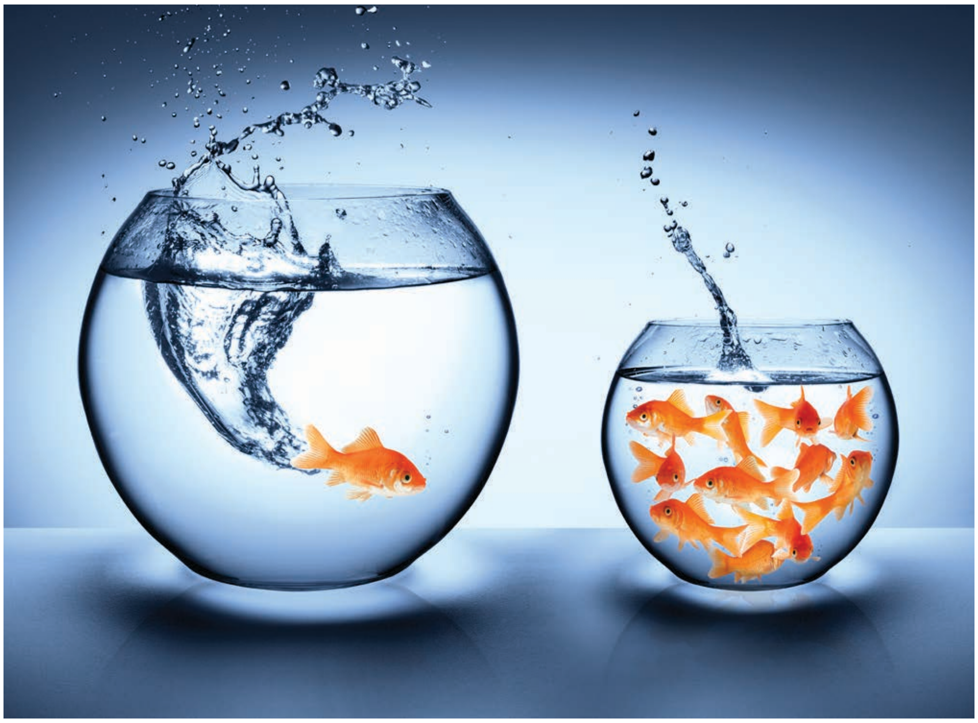

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News & views

All the highlights from the last month, for all the latest updates visit etfstream.com

The rise of creative beta ETFs

By Jamie Gordon

Fund selectors face the dual dilemma of narrow leadership within US equities and pressure to remain at least benchmark neutral in their allocation to the market. Happily, European investors now have a broad and increasingly creative array of smart beta ETFs offering unique routes for slicing US exposure.

So far in 2024, there has been one clear posterchild for moving away from market cap-weighted indices – equal-weight S&P 500 ETFs – with three such strategies breaking into the top 10 inflowing products within Morningstar's US Large-Cap Blended Equity category for Q3.

The Xtrackers S&P500 Equal Weight ETF (XDEW), the iShares S&P 500 Equal Weight ETF (ESWP) and the XTrackers S&P 500 Equal Weight ESG ETF (XSZP) booked net inflows of €2.1bn, €1.4bn and €1.1bn over the quarter respectively.

Jose Garcia-Zarate, associate director of passive strategies at Morningstar, said the revived interest in equal-weight strategies: "It suggests that some investors are becoming wary of the high concentration in tech stocks found in traditional market-cap-weighted benchmarks."

However, these products represent one of the more vanilla options for moving away from market beta US exposure. In January, *ETF Stream* revealed the launch of the VanEck Morningstar US Wide Moat UCITS ETF (MOTU), which replicates the Morningstar Wide Moat Focus index of 50 US stocks deemed to have a competitive advantage owing to their 'economic moat'.

The moat concept was first coined by Warren Buffett and is implemented by Morningstar equity analysts identifying companies benefitting from cost leadership, economies of scale, network effects and intangible assets, such as brand strength and high switching costs for users.

Less than four months later, the Pacer US Cash Cows 100 UCITS ETF (COWZ) launched as part of the Pacer ETFs' three-product opening gambit in the UCITS landscape. Unlike MOTU, COWZ focuses solely on one quantitative measure – free cash flow – which it achieves by tracking the Pacer US Cash Cows 100 index. This index captures the 100 top Russell 1000 constituents by free cash flow (FCF) yield, meaning they have enough cash to satisfy their obligations and invest in potential opportunities.

There may yet be further creative innovations for US exposure in the European product pipeline, with Research Affiliates mulling the possibility of bringing its 'deletions' ETF to UCITS format, a source close to the company told *ETF Stream*. The Research Affiliates Deletions ETF (NIXT), which launched in September in partnership with white-label issuer ETF Architect, is a contrarian strategy that looks to capitalise on the long-term mean reversion of stocks removed from US large and mid-cap indices.

The ETF tracks the NIXT index and captures deletions from the top 500 and top 1,000 US companies by market cap and holds them for five years, rebalancing annually to equal weight.

This long road to recovery or deep value strategy looks set to herald strong comeback story returns, with S&P 500, Russell 1000 and Nasdaq 100 deletions having outperformed by more than 5% per annum for the five years following their ejection, over the period from 1990 to 2022.

Overall, while asset allocators may feel trapped by the career risk of straying too far from large US equity allocations, the gamut of European ETF options to capture the market continues to broaden to offer increasingly unique exposures over time.

"[Revived interest in equal-weight strategies] suggests that some investors are becoming wary of the high concentration in tech stocks found in traditional market-cap-weighted benchmarks."

Jamie Gordon is features editor at ETF Stream

Dateline: The month in review

14 October
ETF performance fees: How might they work?

ETF performance fees face some hurdles when applied to the ETF structure due to transparency and daily pricing issues, despite some service providers and issuers sharpening their focus on this area. Performance fees can be structured through models like high-water marks or benchmark-based fees, but ensuring alignment with investor interests remains difficult, with ESMA guidelines restricting some fee structures. Fulcrum fee models have been tested in Europe – though with limited success - leaving the future of performance fees in ETFs uncertain.

15 October
Robeco: The start of a multi-asset active ETF platform

Robeco unveiled its hotly anticipated four-strong range of active ETFs including three equity strategies and one thematic strategy. These ETFs focus on balancing risk, return, and sustainability, marking a shift from Robeco's mutual fund focus. Robeco's head of ETFs Nick King said the asset manager plans to prioritise active fixed income ETFs in 2025. "We want to be a multi asset platform, so fixed income is going to be the next area of focus moving into 2025. We will also be looking at other equity launches over the course of the year as well, but our primary emphasis will be on fixed income products."

8 October
BlackRock's S&P 500 ETF: Europe's first to $100bn

BlackRock's S&P 500 ETF earned the title of Europe's first ETF to reach $100bn after coming to market 14 years ago. $11bn of assets have poured into the product this year alone and remains a popular choice among investors despite not being Europe's cheapest S&P 500 ETF. While CSPX's total expense ratio (TERs) of 0.07% does not make it the cheapest S&P 500 ETF in Europe, the strategy boasts the tightest bid-ask spread of any S&P 500 ETF in Europe over the trailing month. Higher over-the-counter (OTC) volumes for the product, which indicate increased usage as a financial instrument, and greater retail participation, driving more frequent trading in smaller ticket sizes, have pushed volatility in spreads down to record lows.

16 October
Research Affiliates mulls Europe launch of deletions ETF

Research Affiliates is considering launching its Deletions ETF (NIXT) in Europe following strong initial interest in the US, a source familiar with the matter told *ETF Stream*. This contrarian ETF, developed with ETF Architect, invests in stocks removed from major indices, aiming to capitalise on their potential mean reversion and market outperformance over five years.

17 October
FCA's SDR marketing delay: 'More time is good'

At *ETF Stream*'s ESG ETFs Workshop 2024, fund selectors welcomed the Financial Conduct Authority's (FCA) decision to delay the Sustainable Disclosure Requirements (SDR) rollout. They agreed that the extra time allows for better adaptation to labelling criteria and while uptake of SDR's four ESG labels has been slow, fund selectors noted the delay would help fund managers meet these standards more effectively. The discussion comes against a backdrop of growing industry anxiety around the low industry uptake of the SDR's four investment labels, 'sustainability focus', 'sustainability improvers', 'sustainability impact' and 'sustainability mixed goals'.

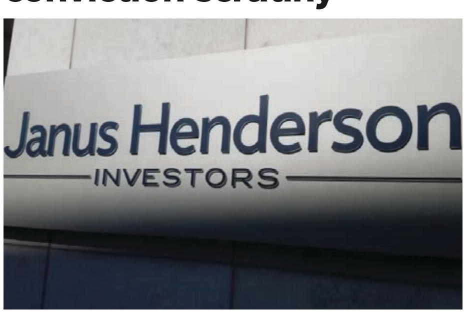
21 October
Self-indexed ETFs charge higher fees than public index counterparts

Self-indexed ETFs often charge higher fees than those tracking public indices, according to a study from Oxford University. Despite eliminating licensing fees, these ETFs have 12-14% higher costs due to potential conflicts of interest and issuers – especially those with advisory services– are incentivised to promote higher-fee, self-owned products. Although self-indexing promises cost benefits, actual savings often don't reach investors. Self-indexing is more common in the US with almost 20% of ETFs tracking a proprietary index. The practice is rarer in Europe, however, since ESMA guidelines require indices tracked by UCITS funds to be independently calculated; but there are still a handful of issuers self-indexing in Europe, including WisdomTree.

23 October
Fidelity debuts two active Paris-aligned fixed income ETFs

Fidelity launched two active, Paris-aligned fixed income ETFs, the Fidelity Sustainable EUR High Yield Bond Paris-Aligned Multifactor UCITS ETF (FYEI) and the Fidelity Sustainable USD High Yield Paris-Aligned Multifactor UCITS ETF (FYUI). These ETFs – aligned with 1.5°C climate goals – target high-yield corporate bonds in euro and USD markets, respectively, and are benchmarked against Solactive's climate-focused indices. Both ETFs have a TER of 0.30% and are classified as Article 9 under SFDR.

24 October
Janus Henderson's first ETF in Europe faces high-conviction scrutiny



Janus Henderson's first European ETF, the Janus Henderson Tabula Japan High Conviction Equity UCITS ETF (JCPN), has sparked debate among fund selectors about its "high-conviction" label. Despite its name, some analysts suggest it resembles a risk-controlled portfolio rather than a bold, high-conviction strategy with the top 10 stocks in the fund closely resembling the Tokyo Stock Price index.

28 October
'Several' mutual funds to add ETF share classes after CBI U-turn

The Central Bank of Ireland (CBI) announced the upcoming release of Q&As which will enable Irish-domiciled mutual funds to add ETF share classes without renaming the entire sub-fund. This change aligns CBI's approach with that of Luxembourg and aims to make it easier for fund managers to enter the ETF market, potentially encouraging more mutual funds to adopt an ETF structure. Luxembourg's more relaxed rules have meant that the region welcomed Europe's first collateralised loan obligation (CLO) ETF – the Fair Oaks AAA CLO UCITS ETF (FAAA) – as a share class of the firm's existing CLO active fund.

30 October
BlackRock extends range of US equity ETFs with double launch

In a double launch, BlackRock unveiled two swap based ETFs capturing US equities. The iShares Russell 2000 Swap UCITS ETF uses unfunded total return swaps to replicate the performance of the Russell 2000 index, while the iShares Nasdaq 100 Swap UCITS ETF offers synthetic exposure to the large-cap growth segment of the US equity market. The launches come after the firm debuted the iShares MSCI World Swap UCITS ETF (IWDS) in March and follow a strong year for US equities.

Most read October

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Expert Investors

Arrival of CLO ETFs ‘interesting’

Expert Investors is a series where ETF Stream interviews fund selectors on the role of ETFs within their asset allocation. In the hot seat this month is Jaime Arevalo, multi-asset portfolio manager at Schroders

By Jamie Gordon

With the active fixed income ETF roster emerging alongside the evolving interest rate environment, Jaime Arevalo, multi-asset portfolio manager at Schroders, described the arrival of Europe’s first collateralised loan obligation (CLO) ETF as “interesting”.

Within the fixed income buckets of Schroders’ portfolio, ETFs are predominantly used “as a cost-efficient route for getting exposure to a certain part of the curve”, Arevalo said.

While the Federal Reserve’s decision to cut its Funds Rate by 50 basis points (bps) did not prompt Arevalo’s team to recompose its asset allocation, he noted they are targeting high quality credit and shortening duration.

Arevalo added his team has been exposed to a broad range of securitised credit “for some time”.

“We have global exposure through an active fund capturing ABS, CLOs and more, though this is an enhancement rather than core component of our fixed income position.”

However, he said the arrival of Europe’s first CLO ETF, the Fair Oaks AAA CLO UCITS ETF (FAAA), was an “interesting” development and added “it would be useful” to have more ETF launches in the space, with recent ETF entrant Janus Henderson “well-placed to provide that kind of exposure”.

“Sometimes, there are exposures you want to have in the portfolio, particularly in fixed income, but no vehicles which are affordable as you have to pay for expertise to capture these asset classes,” Arevalo said.

Small caps are back

On the equity front, Arevalo said his team had been rebuilding a small cap position prior to the Fed rate hike in September, adding a 1% allocation to the Russell 2000 index. “The goal is for this to be tactical and not a main driver of our performance,” he added.

“But it has been a good call to size up the small and midcap segment ahead of the Fed rate cut decision.”

“We understand the risks of allocating to this segment. If fears of a recession are realised and we see more turbulence in the US, one segment that will be hurt is small and midcaps – but for now, we do not see an immediate recession.”

An eye on China

Finally, Arevalo noted increased interest in China exposure, on the back of policymakers implementing the largest monetary stimulus package since the 2008 Global Financial Crisis (GFC), spurring some China equity ETFs to gain more than 50% in a month.

“We do not have a direct exposure to China right now, but we are very interested in understanding what is happening and the extent of potential stimulus in future.”

“The issue that we see is a lack of clarity around how to fix the structural issues in China’s real estate market, which is problematic given the middle class has been the primary driver of internal consumption and their savings are largely invested in property. Fixing structural issues in Chinese property is going to be key for consumer behaviour,” he concluded.

“If fears of a recession are realised and we see more turbulence in the US, one segment that will be hurt is small and midcaps – but for now, we do not see an immediate recession.”

Jamie Gordon is features editor at ETF Stream


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Xtrackers CSI500 Swap UCITS ETF 1C (XCSI)

This issue's ETF of the month is DWS's XCSI, which launched in time to capture a China equity rally while capitalising on a unique structural anomaly

This month's ETF in the spotlight is a recent China equity offering from DWS, which captures the recently in-vogue Sino onshore market while benefiting from a structural uplift, owing to its swap-based replication methodology.

The Xtrackers CSI500 Swap UCITS ETF 1C (XCSI) launched at the end of July to offer synthetic exposure to small and midcap China A-Shares, much like a rival strategy, the Invesco S&P China A MidCap 500 Swap UCITS ETF (C500).

However, while C500 has amassed $20m assets under management (AUM) since launching in 2022, XCSI boasts impressive early AUM of $109m, as at 30 October.

While some of this owes to flattering market dynamics, with China equities having been in freefall until the start of 2024, early asset gathering has been impressive and the timing of XCSI's launch fortuitous.

STAT ATTACK

Ticker	XCSI
Launch date	31
One-month return	10.8%
AUM	$109m
Data as at 30 October	

In September, the People's Bank of China (PBoC) cut key policy rates, released $140bn of liquidity into Chinese credit supply, all while rates on existing mortgages were slashed and the minimum downpayment for second property purchases was cut by 10 percentage points.

Between lowering borrowing costs and the interconnectedness of China's property sector and consumer behaviour, these measures had a marked impact on domestically focused companies and catalysed 10.8% gains for XCSI in the month to 30 October. However, it is not just the underlying exposure that earns DWS's new Sino entrant its plaudits, but the replication methodology it employs to achieve this.

Like Invesco's C500, XCSI capitalises on a structural anomaly in the A-Shares market. This exists because hedge funds looking to short the short the market are forced to use index derivatives written by banks to access the exposure, owing to there being no physical securities lending market for offshore investors.

Banks then hedge their own exposure to these contracts using ETFs that offer synthetic replication of an A-Shares index, receiving an attractive level of swap pricing that results in outperformance for an onshore China ETF.

The upshot is while an ETF would usually pay a swap fee to counterparties to gain exposure to most markets, China's unique market dynamics man ETFs may actually end up paying a negative swap fee, meaning XCSI and C500 may actually receive the swap fee from the counterparty.

The result is an investor receives the performance of the index and a potential boost from the negative swap fee. In fact, when hedge funds are crowding to short China's onshore market, the swap fee on synthetic index exposures offered by the likes of XCSI can surge as high as -16%.

Fund Fights

Playing defence tech with HANetf NATO and Global X ARMR ETFs

Fund Fights is a series where ETF Stream analyses the strengths and weaknesses of similar ETFs. This month, HANetf's NATO and Global X's ARMR go head-to-head

With geopolitical tensions rising and the global order under threat, a secular rise in defence spending is underway. With future investment likely to focus on the technological arms race, this fund fight compares ETFs looking to capture this trend from HANetf and Global X.

HANetf's NATO

The longer standing of the two ETFs, HANetf's Future of Defence UCITS ETF (NATO), recently passed an assets under management (AUM) milestone of $500m.

NATO offers exposure to firms generating revenue from NATO and NATO+ ally defence and cyber expenditure. Upon first impression, its portfolio contrasts the old and the new; part NASDAQ growth, part old world industry.

The largest of its 59 holdings, as at 22 October, was Palantir Technologies, a software company recently promoted to the S&P 500. It sits alongside BAE Systems and Northrop Grumman in the top five, industrial giants with roots going back more than a century.

Palantir, which became famous after helping the CIA track down Osama Bin Laden, trades at 226 times next year's forecasted earnings, according to Nasdaq figures, a substantial premium to its industrial counterparts. Both currently change hands around 21x. According to HANetf calculations, the NATO portfolio trades at a reasonable 20.9x next year's earnings – on a weighted-average basis – this despite a 44% allocation to technology stocks. The balance is made up by industrials.

STAT ATTACK

	NATO	ARMR
Launch	Jul-23	Sep-24
AUM	$525m	$1.5m
TER	0.49%	0.50%
Underlying Index	EQM Future of Defence	Mirae Asset Defence Tech
Median market cap	$36bn	$29.7b

Data as at 24/10/24

Global X's ARMR

The Defence Tech UCITS ETF (ARMR) is a new entrant, having debuted just over one month ago. While ARMR does not specifically position for the spending of just NATO members and allies, it holds no countries listed outside of the group. ARMR's regional exposure is therefore similar to NATO's. ARMR allocated 71% of its basket to US stocks at the end of September while NATO was not far behind at 64%. NATO, however, had a slightly higher weighting to France – 11% versus just 5% for ARMR – while both had just under 10% allocated to UK listed companies.

Constituents for ARMR's underlying index are sourced by screening for revenue exposure to three technological fields: unmanned defence systems, (defence) AI and (defence) cybersecurity. Stocks are then weighted by market cap. The result is a 35-stock portfolio with a surprisingly industrial profile. Despite having 'tech' in its name, ARMR only had an 18% exposure to the technology sector as of the end of September, with 80% in industrials and a small slither in real estate.

The value tilt notwithstanding, ARMR is slightly more expensive on a forward P/E basis – 21.9x according to Global X calculations – but this can perhaps be explained by its largest holding, also Palantir. As mentioned earlier, Palantir has a forward P/E of 226x; but it is a 13.5% position in ARMR versus just 5.8% in NATO.

Fund fight, fighting funds

In some ways, the two ETFs bear similarities, including their comparable regional exposures, trading at similar valuations and very similar total expense ratios (TERs).

The essential difference is how each have elected to trade off their defence and technology exposure.

HAN's Future of Defence ETF, on one hand, by including cybersecurity stocks like Fortinet and Palo Alto Networks, has sacrificed some pure-play defence exposure in favour of technology. Global X's Defence Tech ETF, on the other, compromises on technology but in doing so boasts much cleaner defence exposure.

The Patient Investor

Is the shareholder democracy dream coming closer?

Big funds in the political firing line are looking to pass-through voting to extend responsibility for corporate scrutiny to shareholders

By Justin Reynolds

Of the many controversies that have raged through this year's long US election campaign, one of the most curious is the row over 'woke capitalism'.

With BlackRock, Vanguard and State Street now controlling up to 20% of shares in many US-listed companies – BlackRock's assets under management has surged to an all-time high of $11.5trn – the capacity of the 'Big Three' fund managers to cast influence over corporate governance has come under increasingly intense scrutiny from both left and right.

Larry Fink's seeming embrace in recent annual letters of BlackRock's ability to drive a sustainability agenda has encouraged liberals and dismayed many conservatives, generating somewhat comical accusations that one of Wall Street's most formidable operators has morphed into some kind of tree hugger.

As the storm has gathered BlackRock and its peers have backed fewer ESG proposals over the past couple of years. And all three are ramping up investment in pass-through voting, a fast-evolving voting technology that that promises to expose company shares held within funds to shareholder influence.

Making 'popular capitalism' popular

As well as relieving the big funds of the increasingly vexed responsibility of casting votes on behalf of shareholders, the innovation promises to advance the elusive ideal of 'popular capitalism'.

Visions of mass share ownership have continually surfaced since the 1980s, when the Reagan administration promoted employee enrolment in 401(k) pension savings schemes powered by equities, and the Thatcher governments rolled out a privatisation programme that encouraged many UK citizens to acquire shares in former public companies such as BT and British Gas.

Through the 1980s and 90s the number of British shareholders rose from three million to nine million – about 15% of the population – and by 2021 11 million owned stocks and shares ISAs, with two million managing their own pensions through SIPPs. The pension auto-enrolment framework introduced that year increased the number of workplace pension holders from 46% to 80%, making most UK workers share owners overnight, whether they were aware of it or not.

But though share ownership has widened, its nature has changed, making it tougher for investors to exercise influence over the companies in which they hold a stake.

Five decades ago, more than half of UK shares were held by individuals, who had opportunities to have their say – through regular communications with executives and attendance at general meetings – that present day holders have lost, or have never had. Today little more than 10% of UK shares are individually owned and investors are handing their money to an ever more narrower set of funds.

BlackRock, Vanguard and State Street now control 80% of all the assets under management in the US and one third of all assets managed worldwide. Around 100 asset managers are entrusted with the oversight of about a third of the world's invested capital.

> **"But though share ownership has widened, its nature has changed, making it tougher for investors to exercise influence over the companies in which they hold a stake"**

As the financial commentator Merryn Somerset Webb puts it in her book, *Share Power*, we now have 'managerial rather than shareholder capitalism'. The digital investment platforms through which most of us hold our shares present another intermediary between investors and companies. Platforms pass on dividends and capital gains but retain technical ownership of the shares they hold.

Before their entanglement in the culture wars the big funds, assisted by proxy voting agencies, had been very ready to assert their capacity to hold companies to account on behalf of shareholders.

There is also something to be said for the argument that concentration of power in the biggest institutions gives them the clout to hold today's giant corporations to account that individual shareholders struggle to summon. But breakthroughs in pass-through voting technology are opening the opportunity to pass substantial responsibility for voting onto shareholders themselves.

Voting developments

Voter choice app developer Tumelo, for example, one of the field's pacesetters, allows investors to access resolutions for any of their funds' portfolio companies as soon as they become available and to view detailed reports on the votes placed. Investors can vote on proposals at companies to which they have the greatest exposure, or select from a range of voting policies.

Somerset Webb's book cites a case study implemented by Tumelo and fund managers Legal & General Investment Management (LGIM) as heralding a new future for shareholder engagement.

Some 50,000 investors were invited to access lists of the companies they hold via their funds through the LGIM website, where they were able to see resolutions coming up for those companies, review arguments for both sides, see how LGIM and other investors were intending to vote, cast their own vote, and see the result.

BlackRock's Voting Choice initiative employs a similar framework to open up more than 650 global funds totalling $2.6tn in equity assets, nearly half of all the index equity assets the company holds under management. Last month State Street opened its first European ETF for voting choice.

Vanguard's pilot programme, launched last year, allows investors in five funds to participate in proxy voting on company proposals, offering options to abstain, vote with an ESG focus, vote alongside the company's board, or allow Vanguard to vote on their behalf.

These and other uses of new technology, such as the post-pandemic convention of hosting AGMs online and initiatives such as Primary Bid that make it easier for retail investors to participate in IPOs, may finally be creating the conditions for realisation of Milton Friedman's purist vision of a 'shareholder democracy' in which engaged shareholders hold companies to account without the intervention of other stakeholders.

Power and responsibility

Maybe, but only if investors themselves show themselves willing to take the opportunity. Analysis of Vanguard's pilot programme found that of the 45,000 shareholders who voted 45% were content for the fund manager to vote their shares, with a quarter voting to support ESG shareholder proposals, and a third accepting the recommendations of company boards.

Most revealing, though, only 2% of the two million individual investors invited to participate chose to do so. Take-up has also been slow at BlackRock, the company's figures showing that investors holding less than a quarter of the assets available for Voting Choice have taken advantage of the initiative.

That is worrying for fund managers, leaving them in the political firing line as they continue to make delicate judgements as to how to exercise voting rights on behalf of millions of shareholders.

Also, perhaps, for private investors. A meaningful extension of shareholder voting would serve as a powerful safeguard against political interventions that would dilute their rights: from conservatives, sanctions on funds pursuing ESG agendas; from the left, changes to corporate governance promoting the rights of stakeholders beyond those holding shares.

New technologies like pass-through voting hold out the shimmering prospect of true shareholder democracy. But with power comes responsibility - that of taking an interest in company affairs and casting a vote. Time will tell whether the ideal has ever been anything other than a mirage, of more concern to market purists than shareholders themselves.

Justin Reynolds is a freelance journalist and editor of The Patient Investor blog

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Does a slowing US economy challenge current earnings forecasts?

US recession fears spiked over the summer, with worries about the state of the labour market leading to volatility in equity markets. At face value, a slowing economy would seem to contradict the view of equity analysts, who are currently forecasting a broadening in US profit growth after several quarters of dominance by the 'magnificent seven'. However, the detail within these forecasts is important. Picking through the earnings outlook, it is plausible that earnings do broaden out as the US economy slows.

An outright recession would be more of a challenge, though this is not our base case. Investors should nonetheless be aware of downside risks to the economy, and that risk assets are likely to remain especially sensitive to economic and earnings data.

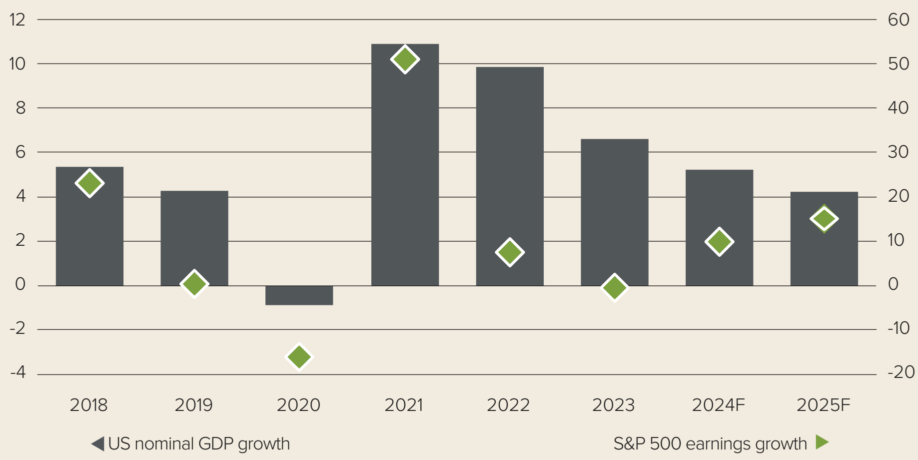
Resilience in equity portfolios will therefore require balance. This includes diversification by sector and style, as well as across cyclicals and defensives, and a focus on quality companies.

The economy is not the stock market

Over 2023 and the first half of 2024, only a handful of stocks in the S&P 500 index saw their earnings expand. The magnificent seven companies grew their profits 31% year on year in 2023 as global technology demand surged, whereas earnings in the rest of the S&P 500 actually contracted.

Yet this was the year in which the broad economy grew by over 6% in nominal terms. This disparity between the performance of the US economy and corporate earnings is important, and is central to why we think

CHART 1: US NOMINAL GDP GROWTH AND S&P 500 EARNINGS GROWTH
% change year on year



Source: BEA, CBO, IBES, LSEG Datastream, S&P Global, J.P. Morgan Asset Management. Nominal GDP forecasts are as published by the CBO. Earnings growth forecasts are as published by IBES. Past performance is not a reliable indicator of current and future results. Data as of 4 October 2024.

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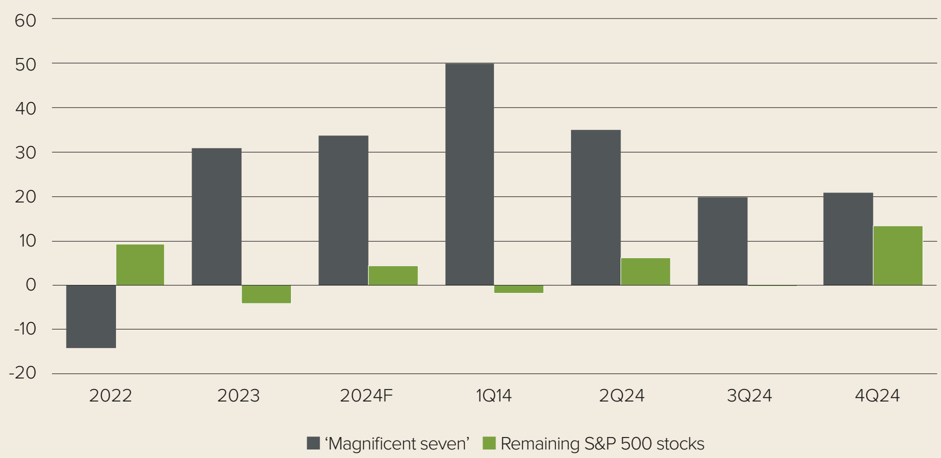
CHART 2: S&P 500 EARNINGS GROWTH
% change year on year in pro forma earnings per share



Source: FactSet, S&P Global, J.P. Morgan Asset Management. Past performance is not a reliable indicator of current and future results. Data as of 30 September 2024.

it is possible for activity to slow while profits broaden.

Digging into the detail of today's earnings forecasts reveals why. Profit growth in the magnificent seven and the rest of the S&P 500 is forecast to converge meaningfully by the final quarter of 2024, which would represent a major pick up in earnings for the non-megacap firms.

Much of the positivity baked into these earnings forecasts reflects idiosyncratic, sector-specific tailwinds. For example, some industries – such as energy and materials – delivered exceptional earnings growth in 2022, with profits boosted by a spike in global commodity prices. Healthcare also saw strong earnings growth thanks to Covid-related demand. However, this strength was paid back in 2023, as the level of earnings per share in these sectors normalised.

As this payback period fades, profits in these industries are forecast to improve meaningfully – one factor behind consensus forecasts for broader earnings participation.

Elsewhere in the US equity market, slowing wage growth is expected to be particularly positive for labour-intensive industries. These sectors have recently faced a margin squeeze, as US labour costs were slower to fall than inflation – a challenge for sectors less able to pass on cost increases, such as industrials and consumer staples. But as wage growth continues to normalise, margin pressures should recede.

Finally, an improvement in the global manufacturing cycle is expected to support broader earnings growth. After a period of pandemic-related strength, global goods demand eased meaningfully in 2023. But gains in manufacturing sentiment indices suggest the demand picture may be improving, which would be a boost for the industrials sector in particular.

Looking further ahead, while we do anticipate policy rate cuts from the Federal Reserve over the next 18 months, we also expect interest rates to settle at higher levels than seen over the 2010s. Alongside a slowing, but not collapsing, US economy, this could also support financials' earnings as net interest margins remain stronger.

Slowing fine, recession more of a challenge

While we think a slowing in US activity doesn't necessarily contradict current earnings expectations, a recession would clearly challenge today's forecasts for broader earnings growth across the S&P 500 index. Sectors such as industrials and financials would struggle to reach current consensus profit numbers in a period of intense consumer weakness.

However, a significant economic downturn is not our base case. Corporate fundamentals remain strong, and layoffs are still muted. Part of the recent increase in the US unemployment rate is down to strong immigration and participation, rather than solely being driven by workers being laid off.

Even if the US does experience a slowdown, the excesses that typically lead to a nasty downturn do not appear to be present today. Household debt levels are contained, and investment levels look moderate rather than overextended.

Conclusion

We do not currently see reasons to be concerned about the fundamentals of the US equity market. Consensus US earnings forecasts don't look overly optimistic given our base case of a slower – rather than collapsing – US economy. Investors should remember that the S&P 500 is not the US economy. Nonetheless, markets will remain reactive to incoming data given perceptions of increased recession risk. Balance is key. Diversification across sectors and styles, as well as a focus on quality companies, looks prudent given still-high uncertainty about the path ahead.

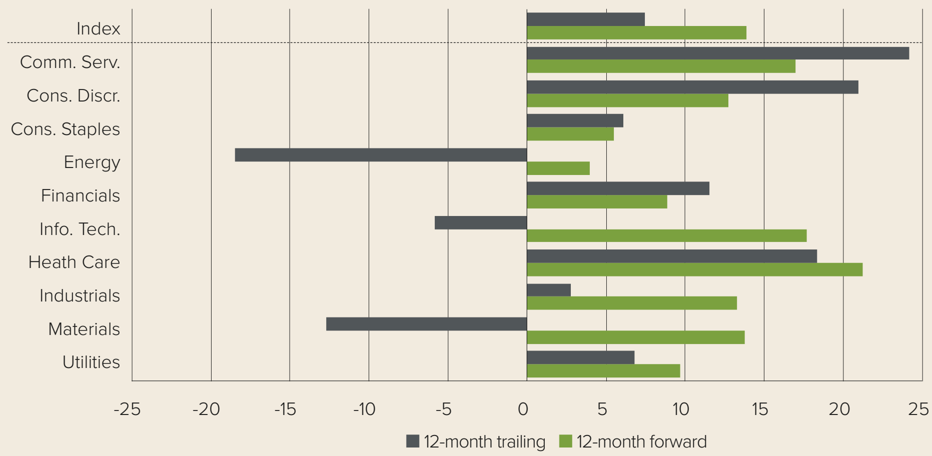
Allocating to US equities with active ETFs

We continue to believe that active alpha can play a critical role in equity portfolios when the future direction of the stock market is uncertain and more differentiated asset performance is expected. As the largest active

"Elsewhere in the US equity market, slowing wage growth is expected to be particularly positive for labour-intensive industries. These sectors have recently faced a margin squeeze, as US labour costs were slower to fall than inflation"

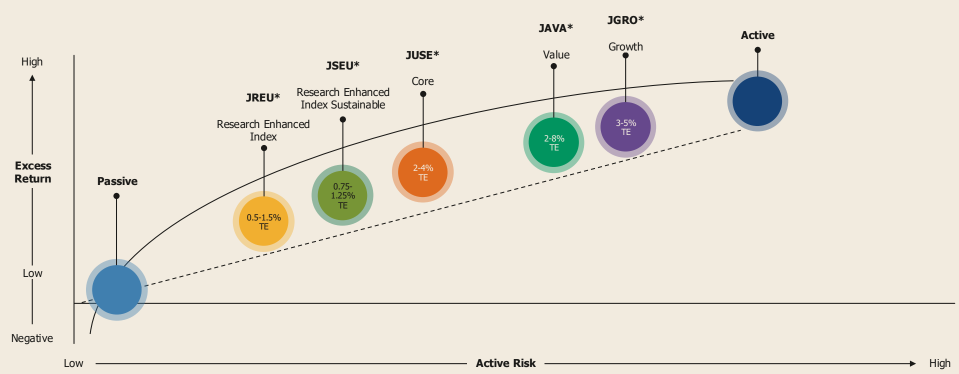
UCITS ETF provider (source: Bloomberg as of 30 September 2024)., we offer investors a variety of active US equity ETFs to express their asset allocation views and sustainability preferences, from index-like Research Enhanced strategies to active core allocations and value or growth tilts.

CHART 3: S&P 500 EARNINGS PER SHARE GROWTH
% change year on year



Source: IBES, LSEG Datastream, S&P Global, J.P. Morgan Asset Management. 12-month forward earnings growth estimates are as published by IBES. Past performance is not a reliable indicator of current and future results. Data as of 4 October 2024.

CHART 4: ACTIVE US EQUITY OFFERINGS BY J.P. MORGAN ASSET MANAGEMENT



Source: J.P. Morgan Asset Management. For illustrative purposes; based on target excess returns and target active risks. TE = Tracking Error.

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Is systematic active the new smart beta ETF?

JREU and FUSR under the microscope

By Laura Gibbons

Low tracking error, 'index-plus' active strategies that aim to outperform by assessing companies on fundamental metrics may bear a resemblance to Europe's well-established smart beta ETFs.

Consequently, fund selectors must consider where these products fit within their portfolio construction and whether they align with their active or systematic investment objectives.

Total assets in smart beta ETFs reached €109.2bn in Q3 this year, now comprising 5.4% of all assets in the European ETF market, while active ETF assets rose to €45bn from €38.8bn in Q2, now accounting for 2.2% of total European ETF assets, according to data from Morningstar.

Comparisons arise between the two when Morningstar identified both JP Morgan Asset Management's (JPMAM) research-enhanced ETFs and Fidelity's research-driven equity strategies as employing "systematic" approaches.

In the report, titled *Active ETFs in Europe: Small, Shy, and on the Rise*, it states Fidelity's active equity ETFs are "benchmark aware and systematic," while JMPAM's "incorporate its analysts' forward-looking fundamental ratings on stocks, but in a diversified and systematic fashion."

"Systematic" might imply a rules-based, disciplined approach that applies consistent processes into the portfolio, reminiscent of smart beta strategies, rather than relying on subjective, high-conviction decisions.

Though, a counter argument can easily be made.

When comparing the iShares Edge MSCI USA Value Factor UCITS ETF (IUVL) with the JPM US Research Enhanced Index Equity (ESG) UCITS ETF (JREU) and the Fidelity Sustainable Research Enhanced US Equity UCITS ETF (FUSR) in terms of their valuation approaches, each demonstrates a slightly different methodology.

While all three ETFs integrate valuation metrics into their stock selection, their approaches differ. The iShares ETF relies on passive screening, using rigid valuation criteria - namely price-to-earnings and price-to-book ratios - to select attractively valued companies.

In contrast, JPMorgan and Fidelity take a more nuanced, research-driven approach, actively analysing companies to uncover those they believe are undervalued or hold intrinsic long-term value.

This topic opens up extensive discussion, and against this backdrop, *ETF Stream* spoke with three fund selectors to see how they are approaching the debate and where these products fit from a portfolio construction point of view.

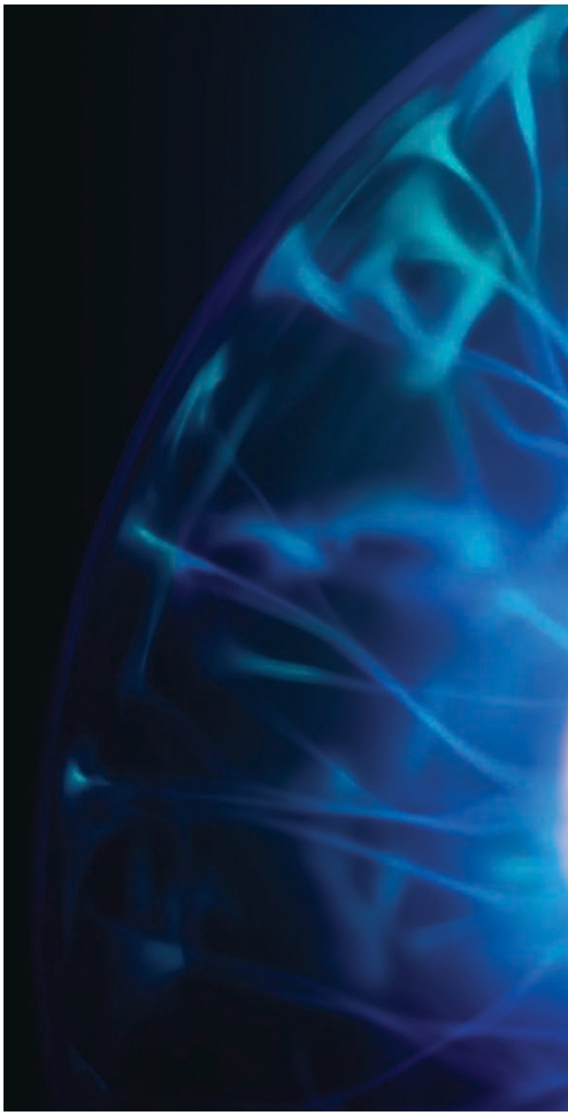
Active versus systematic decision-making

One key area that sparks debate surrounds whether JPMAM's and Fidelity's ETFs are if they employ active or systemic decision making.

At the most basic level – and taking JREU as an example - decisions are actively made by JPMorgan analysts and portfolio managers, who apply fundamental research and subjective judgment on stock selection.

Smart beta strategies, on the other hand, follow predetermined, systematic rules based on academic research without portfolio manager discretion.

Peter Sleep, investment director at Callanish Capital, said JREU relies on fundamental research, analyst insights and a well-defined risk management framework.



In contrast, he explained, commercial smart beta strategies are primarily grounded in academic research and may incorporate risk management depending on the strategy's specific rules.

"The building blocks of smart beta are based on academic research by figures like Fama and French – small cap and value – Jegadeesh and Titman – momentum – and Robert Haugen –minimum variance."

"I have read the research in the past and I do not think they put many constraints in their research to manage risk. The risk management was added by the industry because smart beta can be a have high tracking error".

Meanwhile, Yvan Roduit, head of investment advisory at Raiffeisen, said JP Morgan's extensive research capabilities lends itself more to active and deliberate decision-making surrounding stock selection rather than being systematic.

"That's why it is difficult to label this as smart beta – it is really not. I think it is an

> **"Systematic might imply a rules-based, disciplined approach that applies consistent processes into the portfolio, reminiscent of smart beta strategies, rather than relying on subjective, high-conviction decisions"**

efficient strategy in its own right," he said.

Finally, a spokesperson from JPMAM said: "Our REI equity ETFs are actively managed ETFs which utilise best-in-class fundamental research to generate excess returns over time through bottom-up stock selection."

What are the similarities?

Though 'index-plus' strategies may bear some resemblance to smart beta as they can display similar factor biases, the three fund selectors agreed that this does not make them smart beta strategies.

Both JREU and smart beta approaches may reflect similar factor tilts, such as a bias towards small-cap stocks or earnings growth.

However, Sleep said, "JREU almost certainly has a mild bias to small-cap stocks and earnings growth, but that does not mean it is smart beta. Nearly every active portfolio manager has this bias to small cap and about two-thirds load on earnings growth."

'Systematic' techniques may be one other similarity between the two strategies, such as using an optimiser. Though, as Sleep points out, the optimiser does not equate to a set of rules to weight the stocks in the portfolio.

"If there is an optimiser involved, that is fine. An optimiser is there to balance portfolio risk or tracking error and analyst conviction."

James Penny, chief investment officer at TAM Asset Management, added the dependability of the strategies in terms of performance and risk means that "one would be forgiven for placing it in or near the enhanced beta range."

'The modern version of smart beta'

Zooming out, Penny and Roduit both agreed that the draw of JPMAM's 'index-plus' strategies lie in their ease of scalability, with Yvan adding you can also expect alpha at a low cost.

"It is very straightforward to explain: this is the strategy, how it works, and what the expectations are and that is it."

Ultimately, active ETFs – namely 'index-plus' strategies are the "modern version of smart beta," said Roduit.

"They are smarter and with limitless potential for evolution."

Lauren Gibbons is a reporter for ETF Stream

Which factor ETFs will perform in new rate cutting era?

Investors will watch whether a monetary pivot sparks a similar rotation in factor performance

By Peter Taberner

The US Federal Reserve's decision to cut interest rates in September by an aggressive 50 basis points (bps) to between 4.75% and 5% raises the question of how factor ETFs can perform in this environment.

The move by the Fed marks a turning point against the rate hiking cycle that was brought in to tackle soaring inflation.

Now, it is anticipated that US interest rates are set to fall further, with Fitch Ratings for example forecasting that the upper interest rate will be cut to 4.5% by the end of this year. By the end of 2025 the same rate is set to drop to 3.5% the rating agency estimated.

Which factor ETFs will outperform

Factor ETF providers will need to create a strategic approach to understanding the current environment that they are operating in, where recent factor patterns must be analysed to evaluate where the market would be beneficial to their portfolios.

Bob Hum, US head of factor and outcome ETFs at BlackRock, said that to understand how factors might perform in today's rate cutting cycle, it is essential to evaluate the backdrop through the lens of long-term data such as prior rate cutting cycles, while staying flexible and dynamic to respond to the unique characteristics of the current environment.

"The economic regime that markets are operating in, elements like the strength of the US economy, the level of unemployment and changes in inflation, is a critical variable that can meaningfully impact factor cyclicality," he said.

"In a 'goldilocks' economy with resilient growth and declining inflation, cyclically-oriented factors like value and momentum may be preferred while more defensive factors like low volatility could lag.

"Alternatively, quality and low volatility factors may be better suited to navigate a downturn and potential recession."

As the economic backdrop shifts and trends change, an actively managed factor timing strategy such as the iShares US Equity Factor Rotation ETF (DYNF) can provide dynamism to investor portfolios.

BlackRock's Systematic Group manages this strategy with a data-driven and quantitative approach, modelling numerous economic variables across decades of history and hundreds of US large and mid-cap stocks.

As of 30 September the ETF is overweighting factor characteristics such as momentum and quality, while underweighting low size and low volatility.

Reviewing which factors might benefit from a rate-lashing cycle, Dr Marcin Wojtowicz, ETF research analyst at UBS Asset Management, reflected that rate cuts are generally supportive of broadly defined growth stocks due to a reduction in the discount rate.

"Growth stocks generally provide expected profits further into the future, so a reduction in the discount rate has a larger positive impact.

"Conversely, factors such as value or dividend may experience relative underperformance in a falling interest rate environment." he said.

Nick Kalivas, head of factor and core equity ETF strategy at Invesco, said if an investor envisages the Fed continuing to cut rates, he expects such a scenario to benefit the yield factor as dividend yields become more competitive to money market and short-term rates.

"Historically, we have seen the year over year growth rate of money market fund assets coincide with the 3-month T-bill yield," Kalivas said. "We have also seen relative performance of yield factor coincided with declining rates."

Past performance as interest rates fall

Research conducted by Alex Lustig, a senior consultant for data driven investment management solutions firm Confluence, examined stock returns between 1982 and 2023 in the event of sudden interest rate cuts.

It was found that growth equity outperformed value equity during an interest cutting trend, but this also depends on the pace of the rate decline.

A reduction beyond 5% is necessary to influence growth stocks in the US market, they outperform value equity by 226bps for every 10% decrease after a 5% interest rate.

Also, the study revealed that if the 10-year rate decreases by 15%, growth equity outstrips value equity by around 2.2%.

Rates cuts in different environments

Of course, rate cutting cycles can be prompted by many diverse circumstances as we have seen in recent times such as the financial crash

Dr Wojtowicz and Kalivas agreed that each time there are several variations behind any decision to begin slashing interest rates.

"For example, the rate cuts following the financial crisis were done in a recessionary environment." Dr Wojtowicz said.

"A cycle of rate reductions during Covid was accompanied by large fiscal spending, effects on the real economy and it resulted in

"Over the past 100 years, markets have typically exhibited higher risk and lower returns during election months, say between September and November, compared to non-election months"

a technology sector rally, also precipitated by uncovering of changes that technology can bring such as remote work.

"The current interest rate cycle comes after an inflationary period. It is a different set of conditions compared to the mentioned previous rate reduction cycles, so it may be inappropriate to draw inference for the present cycle."

As the current cycle is generally expected by the market, investors need to account for the extent to which it is already reflected in market prices.

Kalivas said that one must be careful about making blanket statements when it comes to rates.

"Monetary ease due to significant economic weakness, think financial crisis, has different implications than rate cuts linked to adjusting the real rate lower because of falling inflation in a period of sustained economic growth."

He added: "Soft landing has the potential to benefit smaller stocks and value stocks, while rate cuts linked to stress would benefit low volatility and more quality stocks."

Given the high level of concentration and contribution to risk present in the cap weighted S&P 500, investors should investigate factor-based strategies to meet their goals and objectives.

What will be the election impact?

The down-to-the-wire US presidential election outcome is sure to have an impact on the factor ETF market in the current rate reducing climate, although to some it is debatable just how far that political headwinds can usurp the markets in driving top line growth.

Hum explained that it is not unusual for markets to experience heightened volatility during an election year.

"Over the past 100 years, markets have typically exhibited higher risk and lower returns during election months, say between September and November, compared to non-election months," he said.

"Investors seeking potential resilience during this period can consider defensive strategies like quality and minimum volatility."

A victory for Kamala Harris or Donald Trump is highly likely to have an influence on certain assets due to policy direction, such as ESG assets as they should receive a boost reversing their recent fortunes if Harris wins, while fossil fuels would benefit more if Trump wins a second term at the White House.

During Harris' time as vice-president the Inflation Reduction Act was signed two years ago and is viewed as the flagship legislation in the commitment to an economy that is powered by clean energy.

However, the Biden presidency has also seen a surge in gas and oil production, with crude oil production reaching 13.2 million barrels per day in June this year according to the US Energy Information Administration. This was 6.5% more than last year's record high of 12.5 million daily crude oil barrels.

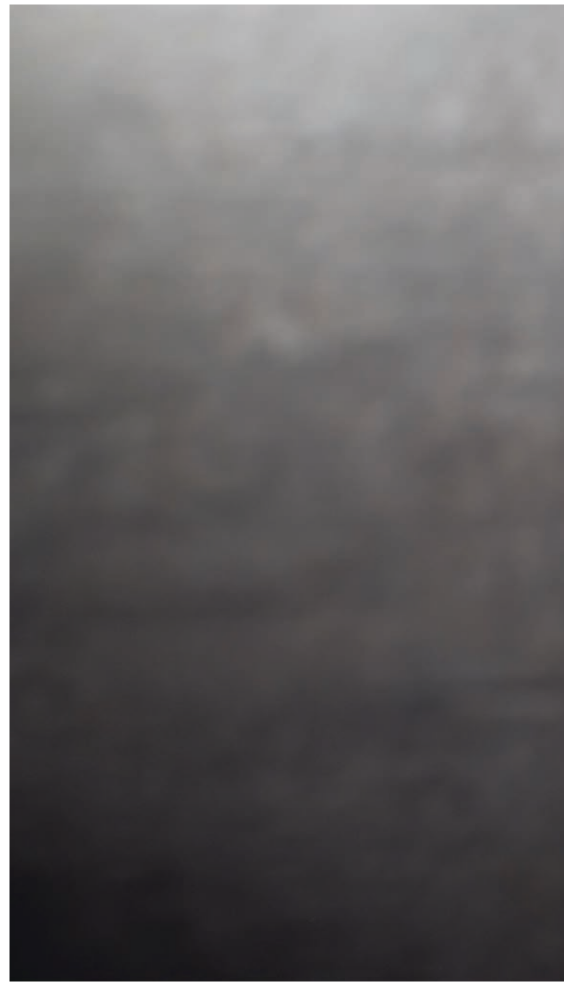
Trump is also well known to be very supportive of the cryptocurrency market and has created a new crypto venture – World Liberty Financial – which trades cryptocurrencies.

European stocks could also be effected by the prospect of Trump sponsored tariffs, where the former president has threatened to have import penalties from Europe on certain products of up to 20%.

Peter Taberner is a freelance journalist

Small cap ETFs: Is the stage set for the return of size?

Investors have begun adding to small cap allocations



By Toby Lawes

Investing orthodoxy teaches us that smaller companies outperform over time, however, will central bank rate cuts provide a backdrop for small cap ETFs to stage a comeback after a decade in the dark?

The so-called 'small firm effect' was examined in a book by Jeremy Seigel and Jeremy Schwartz titled *Stocks for the Long Run*. Between 1926 and 2021, they computed, small caps delivered annual returns of 11.99%, slightly ahead of large caps at 10.35%.

Perhaps the book's most surprising finding, though, was that virtually all the small cap outperformance came during one golden nine-year window between 1975 and 1983.

For the rest of the period returns were all but neck-and-neck – but that is not to say they moved in perfect step.

As Chart 1 illustrates, small caps, as proxied by the Russell 2000, tend to outperform for a period of years, such as between 1998 and 2013, before large caps, as proxied by the S&P 500, take over the running. Market leadership is cyclical.

The current cycle, in force since 2013, has seen blue skies for large caps while small caps – in relative terms – have made heavy weather of it.

The clouds have been particularly dark since 2018. Around then, mega cap tech stocks – spearheaded by Apple, Amazon and more recently Nvidia – began to deliver stellar performance and increasingly dominate large cap indices. Small caps could not keep pace.

A ray of light came from the US inflation print in June this year, however. It showed inflation dropping faster than expected causing futures to price even faster and deeper interest rate cuts.

This precipitated an eyepopping rally in small cap indices. Companies of diminutive stature typically carry higher borrowing costs and thus benefit more from lower rates.

The rally posed an important question: was the dramatic small cap rotation a flash in the pan or a fundamental turning point in market leadership?

ETF Stream asked investors for their views on the fortunes of small caps over both a short and medium time horizon, as well as how they were playing this in portfolios.

The short-term: The next 12 months

Jaisal Pastakia, investment director at Handelsbanken Wealth & Asset Management, presented a bearish view for small caps over the coming year.

For him, two things are required for small caps to perform: easier monetary policy and improving growth prospects. However, Pastakia contends monetary policy is unlikely to come to the support of small caps.

"Our expectation for the next few months is that interest rates go from 'restrictive' to 'less restrictive', which is different to outright 'easy'," he said.

The growth backdrop does not favour small caps either. Large cap earnings are rising while small cap earnings, which tend to be more cyclical, are declining.

Pointing to the ISM Manufacturing New Orders, Pastakia noted that many for-

CHART 1: RUSSELL 2000/S&P 500 RATIO

Source: LSEG, Shiller data, ETF Stream calculations. The chart uses price, rather than index, return values due to availability of data. A rising line illustrates small cap outperformance.

ward-looking indicators augur ill for small cap earnings.

As such, he has been underweight small caps and expects to remain so. “We continue to favour large caps with a bias towards quality,” he added.

Stephan Kemper, chief investment strategist at BNP Paribas, on the other hand, believes that small caps have a “fair chance” of outperforming large caps over the next year.

With the Fed cutting in the context of a robust economy, small cap earnings are expected to pick up while the growth of large cap earnings appears to be slowing.

“This narrowing gap in profit makes the valuation premium of large caps vs small caps incredibly unsustainable,” he argued.

Within the small cap universe, he expressed a preference for “quality” – favouring the S&P 600 small cap index over the more cyclical Russell 2000.

For Iain Barnes, CIO at Netwealth and Dan Caps, investment manger at Evelyn Partners, the matter is more finely balanced and is likely, at least to some extent, to hinge on the outcome of the upcoming presidential election.

According to Caps, smaller companies certainly have significant potential to outperform under the right economic backdrop.

“Easing monetary policy and looser fiscal conditions combined with increasing consumer confidence and business investment” could be a boon for small caps, he said.

However, if there is an inflationary spike and tighter policy, or a more dramatic slowdown than currently predicted, smaller companies will continue to struggle – an assessment Barnes concurred with.

On the upcoming US election, both investors highlighted the significant small cap outperformance on the back of a Trump victory in 2016.

For Barnes, “the 2016 analogue suggests a strong initial bump for US smaller companies. However, it isn’t clear that corporate fundamentals are strong enough to convert this to a more long-standing advantage.”

Barnes sees more opportunity in UK small caps given improved recent market sentiment.

The longer view: The next 5-10 years

Looking further out, Caps is constructive on smaller firms. “We would expect smaller companies to make up ground as we move through the early stages of an economic cycle,” he said.

As such, he established a “moderate” small cap position earlier in the year and will be watching US economic date very closely in the coming months before deciding whether to add.

Kemper is bullish on small caps over the medium-term, too.“The starting point for small caps is much more appealing from a valuation perspective,” he asserted.

“Based on the historic relationship between the P/E ratio and 10-year forward returns, the S&P 500 is expected to return somewhere between just 4-5% [in the next decade].”

At a high level, Kemper is a strong believer in the small firm effect. He considers “the current phase of large cap outperformance as some sort of a correction in a long-term trend.”

According to Barnes, however, the small firm effect has been “severely tested” in recent years. He noted, as did Pastakia, that the outperformance of large caps has coincided with the growth of private markets which has encouraged companies to go public ever later in their development – with mixed results for investors.

On balance, Barnes concluded: “We believe traditional market cycles have been extended rather than broken, but we need to see a catalyst of better structural economic growth in support.”

Pastakia is less sure. For him, “changes in market structure challenge the validity of the small firm effect.”

Pastakia observed that small cap outperformance comes in “fits and starts” but does not believe now is an optimal time to move from his underweight.

The best opportunities for small caps come in the depths of a recession when rates are rates are dropping, sentiment has collapsed and valuations are on side, he explained.

Unlike Kemper, Pastakia does not view current small caps valuations as attractive, with the S&P 600 trading above its long-term average P/E ratio.

“As recently as 12 months ago you could have argued that [small cap] valuations were supportive enough to provide attractive returns over a five-year time horizon; there is much less confidence in this statement now,” he concluded.

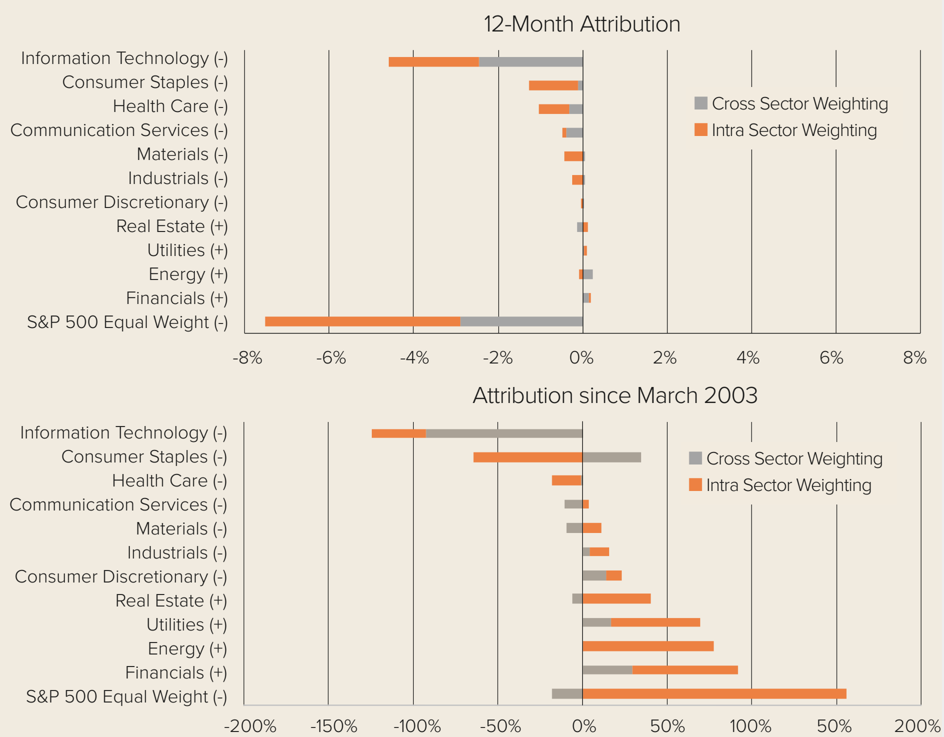
Toby Lawes is senior reporter at ETF Stream

The lesson from equal weight underperformance

Concerns about concentration in US equities have been a persistent issue for investors, leading to a shift towards re-allocation strategies. Equal-weighted approaches have gained popularity as a universal solution. However, despite a recent surge in inflows, the tactical investment case remains unproven for now. Over the past two years, the equal-weighted S&P 500 has underperformed its market-cap weighted counterpart by 13.09%[1]. A closer examination of allocation and attribution metrics reveals the primary cause of this underperformance: significant differences in sector allocations. Notably, the largest active weights are in IT (13.9% vs 31.6%) and Industrials (15.9% vs 8.5%). This might suggest two key points for investors: First, Equal Weight should still be viewed as a tactical rotation strategy whose time has yet to come. Second, investors need to pay close attention to sector allocations.

Yet, the devil is in the details, and fortunately for proponents of equal-weight strategies, long-term capital market history tells a different story. Over the past twenty years, the S&P 500 Equal Weight Index has delivered returns comparable to the market-cap weighted version. Since 1990, it has outperformed the S&P 500 by a notable 63 basis points per year, resulting in a staggering 742% total return difference[1]. Therefore, a strategic rather than tactical perspective may be more needed.

CHART 1: ATTRIBUTION ANALYSIS S&P 500 EQUAL WEIGHT VS. S&P 500



Source: S&P Dow Jones Indices, Factset. Data from March 31st, 2003 to Sept. 30, 2024. Chart is provided for illustrative purposes. Past performance is no guarantee of future results.

Regarding the underlying performance drivers, a recent attribution analysis by S&P offers valuable insights. Chart 1 illustrates the relative impact of equal weighting within a given sector (in orange) and weighting differences across sectors (in grey) over the past twelve months and since the index's inception in 2003. This serves as further evidence of how unusual the current times are and provides a powerful warning that recent "winner takes all" dynamics are not just prominent in the tech sector but extend across virtually all sectors.

The other long-term chart bears another powerful message: it is usually not the top stocks that contribute the most significant returns to the index (especially in non-technology sectors). Instead, a balanced allocation within the sector allows for broader participation and has proven most successful. Simply put, the winners of today are not necessarily the winners of tomorrow.

The implications of these observations for broader investing cannot be overstated at the moment. A lot of investor attention has been on the fact that just a few stocks have outperformed the index, while the rest have trailed. This has made life difficult for many single-stock investors. However, this is neither unusual when compared to the recent past (on average, only 40% of stocks in the S&P 500 have beaten the index each of the last eight years) nor compared to long-term equity market history, where a tiny 2.4% share of the market is responsible for all net global stock market wealth creation[2]. The unusual aspect is that it is the largest stocks that are doing so. Statistically, top-performing stocks often face relentless disruption, which erodes their future returns. Charts 2.1 and 2.2 illustrate this trend for a sample of the top 10 stocks since the 1980s, highlighting their average forward returns. These returns have consistently declined, and once these stocks reached the top 10, they typically underperformed the index from the first year of their peak ranking.

The question now is whether the exception of the last twelve months will indeed last. Depending on the answer, this continues to make a strong case for equal weighted strategies. However, even for market-cap weighted investors, it carries important mes-

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CHART 2.1: AVERAGE FORWARD REALIZED ABSOLUTE RETURN (US TOP 10 COMPANIES). SINCE 1980

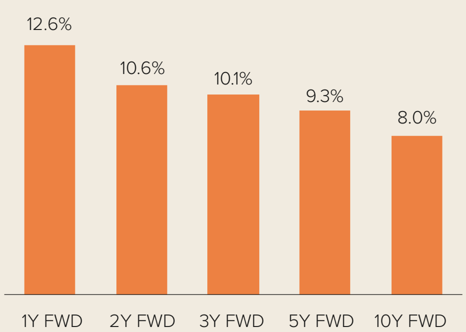
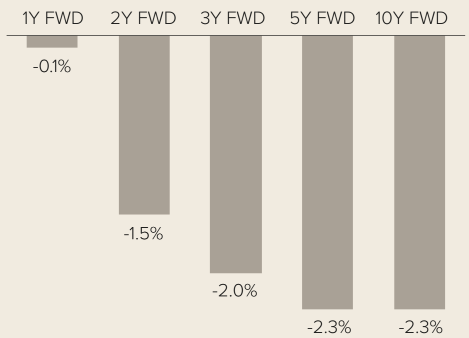


CHART 2.2: AVERAGE FORWARD REALIZED RELATIVE RETURN (US TOP 10 COMPANIES). SINCE 1980



Source: Goldman Sachs, Past performance is not indicative of future returns. As of September 2024

sages for all areas of the portfolio, beyond US equities. Most immediately, there is a need to be vigilant about sector exposure. As concentration has increased, the face of many sectors has changed (Chart 1), leading to heightened idiosyncratic risks. Keeping in mind the performance drag that top companies tend to experience, it is crucial to look for new disruptors.

Thematic solutions, particularly those governed by strict diversification constraints, can aim to identify these next disruptors. Especially in fast-changing themes that span several sectors, they are likely to provide more direct access than a sector view alone.

At the same time, with equal weight remaining mostly driven by size and the anti-momentum factor, this highlights the relevance of a factor investing lens in current times. The jitters around the "Magnificent 7" in early August mostly played out via the factor lens, not sectors. Therefore, scanning portfolios for underlying factor biases, intended or unintentional, is critical. This also puts more emphasis on related factor solutions, especially when blended factor portfolios can offer a more customised tool. The value and quality factors, in particular, warrant a closer look as their combination provides a compelling narrative. Blending robust fundamentals with attractive valuations can results in a well-diversified solution with more favourable risk-return characteristics than a broad developed markets benchmark. Naturally, a solid factor definition and robust indexing choices are crucial for achieving persistent performance. At this point, the sector view re-emerges: For Quality and Value in particular, retaining sector weights in line with the benchmark should be a conscious choice to avoid concentrated sector bets, which in turn may turn out to be value traps.

Overall, while winner-takes-all dynamics have produced impressive short-term results, the challenge for investors may remain the same as last year – keeping up with broad benchmark performance while avoiding some idiosyncratic risk and keeping a keen eye on macro drivers that could catalyse the somewhat overdue performance of the average stock.

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[1] Source: Bloomberg as of 15/10/2024 / SPXEWTR Index vs. SPXT Index. Note that the index was launched in Jan 2003. All data prior to this date is back-tested data.

[2] Source: Long-term shareholder returns: Evidence from 64,000 global stocks (Bessembinder et al., 2023)

S&P Global

Sponsored by S&P Global

Active ETFs capturing 'significant share' of new flows

Insights from data crucial in supporting ETF ecosystem, enhancing liquidity, transparency, and product innovation

In this Q&A, we dive into the role S&P Global Market Intelligence ETF and Benchmarking Management Solutions plays in supporting the ETF and index ecosystem as well as nascent corners of the markets such as active ETFs.

Anthony Rayar, director of product for S&P Global Market Intelligence's ETF Management solutions explains how the team aggregates, validates, and standardises global ETF composition data, ensuring those in the ETF ecosystem can access and use this information effectively.

Data-driven insights are an important part of product development and optimisation, emphasising how real-time data enables better liquidity, efficient pricing, and transparency in the fast-evolving ETF landscape.

These insights can also help to uncover particularly fast evolving segments of the industry – namely active ETFs – revealing the proportion of net flows or the average expense ratios within a specific category.

What does S&P Global Market Intelligence ETF and Benchmarking Management Solutions do?

As part of S&P Global Market Intelligence division, we focus on market data related to ETFs and Indices. Our primary function is to aggregate, validate, and standardise ETF composition data, which we then distribute to our clients. This process supports the workflows of liquidity providers, sponsors, allocators, and researchers, ensuring they have accurate and reliable information for their decision-making.

For example, data input from our sponsors may come in different formats, structured with varied formats. We streamline this process on a global scale across all asset classes, ensuring that market makers, traders, or authorised participants have the necessary data to execute trades efficiently.

In addition to ETFs, we also support index providers, not limited to S&P Dow Jones Indices, and others. Our services extend beyond data aggregation to include regulatory screening, sanctions, PCF generation and our own iNAV+ calculation engine, which recalculates ETFs in real-time, second by second with the ability to fair value.

How has data-driven analysis influenced the growth of the ETF industry in recent years?

Many decisions in the ETF industry are data-driven in one way or another. For example, when it comes to product innovation, two key factors are investor appetite and the financial backdrop. Other considerations, such as client demand, pricing, and operational logistics, are important too, but the foundation is whether there is demand for the product and if the financial and regulatory environment is favourable.

To make these decisions, accurate and timely data provision is key. First, you need to analyse the existing ETFs and identify market gaps. If there are 100 ETFs following strategy A, but only five following strategy B yet have gathered tremendous inflows, you might want to examine those five more closely. You would look at fund flows, performance, fees, reference index data (if applicable), and various other metrics to gauge their success.

Essentially, all these decisions are data driven. It begins with understanding which ETFs have the highest or more consistent demand via inflows and then peeling back the onion to understand the investment strategy behind the ETF to identify how this ETF is meeting the investor's appetite.

How does data help optimise index construction for ETFs to better align with investor goals?

ETFs and indices have always been closely connected, but from an optimisation perspective, there are two key aspects to consider, product availability and the mechanics of trading. When an issuer is looking to launch an ETF with a unique strategy, they can often select an existing index to track or benchmark against. However, if no suitable index exists for the new strategy, a custom index needs to be constructed.

Having a broad view of the available index universe helps sponsors optimise their decision-making. They can decide whether to choose an existing index or create one that better aligns with their strategy, often based on data-driven analysis.

The second area of optimisation involves trading, particularly during rebalance periods. Since we provide composition data for both ETFs and indices, traders have access to the most up-to-date data. This allows them to effectively manage rebalancing by tracking changes in weights and constituents, ensuring efficient pricing and optimising their trading models.

Liquidity and tight spreads have made ETFs popular across asset classes. The ETF

> **"We are able to bring different parties together to share knowledge extracted from the underlying data to improve the process and promote innovation within the product"**

industry started with equities, then expanded into sectors, fixed income, commodities, and now spot cryptocurrency. ETFs add value by providing liquidity to assets that might lack it. With INAV+, clients can price ETFs in real time and independently fair value the underlying assets. S&P Global Market Intelligence has a unique position within the ETF ecosystem being one of the only data providers able to offer both portfolio composition file construction and iNAV services.

How do you think real time data and analytics enable market makers to improve liquidity and narrow bid ask spreads?

The popularity of ETFs across various asset classes can be attributed to their liquidity and tight spreads. Initially focused on equities, the market has since expanded to include sectors, fixed income, commodities, and now spot cryptocurrency. ETFs have proven to be a fantastic price discovery vehicle especially when the underlying asset cannot be priced. This benefit was apparent in 2020 with fixed income ETFs. As the ETF industry has evolved, so too have the analytics associated with it, enhancing the usability and tradability of these products. With INAV+, clients can price ETFs in real time and independently fair value the underlying assets. This transparency helps sponsors, market makers, and traders assess the health of ETFs, ensuring efficient trading and highlighting discrepancies in pricing. Our goal is to offer insights and improve transparency across the market.

How are you differentiated from competitors?

We have had the privilege and pleasure of serving market participants in the ETF ecosystem for over 20 years. Our success is driven by the breadth and depth of our data sets. We offer a one-stop solution, combining data from ETFs, indices, securities finance, regulation, and real-time pricing. Clients can access multiple services under one umbrella, providing them with the flexibility to address various needs across front, middle, and back-office functions. Innovation, client feedback, and localised support are integral to our approach, enabling us to evolve with the industry and provide timely, accurate data using the latest technology. This is what sets us apart.

What role do you play in driving ETF product development through data insights?

We firmly believe in prioritizing people, process, and product. We are able to bring different parties together to share knowledge extracted from the underlying data to improve the process and promote innovation within the product. ETFs have gained popularity due to their transparency, tax advantages, and liquidity. We aim to build on that transparency by offering sponsors a complete view of the ETF universe—whether it is tracking fund flows, analysing constituents held, market activity, reference data, or trading preferences. Our job is to facilitate collaboration among stakeholders, using our data and insights to enhance the entire ecosystem for the benefit of investors and market participants.

The active ETF market is rapidly evolving, where do you sit within this?

When issuers analyse data or assess liquidity, having access to comprehensive underlying data is essential. This allows them to identify trends, such as the growing shift toward active management. By analysing fund flows and reference data related to ETF launches, we can see that many recent launches are focused on active strategies. Our data indicates that active ETFs are capturing a significant share of new flows. Clients rely on these insights to monitor trends, and our data helps them identify where attention and investment are shifting, particularly towards actively managed products.

The curious case of the size factor

How might investors ride the next wave of momentum in small-cap equities?

By Hoshang Daroga, CFA

In its simplest terms, factor investing involves investing in stocks with specific characteristics in a rules-based approach. There is a wealth of academic research on factor investing, and most agree on six key factors: value, size, momentum, volatility, yield, and quality. Among these, the size factor has been somewhat neglected in recent years and rightfully so as small-cap stocks have significantly underperformed large-cap stocks. However, the increasing dominance of large-cap stocks in benchmark indices and market-cap index tracking funds has led to concerns about concentration risk.

Firstly, let us define the size factor: The size factor refers to the tendency of small-cap stocks to outperform large-cap stocks over the long term. The argument is that small-cap stocks carry more risk, which should, in theory, result in higher returns to compensate for this additional risk.

However, the past decade has defied this theory, with US small-caps significantly underperforming their large-cap counterparts. As shown in the figure below, there have been only two years – 2016 and 2020 – where small-caps outperformed large-caps in the US, challenging even the most patient investors.

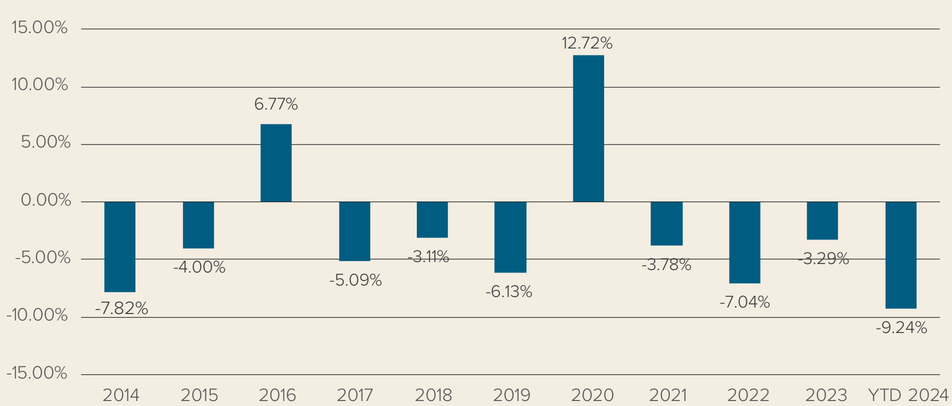
With the strange performance behaviour of the size factor, a growing number of academics have re-examined the data and some have come to conclude that the size factor never really existed in the first place.

What happened to small-caps over the last decade?

Several factors explain the diminished performance of small-caps over the past decade. For one, large-cap stocks like Apple, Microsoft, Google, Meta (formerly Facebook) and Amazon have grown even larger.

These companies benefit from robust business models with strong competitive

US SIZE FACTOR (SMALLCAP RETURNS - LARGECAP RETURNS)AS OF 31-AUG-2024



Source: Elston Research, Ken French data, as of 31 August 2024

moats. Massive investments in research and development have allowed them to dominate emerging technologies. Additionally, their access to capital enables them to acquire potential competitors before they become significant threats, as seen with Facebook's (now Meta) acquisition of Instagram.

Another reason for small-cap underperformance is that approximately 45% of small-cap stocks are unprofitable – delivered negative earnings – and this percentage has been steadily rising. Meanwhile, profitable small-caps are frequently targeted for acquisition by private equity firms or large-cap companies.

Current market conditions and concentration risk

Today's market presents a unique challenge with increased concentration risk among large-cap stocks. The top seven companies alone account for over one-third of the total market capitalisation in the US equity market. Investors using passive, market-cap based index-tracking funds and ETFs are

exposed to this concentration risk, but it is essential to remember that concentration risk is a choice, not an obligation.

However, the broader US economy is performing well. Real GDP growth is hovering around 3%, inflation is not far off the Federal Reserve's 2% target and with potential interest rate cuts on the horizon, there is a tailwind for the broader market of 493 stocks beyond the top seven.

While these stocks are smaller in comparison to the large-cap giants, the landscape is different for small-cap stocks. A rising tide may not lift all boats, especially in the small-cap space, where a selective approach is crucial.

Investing in small-caps: What to look out for

Investing in small-cap stocks can be rewarding, but it comes with its own set of risks. Small-cap companies typically have more growth potential but are also more vulnerable to market volatility, economic downturns, and operational challenges. As such, it is vital to be selective when investing in this space.

Here are a few factors to consider:

1. Quality of earnings: One of the key risks with small-cap stocks is that many of them are unprofitable. Focus on companies that demonstrate consistent earnings growth and have a sustainable business model. Look for profitability rather than just revenue growth.

2. Management and strategy: Strong leadership is essential for small-cap companies, especially during times of uncertainty. Pay attention to companies with experienced management teams and a clear strategic vision. Companies that can efficiently allocate capital and adapt to changing market conditions tend to outperform their peers.

3. Balance sheet strength: Financial health is another critical factor. Companies with excessive debt can struggle during periods of rising interest rates or economic slowdown. A solid balance sheet with manageable debt levels and sufficient cash flow can provide the cushion needed to weather downturns.

4. Market position and moat: Small-cap companies with a competitive advantage in their niche market are more likely to succeed. Whether through unique products, services, or intellectual property, having a defensible position in their industry is crucial.

Conclusion

While small-cap stocks have underperformed in recent years, the size factor still holds potential for those willing to take a selective approach.

With concentration risk rising in large-cap stocks, investors may find opportunities among high-quality small-caps with strong fundamentals. However, careful due diligence is required to navigate the unique risks associated with investing in smaller companies.

By focusing on quality, management strength, financial health, and competitive positioning, investors can ride the next wave of momentum in the small-cap space.

Hoshang Daroga CFA is investment director at Elston Consulting

Events

This section provides a summary of the latest ETF Stream events including webinars, roundtables and the Big Call series

ETF Stream Presents

ETFs to address asset allocation challenges in a new market regime

With developed market central banks beginning their rate-cutting cycles in earnest against an uncertain economic backdrop, ETF investors are wrestling with how to position portfolios for the new world. **Chair:** Theo Andrew, editor, ETF Stream

A potential turning point for markets arrived in 2021. After decades of stable prices and low and falling interest rates, inflation proved that it was laying dormant; not extinct. Many investors, commentators and – above all – central bankers were blindsided by its return.

Somewhat belatedly, a historic rate-hiking cycle began and benchmark interest rates remained elevated for longer than many investors anticipated – generating a difficult environment for allocators conditioned by the old regime of low inflation and falling rates.

ETFs, meanwhile, have continued their seemingly unstoppable growth. The toolkit available to investors is now more expansive than ever.

This roundtable discussion, in partnership with Fidelity International, assessed the outlook for economies, examined the potential risks faced by portfolios and explored how asset allocators are positioning in this uncertain environment.

Meet the experts

Ray Paulding
Sales director at Fidelity International

Dan Caps
Investment manager at Evelyn Partners

Scott Gardner
Investment strategist at JP Morgan (Nutmeg)

Stacie Mitchinson
Systematic investment director at Fidelity International

Iain Barnes
Chief investment officer at Netwealth

Richard Flax
Chief investment officer at Moneyfarm

Weixu Yan
Head of passives at Close Brothers Asset Management

Stephen Dowds
Chief investment officer at Hay Hill Wealth

Jack Turner
Head of ESG portfolio management at 7im

In association with

Fidelity INTERNATIONAL

Outlook for US economy

Paulding: Fidelity's macro team are of the view that we remain late cycle. We feel it will be a period of positive returns for risk assets, but with enhanced volatility. US fundamentals look good in terms of low unemployment, low inflation, and a robust outlook. But some signs of distress are emerging in the labour market, as well as in some high-frequency data like credit card delinquencies.

Barnes: A lot of people have been anticipating a slowdown for a long time, and the unemployment rate is ticking up. But all in all, the Fed appears to have played a bit of a blinder in terms of managing through a huge period of uncertainty.

Caps: We have had the fastest rate-hiking cycle in history, four of the last five recessions have followed an inverted yield curve, credit card delinquencies are up, savings rates are down, and the labour market is starting to soften. While we don't have recession as our base case, it's very finely balanced at this point.

Flax: Direction of travel of US data doesn't look great, but that's coming from pretty robust levels. The Fed has begun to ease which should help mitigate those risks over time. Margins rebounded strongly after covid, and are expected to expand further next year, which could elicit some sort of regulatory, political, or market-based reaction.

"We have a view that inflation will be sticky and that ten-year yields in the US won't come down much – staying around the 4% mark. Interestingly, a recession is priced into markets more than a spike in inflation"

Stephen Dowds, Hay Hill Heath

Turner: Overall, the economy looks relatively sound. The unemployment rate is still very low, so we were surprised by the 50bp Fed cut.

Dowds: We think the US is heading for a soft landing. We think inflation is likely to prove a little stickier and the yield curve will once again be upward sloping. We have been operating in a negative real yield backdrop for years now. People, I think, want a real return on their money.

Gardner: The central bank now views inflation as largely under control, so has begun easing to minimise the potential impact of refinancing. We are seeing pretty decent liquidity conditions in the US, despite the QT going on. Now the Fed is easing, we expect continued good liquidity going forward.

Risks to portfolios

Turner: Inflation ticking back up. The consensus is heavily tilted towards it continuing to come down. The market has fully priced this in. It is hard to see real escalation in the Middle East.

Dowds: Recession. Because we have a view that inflation will be sticky and that ten-year yields in the US won't come down much – staying around the 4% mark. Interestingly, a recession is priced into markets more than a spike in inflation.

Flax: With a tight labour market, especially in certain sectors where skilled workers are

"US fundamentals look good in terms of low unemployment, low inflation, and a robust outlook. But some signs of distress are emerging in the labour market, as well as in some high-frequency data like credit card delinquencies"

Ray Paulding, Fidelity International

scarce, the possibility of a shorter-than-expected monetary tightening cycle is increasing. If inflation does not decline towards the 2% target as anticipated, portfolios could face heightened risks from prolonged inflationary pressures and potential policy adjustments.

Gardner: The labour market is actually improving in the UK. Even with high levels of migration, wages are structurally elevated, and the public sector pay rises are still to feed through to services inflation. There is an Ofgem price increase coming too. So the BOE will probably cut whilst inflation is accelerating, which could be an interesting environment.

Yan: A black swan event. A depression with high inflation because we lack the policy tools to fight it – ease rates to prop up the economy, or hike to fight inflation? Then you could get more of a hard landing scenario.

Caps: If inflation spikes and we do have a recession, or at least a notable slowdown, you get a situation where the Fed wants to cut but with inflation spiking, they are stuck between a rock and a hard place.

Asset Allocation

Yan: Slightly overweight equities as economies look ok for now. But gone from having a few thematic allocations to just one, rotating into the S&P 500 to neutralise some of the specific risks. Slightly underweight duration, but within fixed income using a barbell approach, with exposure to 0-5 years as well as fifteen years plus.

Gardner: We use market cap as our base, but recently bought some more Nasdaq as we think the structural US growth story will continue to play out. We do make tactical allocations, too. For example, we are playing European industrials at the moment. In terms of duration, we are neutral in the portfolios but underweight government bonds. We are overweight credit but not looking to add with spreads at these levels.

Barnes: We do take positions outside the cap-weighted S&P 500, what we call 'cyclical positions.' If there are concerns around the US outlook, I'm not sure small caps are where you want to be. At the moment, we prefer to look outside the US for these allocations. We do not like Europe but the UK is really interesting.

Caps: We have a balance of cap-weighted and equal-weight S&P 500. If we see some of the froth come off AI, the bubble bursts, we want some protection against that. We are adding to government bonds (gilts and Treasuries) as disaster insurance and heading back towards benchmark duration. If we do see rates cut a bit faster than anticipated because of a softening economic landscape, that will help buffer our equities.

Dowds: Given our view on an upward sloping yield curve and the ten-year yield settling around the 4% mark, that makes bonds ok for the income and not great for the capital. We have been underweight fixed income for years. What else can we use to diversify some of the risks away? We use things like gold and oil rather than hedge funds.

Flax: For the next twelve months at least this isn't the worst environment for equities. There's a global rate-cutting cycle, economies will pick up which is good for profit growth. US large caps look a bit expensive; the rest of the world not particularly.

Turner: We are broadly in line in terms of equities, but marginally overweight duration. We've held equal-weight for some time now, as well as a long-term healthcare position. We have global exposure and have been long the yen for some time, which we recently trimmed a bit.

KEY TAKEAWAYS

Caps: I generally get a bit nervous when there's lots of consensus, but in this case the consensus is that the outlook is unclear, which I'm more comfortable with. We have a balanced view: cognisant of the risks out there, but not off to the races just because we've had some rate cuts and everything feels rosy.

Mitchinson: It was interesting to hear on a product view that there is more interest around active ETFs. And some scepticism around ESG is not that surprising at all. We have seen that in terms of flows this year.

Barnes: It's going to be an interesting period for markets in the coming months. I'm going to focus more on regional dispersion than any sort of headline moves of asset class returns.

Paulding: From our point of view as a product provider, it's interesting to hear that there isn't much product-wise that people are looking for due to the uncertainty and lack of conviction around markets.

Turner: It was interesting to hear how people have been implementing duration. We have typically been longer duration than others, but that seems to be changing a bit.

Yan: From a product point of view, more diversifiers in ETF form would be very useful.

Gardner: It seems there is cautious optimism around. There are some concerns about a deterioration in the labour market, but no one is really banging the table for a recession.

Dowds: While there was broad consensus on the big picture, there were quite different views underneath that, and it was interesting to hear the different ways people are implementing them.

ETF Stream Presents

Navigating an uncertain market environment: What role can ETFs Play

This roundtable saw Swiss investors sit down with DWS to discuss how they are allocating with ETFs amid market uncertainty, US equity dominance and an interest evolving rate environment

Chair: Jamie Gordon, features editor, ETF Stream

Investors head into the closing months of 2024 with increasing trepidation around economic data, job prints, central bank policy and growing question marks surrounding the longevity of stellar US earnings and whether this story can broaden out across sectors and down the market cap spectrum.

This Geneva roundtable hosted in September in partnership with DWS unpacked how Swiss professional investors are viewing the market, parsing their equity and fixed income buckets and how ETFs are proving key in remaining nimble amid an increasingly volatile backdrop.

Positioning for macro uncertainty

Lowe: The wobble in August and the unwind was brutal. Seeing VIX spike above 60, these opportunities do not crop up too often. As we head into year-end, we will likely see volatility spike from time to time on the VIX and those are the times we step into the market

Meet the experts

Yvan Roduit
head of investment advisory, Raiffeisen

Jaime Arevalo
multi-asset portfolio manager, Schroders

Antoine Denis
head of advisory, Syz Group

Amaya Gutierrez
head of investment and portfolio advisory, Rothschild & Co

Keith Michael Lowe
senior vice president securities advisory and execution EMEA, Citi Wealth

Gilles Boitel
head of Xtrackers sales Switzerland and Israel, DWS

In association with

Xtrackers by DWS

and use structures that benefit from an uptick in volatility. This is opportunistically positive when volatility spikes, because longer term, we are still fundamentally positive on the US market.

Gutiérrez: We remain overweight equities and the recovery since August has played in our favour, but that is a position we are monitoring. We have started to take some risk off the table, gradually. We began with a sector lens, reducing our allocation to consumer discretionary and increasing in consumer staples. We are monitoring cooling signals, but we are not taking action just yet.

Roduit: We use six factors to assess the risk in the market, from one – no risk – to five – risk – we are at 2.2 now. We are cautious about the economy. We are underweight equities, underweight bonds, overweight gold and Swiss risk. We have a structural bias to Switzerland.

Arevalo: It is challenging because we must basically accept this was going to be a very volatile year from the beginning. Volatile because of geopolitics, elections, expectations around recession, inflation, where China is going to be and how the market is pricing in no recession, less inflation and how any economic data is released. The concern from my side and from my team's side is that there are a lot of positive expectations that have been priced in.

Denis: We are also expecting greater volatility because the fact is, we will see more normalisation in the market. Growth is slowing down and same on the jobs side, inflation is cooling down. This is a treat for the market, our view is still on the soft-landing side. But normalisation comes with adjustments, so we expect to see some changes in market leadership and volatility along the way.

Boitel: DWS's view has changed over the summer and we have gone slightly underweight equities. We favour European equities over the US. We see China to be disappointing, with GDP growth rates of below 5% for this and next year. We continue to like Japan, but we do not see a large uptick, more appreciating its safe haven potential. We are not so bullish on Switzerland or the Swiss franc, because of the relative moves of other central banks and the property market. We have reduced equities to favour high quality European corporate bonds. We have gone up on gold and on oil in the commodity space. Towards the end of the year, we may become more bullish on US equities, but with a clearer view on sectors.

> **"The wobble in August and the unwind was brutal. Seeing VIX spike above 60, these opportunities do not crop up too often. As we head into year-end, we will likely see volatility spike from time to time"**
>
> **Keith Michael Lowe**, Citi Wealth

A US-World barbell as the Presidential election looms

Boitel: On the client side, we have had an impressive summer of sector and factor rotation from our trend following clients. Many have followed momentum strategies for the first seven months of the year and have switched into quality for two weeks now, or even into minimum volatility. Within sector allocations, clients did well in IT and financials and shifted into communication and utilities and covering with healthcare. In the Swiss private banking space, clients have moved away from broad indices and are increasingly using our equal weight S&P 500 ETF; the amount of flow we have seen has been astounding. On the advisory side, more clients have wanted to play dynamically on US equities and disregard most of the rest of the equity universe. This means using a barbell strategy, MSCI World ex USA strategy to delta one cover that market and then in the US, they will be sector rotating, equal weighting, factor rotating, bringing in Russell 2000, dynamically diminish or increase US exposure. We have seen a lot of flow in and out of world sectors.

Denis: Investors are very US-centric. In equities, they invest in the 'rest of the world' and then in the US, they are more selective. We still like the big names, but it is also dangerous not to be invested in them, so investors do not have much of a choice in this. We use a lot of the S&P 500 equal weight ETF. Valuations are high, growth is slowing and we would expect multiples to come down. When

you ride at high altitude, the air is very thin, so disappointments are expected as well. It is not easy to tell clients to move away from those big names.

Roduit: There is a lot to be said about the opportunity cost of not being invested in those big names. Clients, especially private clients, would ask why we are not invested, even when they are expensive. We also use S&P 500 equal weight instruments in advisory and DPM, to be part of the repricing of those names, but it is difficult to discuss that with clients.

Gutiérrez: Volatility brings opportunities. It entails difficult conversations with clients, but it is also a time in which we can propose new investment ideas. More volatility could come as the US elections approach. Some clients have been hesitant to add more risk and it will be interesting to see how November impacts the economic outlook in the US – for now visibility remains limited. As mentioned, we have reduced consumer discretionary to increase staples, but we also we have tried to avoid healthcare, because it tends to be in the arena during times of US elections.

Lowe: We have a thematic overweight in our level three portfolio – which is similar to a classic 60/40 – there is a 1.5% weighting to the S&P 500 equal weight. The other point our global investment committee is making is the Russell 2000 tends to do well in and after the election cycle, resulting in a thematic allocation to US SMID growth of 2.5%. There is also a thematic overweight of 2% to US healthcare equipment suppliers, based on an EPS recovery in H2.

Arevalo: When we look at elections, we are essentially building scenarios. If the Democrats stay in office, it will play well for certain areas but at the same time, we would be concerned about taxes. We are actually more concerned about Trump re-entering office, which could be the trigger of a reflationary environment. We would also have a labour market that would be more difficult to stabilise, due to less migration. Our positioning at the moment is to be as cautious as possible, without missing the momentum, both in the US and elsewhere. We have large cap exposure but are also building up our Russell 2000 position, because assuming there is no recession, this will be the sector.

Fixed income and the start of the easing cycle

Denis: We do not see a pause in the rate cut pathway. In terms of duration positioning, we try to find the sweet spot between too short and too long and right now that sees us at a round five to 10 years. We tell our clients not to miss the train on yields, because next year the hangover might happen, where we cannot place in any fiduciary deposits. We keep on the investment grade side; we are cautious about high yield for now and spreads remain too tight.

Lowe: On our balanced portfolio, we remain underweight fixed income by 3.5% versus equities. Within that, most of it is within US govvies with a focus on intermediate duration. Within investment grade, we tend to be in that crossover rating where your yield pickup could be 100-120 basis points, six-to-seven-year duration, in the belly of the curve. In high yield, we are not really doing it, but we do see some clients trying to trade around it, using ETFs mostly.

Boitel: Over recent months, euro corporates have amassed impressive flows, while investors have rotated out of long-dated US Treasuries and looked to the shorter end of the curve. On the advisory side, we are seeing investors locking in yields with target maturity funds, especially in the 2031-2033 range. These have been popular as investors have a fear of missing out and want to lock in those yields at elevated levels. Fixed maturity ETFs have seen massive flows, driven by advisory, while it has been less of a tool for DPM, due to other single securities and investment vehicles being pre-selected or more cost-efficient for larger trades.

Arevalo: Fixed maturity strategies are something we have been interested in and something we have used, mostly in advisory mandates. As has been said, much of the client interest has come from locking in yields and targeting 2028 to 2030.

Gutiérrez: Overall, we turned more positive on the asset class at the end of 2022. We were underweight for a long time before that. We saw a lot of client interest in building fixed income portfolios in order lock in yields as the easing cycle approached. Additionally, we remain overweight duration and, given tight spreads, we reduced our exposure to low investment grade and high yield.

KEY TAKEAWAYS

Roduit: We are satisfied with the current ETF offering and how issuers continue to innovate. We are big fans of growing product classes such as active ETFs in advisory and DPM.

Gutiérrez: We combine traditional passive and active ETFs within our offering, each of them have a role in portfolios. For now, we see clients a little bit concerned about geopolitical risks rather than greatly concerned about the economic outlook. There is some fear about missing out on the continued rally; hence, we believe that staying invested with a long-term horizon remains the best strategy.

Arevalo: ETFs give us efficient exposure to a market in terms of tracking error, cost, liquidity. ETFs are also useful because they are available in different currencies accessible through different listings. They can be powerful as they can allow you to rebalance and implement your views quickly. Active ETFs will add a lot of value and the current roster is somewhere between traditional passive and active, in terms of tracking error and cost.

Lowe: Our team is utilising ETFs not just for strategic long-term core holdings in equity and fixed income, but also as flexible tools to capitalise on market opportunities This has proven its effectiveness especially when market dynamics shift as during the spike in volatility at the beginning of August.

Denis: We are excited about fixed maturity ETFs and they fit the proposals of some clients that have cashflow needs, so we can easily ladder these ETFs based on what those needs are. Looking ahead, because we are constrained by the UCITS framework, we lack options on UCITS ETFs.

Boitel: It is always interesting to hear and better understand how our clients are positioned and what they require. We are looking at what the market needs, because, as a product provider, it is easy to live in one's own bubble, being so passionate about our products and investment ideas. It is always useful to hear what demand is out there and make sure it influences our product innovation, making sure client demand is meant, also if it contradicts our views at times.

Data dashboard: October 2024

2024 winners including equal weight, overnight rate and research enhanced active continued to shine with strong inflows in October

Data provided by etfbook

Data as at 18 October

TOP PERFORMANCE

TOP 10 BEST PERFORMING ETFS

Name	Ticker	Return
Global X Blockchain	SILBKCH	16.52
iShares Blockchain Technology	BLKC	16.47
VanEck Crypto and Blockchain Innovators	DAPP	15.6
WisdomTree Blockchain	WBLK	15.05
Grayscale Future of Finance	GFOF	15.02
VanEck Uranium and Nuclear Technologies	NUCL	9.98
Global X Uranium	URNU	9.88
iShares MSCI USA Banks	XUFB	9.19
Ishares S&P U.S. Banks	BNKS	9.12
Sprott Junior Uranium Miners	URNJ	8.17

TOP 10 WORST PERFORMING ETFS

Name	Ticker	Return
Invesco Chinext 50	CN50	-21.07
HSBC Hang Seng Tech	HSTE	-14.66
UBS ETF - Solactive China Technology	UIC2	-13.49
Chimera S&P China HK Shariah	CHHKSH	-12.89
Global X Solar	RAYZ	-12.81
iShares MSCI China Tech	CTEC	-12.69
Invesco S&P China A Midcap 500 Swap	C500	-11.51
Invesco Solar Energy	ISUN	-11.5
Xtrackers Harvest MSCI China Tech 100	XCTE	-11.48
Invesco S&P China A 300 Swap	C300	-11.00

INFLOWS

Name	Ticker	Inflows ($m)
iShares € High Yield Corp Bond	IHYG	1,054.03
iShares Core S&P 500	CSPX	709.72
iShares Core MSCI World	IWDA	665.33
UBS ETF S&P 500 ESG	SSESG	541.82
Xtrackers S&P 500 Equal Weight	XDEW	483.01
Xtrackers II EUR Overnight Rate Swap	XEON	441.08
Amundi Euro Government Bond 7-10y	MTD	427.35
Spdr MSCI World	SWRD	421.37
Vanguard S&P 500	VUSA	420.07
JPM Us Research Enhanced Index Equity (ESG)	JREU	346.6

OUTFLOWS

Name	Ticker	Outflows ($m)
Xtrackers MSCI USA Information Technology	XUTC	-136.57
iShares € Corp Bond Large Cap	IBCS	-151.51
L&G India INR Government Bond	TIGR	-170.78
iShares $ Treasury Bond 1-3yr	IBTA	-174.29
UBS ETF - MSCI ACWI ESG Unvrsl Lw Carbon Select	AWESG	-181.57
iShares OMX Stockholm Capped	OM3X	-264.47
iShares Ibonds Dec 2025 Term USD Corp	ID25	-267.88
iShares $ Treasury Bond 7-10yr	IBTM	-469.03
HSBC Global Corporate Bond	ZQH	-790.98
iShares Core € Corp Bond	IEAC	-1,177.46

NEW LISTINGS

Name	Fund ISIN
iShares Russell 2000 Swap	
iShares Nasdaq 100 Swap	
KraneShares Global Carbon Strategy	
AXA IM ICE US Treasury +25y	
21shares Future of Crypto Index ETP	
Performance Trust Total Return Bond	
AXA IM ICE US Treasury 0-1y	
Robeco 3D European Equity	
Robeco 3D Global Equity	
Robeco 3D US Equity	
Robeco Dynamic Theme Machine	
Fidelity Global Quality Income	
L&G Corporate Bond Ex-Banks Higher Ratings 0-2y	
Leonteq ETP ON Leonteq EUR Overnight Return Index EUR	