
A MOMENT IN MARKETS – NAVIGATING EQUITY MARKETS IN THE YEAR AHEAD

Mobeen Tahir – Director, Research
20 Jan 2021

The conundrum

Is there a coherent way to think about equities and have a strategy for the year ahead?

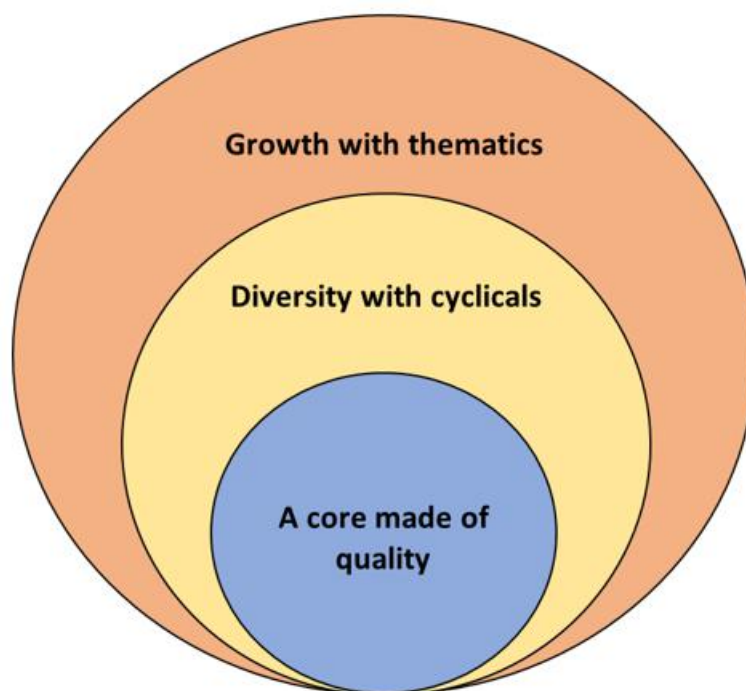
We have just concluded a tumultuous year for asset markets. In March, equities endured volatility reminiscent of levels previously seen during the global financial crisis. What followed thereafter was an equity rally that many touted as being disconnected with the economic reality. The recovery in markets, however, was not evenly distributed and returns were not stellar across the board. While the NASDAQ Composite Index was up over 43% last year, the Euro Stoxx 50 Index ended the year down 5%¹ (in USD and EUR respectively).

Investors are intrigued by the possibilities and opportunities in the year ahead. Was the strength in the tech sector transient or will the dominance continue? Are we going to see a reincarnation of value after the challenges faced by a multitude of sectors last year? And most importantly, how do all the different pieces come together?

Here we offer one approach for conceptualizing these problems and developing a cohesive example framework for investing in equities this year. Every investor should make their own decision in establishing their investment needs and constraints to determine how this, or any other framework, can aid their decision making.

The proposed framework

The framework is comprised of three key components (see figure below) which together add diversity and balance. Each component has an important role to play.



Source: WisdomTree. For illustrative purposes only.

1. A core made of quality:

Quality is an ‘all-weather’ factor that promises balance, i.e., the ability to protect against market downturns without foregoing participation in the upside. ‘Quality’ refers to strong and stable businesses that are profitable and typically have relatively low leverage. This enables them to better withstand downside shocks. Since such businesses can exist in any sector, quality does not cause the core of the portfolio to lose its diversity if it supplements or replaces a pure beta exposure.

With many major economies including the US and those in Europe still reeling from the pandemic, the desired economic recovery this year cannot be anticipated entirely without perils. Bankruptcy, in the face of economic challenges, remains one of the key risks facing businesses in the year ahead. Those companies that entered the pandemic with a strong balance sheet and have stayed profitable enough through the ordeal, make a case to constitute the core exposure.

2. Diversity with cyclicals:

Pockets of the global equity market that are poised to benefit from an economic upswing, that may already have started or is impending depending on where you look, can add diversity and growth potential to the portfolio. Numerous avenues can be explored within this component.

Small caps are one of those avenues. Small-cap stocks typically have a high beta with the underlying economy. The buoyancy in stock markets since vaccine news took centre stage in November has helped small caps outpace large caps in various markets, e.g., the

Russell 2000 Index has overshadowed the S&P 500 Index since the start of November². As the economic recovery gathers steam, small caps are likely to pick up pace too.

The notion of ‘diversity’ in equity markets is almost incomplete without emerging markets, particularly China. The country’s success in overcoming the pandemic and swiftly putting its economic recovery on track stands in stark contrast with other major economies. China has recently reiterated its growth ambitions with a new five-year plan and is reaffirming its global stature through trade and investment deals with partners in the Asia Pacific region as well as the European Union. China’s strength is expected to permeate into emerging markets more broadly which may find additional support from a weak US dollar.

‘Value’, if defined as businesses or sectors that have faced headwinds from the pandemic and the resulting economic downturn, have an improving outlook as we emerge from the crisis. Within this framework, whether value will outperform growth is not a critical question as the two can coexist in separate buckets.

3. Growth with thematic:

The notion of growth is increasingly shifting away from stocks with positive momentum to businesses that align more closely with megatrends. Structural shifts in markets offer investment opportunities that promise growth and offer a potentially longer shelf life. Investors appear to be placing their faith in such themes as they are built on the principle of ‘market-creating innovation’, i.e., a process that creates new demand which stems from doing things that have not been done before.

Tech-related themes fall neatly within this bracket because of the innovation they bring and how they continue to positively disrupt the status quo. The advent of the smartphone just over a decade ago created a whole new economy of applications and instilled growth which would have been difficult, if not impossible, to foresee. For this reason, future innovation becomes challenging to price in and comes as a positive surprise when it happens. Growth potential is also why markets might not necessarily anguish over elevated valuation multiples for the tech sector. In some cases, like Tesla, the valuation multiples may even be absurd and defy conventional finance wisdom.

Many investors who sought such themes last year reaped attractive rewards, e.g., some cloud computing strategies more than doubled in value over the year. The growing interest in thematic investing is therefore unlikely to be transitory and may accelerate as a trend itself this year. Having a thematic component in the example framework to complement the core and the diversifiers can add an exciting element of growth potential.

Conclusion

How to weight the different components and how the equity allocation fits within a broader portfolio are all important considerations for an investor to make. The framework illustrated here is a first step in that discussion and should help synthesize an equity strategy in a year that might present many opportunities for investors.

¹ Source: Bloomberg as of 19 January 2021

² as of 19 January

Related blogs

- + [A moment in markets Is all the vaccine good news priced in](#)
- + [A moment in markets Tailwinds for China may get stronger still](#)

Related products

- + [GGRA/GGRG WisdomTree Global Quality Dividend Growth UCITS ETF - USD Acc](#)
- + [DFEE/DFE WisdomTree Europe SmallCap Dividend UCITS ETF](#)
- + [VOLT - WisdomTree Battery Solutions UCITS ETF - USD Acc](#)
- + [WCLD - WisdomTree Cloud Computing UCITS ETF - USD Acc](#)
- + [WTAI - WisdomTree Artificial Intelligence UCITS ETF - USD Acc](#)
- + CHIC/CHIN/CHIP ICBCCS WisdomTree S&P China 500 UCITS ETF Class B - USD

View the online version of this article [here](#).

Important Information

Marketing communications issued in the European Economic Area (“EEA”): This document has been issued and approved by WisdomTree Ireland Limited, which is authorised and regulated by the Central Bank of Ireland.

Marketing communications issued in jurisdictions outside of the EEA: This document has been issued and approved by WisdomTree UK Limited, which is authorised and regulated by the United Kingdom Financial Conduct Authority.

WisdomTree Ireland Limited and WisdomTree UK Limited are each referred to as “WisdomTree” (as applicable). Our Conflicts of Interest Policy and Inventory are available on request.

For professional clients only. The information contained in this document is for your general information only and is neither an offer for sale nor a solicitation of an offer to buy securities or shares. This document should not be used as the basis for any investment decision. Investments may go up or down in value and you may lose some or all of the amount invested. Past performance is not necessarily a guide to future performance. Any decision to invest should be based on the information contained in the appropriate prospectus and after seeking independent investment, tax and legal advice.

The application of regulations and tax laws can often lead to a number of different interpretations. Any views or opinions expressed in this communication represent the views of WisdomTree and should not be construed as regulatory, tax or legal advice. WisdomTree makes no warranty or representation as to the accuracy of any of the views or opinions expressed in this communication. Any decision to invest should be based on the information contained in the appropriate prospectus and after seeking independent investment, tax and legal advice.

This document is not, and under no circumstances is to be construed as, an advertisement or any other step in furtherance of a public offering of shares or securities in the United States or any province or territory thereof. Neither this document nor any copy hereof should be taken, transmitted or distributed (directly or indirectly) into the United States.

Although WisdomTree endeavours to ensure the accuracy of the content in this document, WisdomTree does not warrant or guarantee its accuracy or correctness. Where WisdomTree has expressed its own opinions related to product or market activity, these views may change. Neither WisdomTree, nor any affiliate, nor any of their respective officers, directors, partners, or employees accepts any liability whatsoever for any direct or consequential loss arising from any use of this document or its contents.