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Equity investing for a new era:

The return of alpha

The long period of moderation – in inflation, interest rates and market volatility – has passed. The pandemic period, inclusive of the crisis response and aftermath, roused an entirely new set of circumstances upon which the economy and markets are establishing their footing. For equity investors, we believe this regime change means a different opportunity set than the one that prevailed over the past decade and a half — and one that favors alpha (excess return) over beta (market return).

Highlights

01

The post-GFC period of easy money is ended. The post-pandemic era is setting up to be more volatile with greater differentiation across individual stocks.

02

Beta, or market return, may be sufficient when a rising tide lifts all boats. In the more traditional investing landscape now forming, we see alpha at the center.

03

A more discerning market that prices stocks on their underlying fundamentals is an opportunity for skilled stock pickers to outperform.

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The end — and beginning — of an era

Capturing the essence of the new market regime requires context and reflection on the dynamics that existed prior to the current moment. The years following the 2008 Global Financial Crisis (GFC) were characterised by 1) fragility — households and businesses were recovering from a deep recession and fallout from financial and corporate failures. And 2) accommodation — the U.S. Federal Reserve (Fed) and other developed market central banks cut rates to near zero and implemented quantitative easing for the first time in order to stimulate economies and help consumers and businesses heal, propping up markets in the process.

Fast forward to 2020 and the COVID-19 crisis. It was a time marked by a global economic shutdown and restart and an unprecedented combination of monetary and fiscal support that was far greater than that seen during the GFC even as the earlier crisis imposed a more potent shock to GDP. Consumer pockets were padded with stimulus money and demand for goods was great — but supply was limited, having been disrupted by pandemic-related closures.

What followed was supply-side inflation ignited by the crisis, accommodated by fiscal (government tax and spending) and monetary (central bank policy) stimulus, and exacerbated by war in Ukraine. Central banks raised rates to combat soaring prices. While inflation is beginning to moderate, sticky elements such as wages may be harder to bring down, setting the stage for higher inflation and interest rates for longer, just as stock valuations also are higher.

> **"As the age of extreme moderation in inflation, rates and volatility ends, we see stock selection becoming more important as individual companies adapt to the new regime with varying degrees of dynamism and success."**

Defining times

Post-GFC era 2009-2019	• "Underwater" consumers repairing balance sheets • Low to moderate economic growth • Low inflation and interest rates; accommodative central banks • Extreme market returns as stock valuations move from depressed to the high end of normal • Little differentiation in individual stock returns; "buy the dip" environment
Pandemic era 2020-2021	• Massive policy stimulus expands the monetary base and creates excess savings • Economic closures stress supply chains • Supply/demand imbalance pushes up inflation • Tech stocks lead in a low-contact, stay-at-home world
Post-pandemic era 2022-?	• Resilient consumer and corporate balance sheets; likely consumer run-down of COVID savings • Inflationary dynamics, including full employment, aging demographics, deglobalisation and decarbonisation • Structurally higher inflation and interest rates • Higher stock valuations, higher volatility, more "normal" market returns • Greater dispersion in earnings, valuations and returns

Investment implications: the alpha opportunity

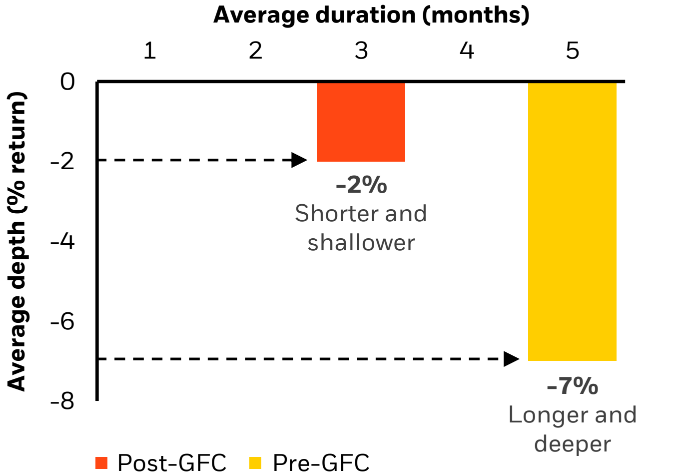
We believe the post-pandemic investment regime characterised by higher inflation, rates and valuations will require a new approach to equity investing. One implication of this new backdrop is lower market return, or beta, suggesting that a higher portion of equity portfolio returns will need to come from alpha, or excess return.

For the 12 years following the GFC, returns to beta were abnormally high as valuations moved from very low to normal, and the differentiation in returns between individual stocks was slim. Investors bought the dips and, as a result, the drawdowns were quite short and shallow. The Fed also was willing to come to the rescue in the case of any wobbles. Beta was king, as well-supported markets provided extreme performance, resulting in an average annual S&P 500 return of 15% over calendar years 2010 to 2021.

In contrast, the era before the GFC featured longer and deeper equity market drawdowns, as shown to the right, meaning more volatility as well as greater opportunity for skilled stock picking to deliver above-market returns (or alpha). We see this dynamic returning and the outlook for alpha turning more positive.

To buy or not to buy the dip

Depth and duration of equity market drawdowns



The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results. Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index. Source: BlackRock Fundamental Equities, July 2024. Chart shows the average depth (% return) and duration (in months) of Russell 1000 Index drawdowns during the pre-GFC (January 1979-February 2009) and post-GFC (March 2009-December 2021) periods.

Five factors favoring stock picking

While there are no crystal balls in investing and markets are notoriously unpredictable, we see various market dynamics taking shape that support the case for an alpha-centric approach to equity investing:

1 Volatility more likely to increase than decrease

Equity market volatility has been relatively low for most of 2024.* Strong earnings and optimism around artificial intelligence (AI) have kept markets buoyant even amid macroeconomic uncertainty. Yet high valuations, geopolitical concerns, supply disruptions and data-dependent central banks committed to fighting inflation are likely to stoke bouts of volatility across time.

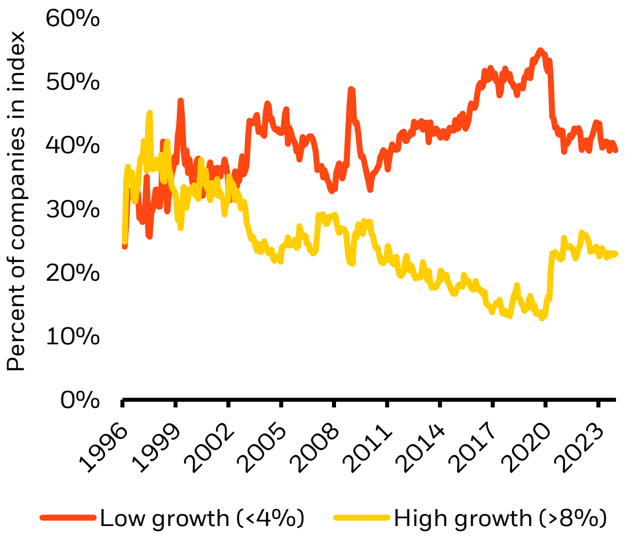
The market dips inherent in volatility can lead to mispricings, presenting opportunities for active stock pickers to purchase shares of companies with good prospects at a discount.

2 Stock dispersion normalising

Stock dispersion was muted after the GFC with little difference in return across top and bottom performers. It was a beta-driven environment in which a rising tide lifted all boats. This reduced the reward to stock pickers, as there was smaller advantage to identifying "winners" or avoiding "losers."

We see dispersion in earnings, valuations and returns increasing in the post-pandemic period, setting up an environment in which skilled stock picking can provide more meaningful contribution to portfolio outcomes. The chart below shows the percent of high-growth versus low-growth companies in the MSCI World Index across time, with the current gap large enough to suggest potential for skilled stock picking to generate outperformance.

All stocks are not created equal
Revenue growth dispersion, 1996-2023

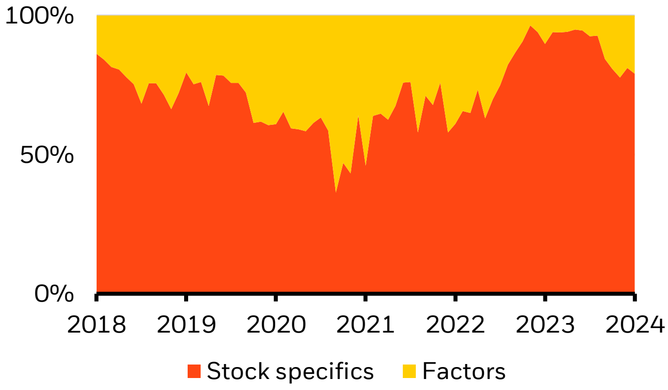


Sources: Datastream, I/B/E/S and Goldman Sachs Global Investment Research, as of Dec. 31, 2023. Chart shows revenue growth as represented by sales growth estimates for companies in the MSCI World Index.

3 Stock specifics gaining influence

Our data further finds that the dispersion in returns is more recently based on stock-specific variables and less on the factor characteristics of the stocks (e.g., growth vs. value, small vs. large), which were more dominant in 2020 and 2021. See chart below. While the continuation of this trend cannot be assured, we believe active selection focused on fundamentals can have greater bearing on investor outcomes. We also expect to see an increasing shift in focus from macro concerns at large to how individual companies are able to navigate an environment of slower growth and higher inflation and rates, making company specifics more important to investment decision-making.

Stock specifics driving dispersion
Decomposition of stock return dispersion, 2018-2024



The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results. Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index. Source: BlackRock Risk & Quantitative Analysis, June 2024. Chart shows the decomposition of stock return dispersion for the MSCI World Index broken out by factors and stock specifics.

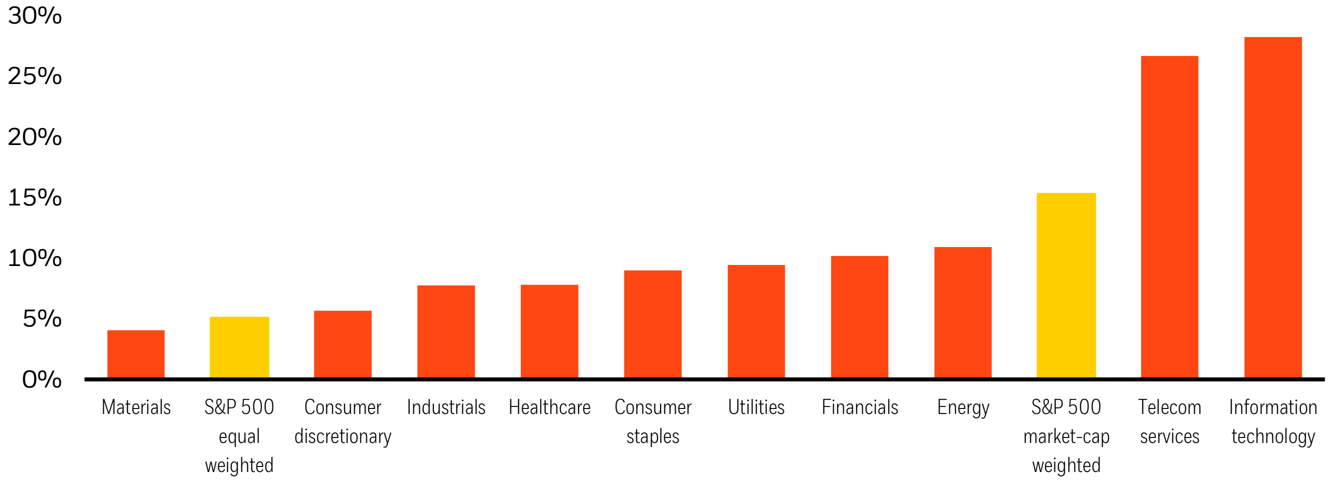
What is alpha?

Alpha is a measure of excess return above that offered by the broad stock market. It is the counterpart to beta, which is the market average. Beta is what one would receive by tracking an index. Active investors seek alpha by selectively choosing stocks in pursuit of returns beyond the index average. Beta was appealing (or sufficient) in the era of low rates, low inflation and low volatility. We see alpha being more important to investor objectives and outcomes as market returns normalise down to historic averages, market dynamics grow more complex and stock dispersion increases.

* Equity volatility as measured by the VIX index. Data from Refinitiv DataStream, July 2024.

A tale of two markets

S&P 500 Index performance by sector, year-to-date 2024



The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results. Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index. Source: BlackRock Investment Institute, with data from Refinitiv, June 28, 2024. Chart shows the year-to-date return of the S&P 500 Index both market-cap weighted and equal weighted (in which each of the index's 500 stocks is proportioned at equal measure) and each sector in the index.

4 Market breadth poised to widen

Market breadth is historically narrow, with 27% of the S&P 500 Index's market cap attributed to the top five stocks as of June 30, 2024. This compares to just under 16% pre-COVID (year-end 2019) and 13% ahead of the GFC (year-end 2007), according to data from Refinitiv. Comparing the index's market cap-weighted and equal-weighted returns illustrates just how much the mega-cap stocks — primarily tech-related shares across IT and telecom services — have driven index performance in the U.S. this year. See chart above. As the market increasingly acknowledges and values company fundamentals, we expect market breadth to widen beyond the current leaders and create greater opportunity for active stock pickers with the research capabilities to identify companies with strong fundamentals and attractive long-term growth prospects.

5 AI-driven opportunity and disruption

Given its wide reach and immense potential, we see artificial intelligence (AI) contributing to increased dispersion in the marketplace. Among software companies, for example, we believe the winners will successfully incorporate AI into their products and be able to raise prices while those that fail will become obsolete. Elsewhere in technology, we could see some companies using AI to increase profitability while others merely experience it as a cost of doing business. The impact is not limited to the tech sector. Across industries, we expect new business models will arise, powered by AI innovation, and others will be disrupted (e.g., call centers where humans are displaced by chat bots). Understanding of AI use cases, implications and risks across sectors, industries and individual stocks will have growing influence on investment outcomes, in our view.

The return of stock market dispersion

In the regime now forming — the post-pandemic era — stock valuations, inflation and interest rates are all higher. Supply is being constrained by demographic trends (aging populations and fewer workers), deglobalization and decarbonisation, all of which are inflationary as companies spend to adapt. Going forward, developed market central banks are more likely to be in a position of having to fight inflation rather than bolster the economy, a less friendly scenario for financial markets.

Equities historically have been the highest-returning asset class over the long term, and we see nothing to alter that precedent.* However, higher stock valuations than at the start of the prior regime plus higher interest rates mean less return from markets broadly (beta), in our view. We see more dispersion in earnings estimates, valuations and stock returns — and this suggests greater opportunity for skilled managers to generate more alpha. The result, in our view, is that the years ahead will see active return being a bigger part of investors' overall return profiles.

*Past performance is not a reliable indicator of current or future results.

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