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January 2024
Sustainable Equity Perspectives
AXA IM Equity QI

Sustainable Equity
2023 Review

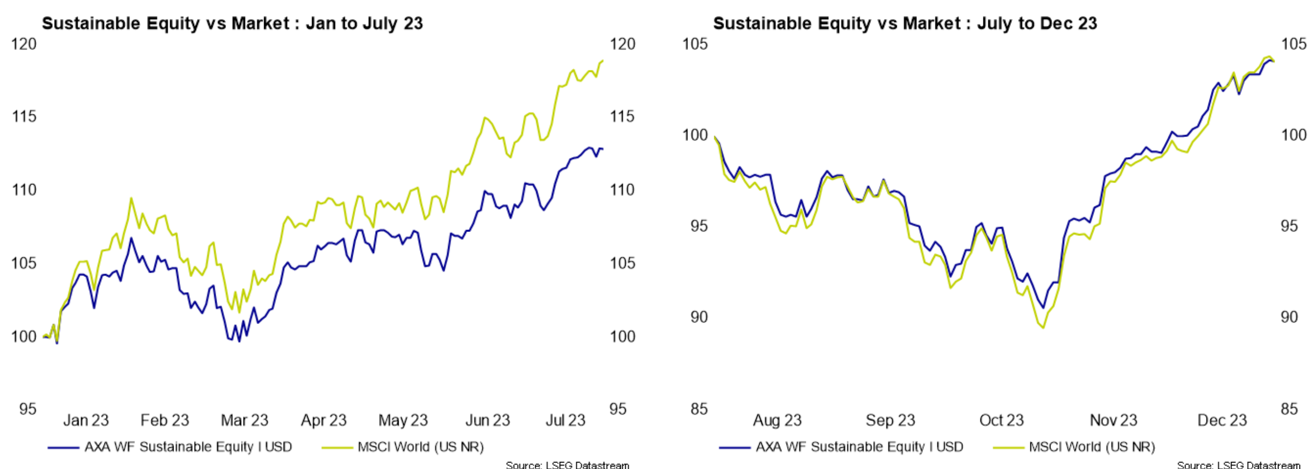
Past performance does not predict future returns

- Global stock markets rose over 2023, with the bulk of returns delivered by 'the Magnificent 7'. These mega-cap US stocks rose 75% over the year, vs 13% for the rest of the S&P 500 Index
- The Sustainable Equity strategy underperformed the benchmark over the full year, but performance improved over the second half of the year as market returns broadened
- Long term, the strategy's proprietary blend of low volatility and quality has been rewarded

The Sustainable Equity strategy underperformed the benchmark (MSCI World Index) over the first 7 months of the year, then performed broadly in-line with its benchmark over the last 5 months. Below we explain what has driven this change in relative performance, breaking the period up between January - July (relative underperformance) and August - December (performance in-line with benchmark) to help explain what we can expect from the strategy in different market environments. We believe one of the strengths of the strategy is its historical predictability, since launch 10 years ago it has consistantly performed in-line with expectations given the market environment, and navigated periods of market volatility to deliver outperformance over the long run, with lower volatility.

Exhibit 1: Performance of Sustainable Equity Strategy versus MSCI World Index

Past performance does not predict future returns



Source: AXA IM, LSEG Datastream. Data to 29th December 2023.

January – July 2023

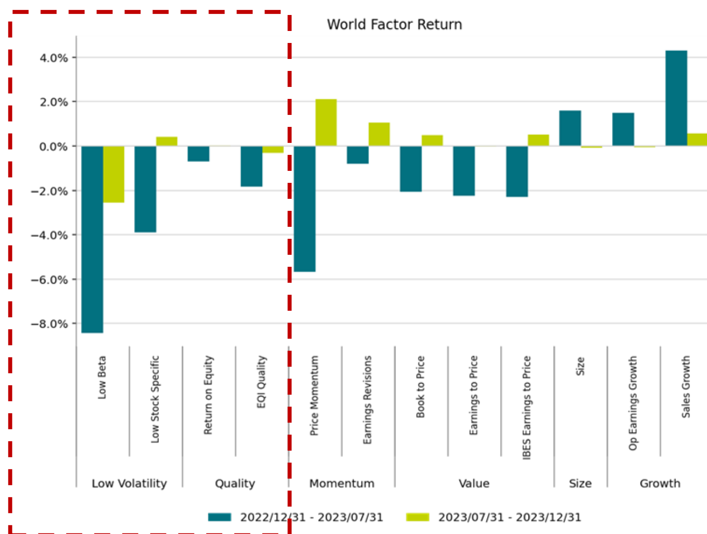
As the benchmark index rose strongly, the strategy underperformed in what was an unusually hostile market environment for the strategy. The two key headwinds were (i) sharp underperformance of low volatility stocks, especially in Q1 and (ii) poor market breadth with only a low number of mega cap stocks driving the market (the 'Magnificent 7').

- The year started with a very strong risk on rally, one of the strongest on record. This proved detrimental to the strategy's focus on stocks with lower volatility and higher quality earnings as low volatility and quality factors underperformed the broad market (see Exhibit 2 below).

- Equity market leadership became increasing concentrated in just a handful of stocks which proved challenging for the strategy's diversified portfolio construction approach. The underweight exposure to some of the largest stocks in the benchmark index such as NVIDIA, Amazon and Meta, were key drivers of underperformance as large stocks most likely to benefit from technological advances in artificial intelligence attracted significant attention.

- The strategy did benefit from its underweight exposure to the energy sector and well rewarded stock selection within financials, but this was insufficient to offset the above strong headwinds.

Exhibit 2: Global Factor Returns 2023



Source: AXA IM. Data to 31 December 2023.

August – December 2023

Over this period market volatility increased, with a sharp sell-off in markets followed by one of the best 1-month returns on record in November, and a further boost in December on raised expectations of interest rate cuts in the New Year. The strategy's relative performance has improved over this period, outperforming the benchmark over August – October when markets were falling, and managing to keep pace with the bull market in the last two months of the year, supported by improved market breadth at both a stock and a factor level.

- The dominance of the so called 'Magnificent 7' has diminished. Furthermore, the breadth of factors driving the market has also broadened and the strategy's focus on high quality stocks has been better rewarded. Even when markets rallied in December as rising expectations of Fed interest rate cuts in 2024 fuelled optimism, the strategy was able to perform broadly in-line with the benchmark (see Exhibit 1 above). This had been difficult earlier in the year when market returns were driven by a handful of stocks.

- The strategy's focus on Low Volatility and Quality factors was better rewarded as their defensive features proved beneficial when markets shifted to risk-on mode over August through to October. In addtion, when the market rallied at the end of the year, our proprietary measure of quality helped the portfolio capture returns in a rising market.

Outlook

The strategy 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.

The macroeconomic outlook for 2024 suggests lower real GDP growth which should allow central banks to start cutting interests rates. Slower real GDP growth could impact corporate revenues. In such an environment we would expect high quality companies to perform well because of their superior earnings and balance sheet resilience. Falling interest rates are also typically positive for high quality companies, particularly high quality-growth companies, which benefit from a lower cost of borrowing to finance their future growth, making it more likely that they will achieve their long-term objectives.

However, if inflation remains higher than expected, or there is a greater than expected slowdown this could result in heightened levels of volatility and market drawdown, which the strategy is positioned well to navigate.

Finally, as expectations of the "Magnificent Seven's" earnings potential are now more aligned relative to the rest of the market, we would expect them to deliver more market-like returns going forward which should benefit a well-diversified portfolio.

No assurance can be given that the Sustainable Equity Strategy will be successful. Investors can lose some or all of their capital invested. The Sustainable Equity strategy is subject to risks including: Counterparty Risk; Operational Risk; Method and Model Risk, and attention is drawn to the fact that strategy is based on the utilisation of a proprietary share selection model. The effectiveness of the model is not guaranteed and the utilisation of the model may not result in the investment objective being met.

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