The benefits of a selective approach to U.S. Equities

NEI

Summary

U.S. equity markets saw strong performance through 2023 thanks to a handful of mega cap companies that drove most of the gains for the S&P 500 and Nasdaq. While the U.S. still has one of the highest growth projections among developed economies in 2024, we believe a slowdown in growth momentum will lead to increased downside risks for stocks. A more selective approach to U.S. equities, backed by a proven strategy from an experienced manager, can capture upside while offering the potential for downside protection in this environment.

Why invest in the U.S. in 2024?

Despite broad expectations of slowing growth and recession at the beginning of 2023, the U.S economy showed continued resilience. Though interest rates remained high, strong labor markets supported real incomes and savings accumulated during the pandemic provided enough of a cushion to support consumption and sustain positive economic surprises which boosted the equity markets through the year. As a result, the S&P 500 Index was the best performing global market in 2023 with strong performance returning 23% in CAD terms. This was primarily driven by a few mega cap names, as U.S. Large Cap stock was the best performing asset class of the year returning 23.3%.

Among developed economies, the U.S. has the highest earnings growth projections for 2024. The consensus earnings estimates have U.S. growth projected to grow 12% in 2024 while other developed markets have less attractive growth projections, with Canada at 10% and Europe at 7%. Despite concerns of narrow leadership concentrated in a few names, optimism prevails due to strong economic data, lower inflation expectations, and a possible easing of Fed rate hikes which makes the case for U.S equities as strong as ever.

Preparing for more volatility in 2024

Despite the strong growth projections for the U.S. economy broadly, the performance of U.S. equities will likely look different in 2024 than it did last year. There are a few key risks on investors' minds that advisors must consider, including high interest rates, slowing economic growth, stickier than expected inflation and possibly even a recession.

While current economic conditions remain strong, driven by a strong U.S. consumer, spending is set to slow due to the following: 80% of U.S. households no longer have excess savings from the pandemic to spend, credit card debt surpassed US$1 trillion last year and default rates are climbing, plus recent data shows job openings, quits rate and hiring are all falling, indicating that the U.S. labour market is weakening.

> **"Taking a more selective approach to your U.S. equity allocation means focusing on stocks with quality and defensive features that can help provide resilience to investor portfolios if economic conditions deteriorate."**

It's impossible to look ahead in 2024 without acknowledging looming political risk as well. Polarization has the potential of preventing even basic functions of government, followed by an electoral cycle that has the potential to impact markets across multiple dimensions. It's likely that politics, a reversal in monetary policy and economic slowdown will all contribute to increased volatility in 2024.

Since U.S. equity indices saw strong performance through 2023, many investors may not be prepared for market turbulence in 2024. While its important to keep an allocation to U.S. equities to participate in the projected growth, now is a good time for advisors to start thinking about a more defensive plan with their client portfolios, so they are prepared when volatility strikes. Taking a more selective approach to their U.S. equity allocation means focusing on stocks with quality and defensive features that can help provide resilience to investor portfolios if economic conditions deteriorate.

Taking an active approach with U.S. equities

An active approach to U.S. equity investing can help investors find opportunities while managing broader market risk. Research from our subadvisor, AllianceBernstein, a trusted asset manager with deep experience in U.S. markets, suggests that this may be a very good time to invest in a strategy focused on high quality names that can help mitigate downside risk.

An active approach using thoughtful, fundamental research can help uncover overlooked names in a way that passive strategies can't. That's because passive strategies can't sift out and adjust the weights of individual stocks with high valuations. While investors will likely still want exposure to some of the biggest U.S. companies like Apple, Microsoft and Alphabet, active managers play an important role in identifying other companies with hallmarks of quality and stability that aren't fully appreciated by the market. Keeping valuation front and center provides a powerful antidote to potential market volatility—and a pathway to long-term gains.

Alliance Bernstein's investment strategy employs a proprietary "QSP" (Quality, Stability and Price) framework that has a track record of delivering strong performance in a variety of market environments. This mean investing in:

- **High quality companies** with consistent financial performance, strong management teams, investments in R&D and human capital
- **Stable companies** with low volatility of stock price returns relative to the market
- **Companies with an attractive price,** free cash flow, yield and dividend yield, that are designed to be less susceptible to wide market swings, and avoiding crowded trades with the goal of paying a reasonable price

AllianceBernstein QSP framework has been especially effective at delivering results during more challenging markets and downturns. A back test that looked back to 1970 (including periods of high inflation) shows that the companies in the top quartile of U.S. stocks in AllianceBernstein's QSP universe outperformed the market by a wider margin than usual during past periods of high inflation, rising rates and slowing economic growth[i].

Managing key risks in investor portfolios

An active approach that uses this framework can help manage risks in today's economic environment in several ways:

1. It may shield investors from inflation and rising interest rates by investing in quality companies with strong pricing power, competitive advantages, innovation and management skill. These qualities can overcome the profitability headwinds created by inflation and higher interest rates. Cash flows are an essential indicator of quality. Companies with high free cash flow have historically performed better through economic slowdowns and recessions. Healthy balance sheets and low debt levels mitigate against rising interest rates.
2. It offsets slowing economic growth by investing in stable companies that can provide a cushion on the downside across a broad array of sectors and industries. Companies with these characteristics are often seen in traditional defensive sectors such as healthcare, utilities and consumer staples, but can also be found in traditionally less defensive sectors like technology, financials and energy.
3. It reduces exposure to crowded trades by using price discipline to limit valuation risk in concentrated pockets of the market. High valuations can end in a painful correction, as we saw in the 2022 bear market, and higher interest rates warrant a greater focus on valuation.

From a historical perspective, current valuations of defensive and quality stocks look quite attractive today. Some of the more traditionally defensive sectors have lagged the market last year. In some cases, these sectors have traded at discounts (on a current earnings power basis) that are at historic lows. This means investors do not need to overpay for quality stocks with consistent profit generation and fundamental resilience — all attractive features in periods of economic and business uncertainty. This provides opportunity for those who take a longer-term perspective to buy high quality, defensive companies at attractive valuations relative to the broader market.

Aiming for more returns with less risk

Ultimately, by investing through the QSP framework the strategy is looking to curate a portfolio of stocks that will offer lower volatility and protection on the downside and still beat the market over the long term – referred to as the

90/70 target, (90% upside capture and 70% downside capture). By delivering this type of a portfolio, investors can gain the confidence to stay invested in the portfolio through turbulent times to keep them on track towards their long-term investment goals.

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The strategy shows its value most prominently during falling markets. In the same way that climbing a hill is easier when one starts halfway up, stocks that lose less in market downturns have less ground to regain when the market recovers. As a result, they are better positioned to compound higher returns during subsequent rallies, resulting in better long-term performance.

Ensuring the investment is responsible

The addition of a responsible investing framework provides an extra layer of risk management. The integration of environmental, social and governance (ESG) principles can lead to more resilient portfolios, as companies with strong sustainability practices are better equipped to weather economic uncertainties and emerging global challenges. At NEI we work closely with subadvisors to ensure that we are generating returns responsibly. AllianceBernstein also leverages a responsible approach to investing by directly integrating considerations of ESG risks into their investment research process. NEI’s Responsible Investing team enhances this investment process by performing a full security evaluation prior to the name being purchased. NEI then leverages the full influence of investors’ capital by voting all proxies and assessing shareholder resolutions. Here are a few examples of U.S. companies in the NEI U.S. Equity RS Fund that we have engaged with to help minimize risk and drive results.

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Walmart

We engaged with Walmart on material issues and influencing the overall landscape the company operates in through our public policy and advocacy work. These activities aim to protect the long-term value of investments, while promoting positive societal and environmental benefits.

- Evaluation of Walmart’s environmental performance identifies several positive commitments to sustainability, e.g. the use of science-based targets (SBTi) for emissions reductions, a project that engages with suppliers, non-government organizations and other stakeholders to reduce emissions in the global value chain by 2030, and green bond issuance
- Proxy voting in the 2022-23 year to vote against extremely excessive executive pay and lack of board independence, and to vote for shareholder proposals requesting a human rights due diligence report, racial equity audit and a workplace health and safety audit
- Engagement over many years, including collaborative discussions in 2023 on labour rights issues in the supply chain, deforestation issues, and most recently in November to discuss human rights due diligence
- Participation in industry groups (beyond Walmart specific engagements) tackling a wide range of issues such as use of plastics, access to nutrition, and equitable supply chains, which all influence change at a sector and industry level

Coca-Cola

We engaged with Coca-Cola to better understand the company's efforts around nutrition and environmental sustainability.

- The company highlighted that it has reduced sugar content and caloric load (90,000 tons of sugar removed since 2017) by offering healthier alternatives rather than just amending core ingredients
- Management emphasized that reduced package sizes can contribute to better portion control—60% to 65% of Coca-Cola's beverage portfolio is offered in 100 calorie packs—and the company has signed 50 calorie pledges around the world
- We also asked about progress on sustainable packaging since the company missed its 2017 plastic targets. Since then, refillable bottles, recycling and plastic reduction goals have clear targets, progress is reported regularly and are linked to executive compensation in the long-term incentive plan. The company added that it is working with regulators on consumer perception to promote more comprehensive and effective recycling practices

A core equity allocation for the long term

Investors need equity returns to beat inflation and to generate real returns to reach their long-term financial goals and an allocation to U.S. equities is an important component of any portfolio. With current short-term interest rates expected to decline, investors in money market funds and GICs may struggle to maintain returns when reinvesting.

We believe that equity portfolios designed to smooth volatility are especially appealing in the current U.S. market environment. In any market or macroeconomic environment, a low-volatility strategy can be paired with other active strategies to meet an investor's individual risk tolerance, time horizon and investment goals. And although it's not easy to construct a perfect 90/70 portfolio, the principle is to reduce exposure to market swings that can erode long-term returns. In times like these, a smoother ride may be just what investors need in 2024.

To learn more visit neiinvestments.com/results

[i] Source: FRED Economic Data, Russell, and AB, as of 30th September 2023. Back-tested performance from January 1970 through to December 2022.