Sustainable Equity QI
Quality and Low Volatility focus rewarded

• The strategy outperformed the market in August, maintaining positive performance quarter- to-date
• The blended exposure to Quality and Low Volatility successfully navigated increased market volatility
• The defensive, well diversified profile of the strategy proved beneficial when markets fell, while the focus on companies with high quality earnings also helped capture market upside

Equity QI Team

What's happening?

Global equities ended the turbulent month of August higher, racking up a fourth month of gains despite heavy selling at the beginning of the month that left investors fearing an impending recession. However, stocks made a remarkable comeback, buoyed by US economic data, including inflation, economic growth, and consumer spending, which set the stage for an interest rate cut from the US Federal Reserve (Fed) in September.

The recovery from the sell-off early in the month has been likened to 1987's 'Black Monday' as traders priced in a 'goldilocks' scenario where the US economy keeps growing but not by so much that policymakers do not cut the base rate.

There was a positive read-across for European stock markets as eurozone inflation fell to a three-year low, but the UK market was broadly flat despite moving close to a record high at the end of the month. The Japanese stock market failed to bounce back fully from its biggest single day rout since the 1987 Black Monday sell-off, ending the month lower.

Portfolio positioning and performance

The Fund outperformed its benchmark, after fees and expenses, as the portfolio's blended exposure to Low Volatility and Quality factors was strongly rewarded over a volatile period for equity markets. While the defensive nature of these factors proved beneficial when markets fell, the focus on companies with high quality earnings also helped capture the upside when markets recovered.

The portfolio's active sector exposure also had a positive impact on performance as the underweight to the energy sector and the overweight to consumer staples were rewarded.

Stock selection was rewarded overall this month. The overweight position in Kellanova was the top contributor at an individual stock level. Shares in the food producer soared after it was announced the confectionary and pet food maker Mars would be taking over the company. Holding a number of other consumer staples stocks with high quality earnings and low volatility including Coca-Cola and Walmart also featured among the top contributors to performance.

Elsewhere, Stock selection was well rewarded within the information technology sector and not holding Intel proved particularly beneficial after the company posted disappointing Q2 earnings and announced job cuts at the beginning of the month. The company has been struggling with tough competition within the chip industry and is not held given its high volatility and poor-quality earnings.

Outlook

The portfolio maintains its exposure to stocks with low-volatility and high-quality earnings, which we believe leads to above-benchmark returns with less volatility over a full market cycle. Slowing inflation and softer macro data means the markets expect rates to fall as central bank attention switches to managing growth risks. In this context, our research predicts a positive outlook for both Quality and Low Volatility factors.

Quality stocks tend to be rewarded when macro sentiment is in a declaration phase of the cycle. Overall, the valuation of Quality is trading at a premium to average levels; however, unlike other factors, Quality’s performance has not historically been sensitive to periods of high valuation. We would recommend an active approach to Quality investing with a focus on forecast quality which is more adaptive to changing economic conditions.

The outlook for Low Volatility has improved considerably since Q2. The improved ranking has been driven by our macro indicator pillar moving into a declaration phase of the cycle which typically favours the Low Volatility factor. Whilst falling interest rates typically weigh on the performance of Low Volatility, this is normally because the cycle is moving into a recovery phase, rather than current conditions where rates are falling to manage a growth slow down. Because Low Volatility has been out of favour recently its valuation and technicals are also supportive.

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