Callan

Equity Investing

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What is Public Equity?

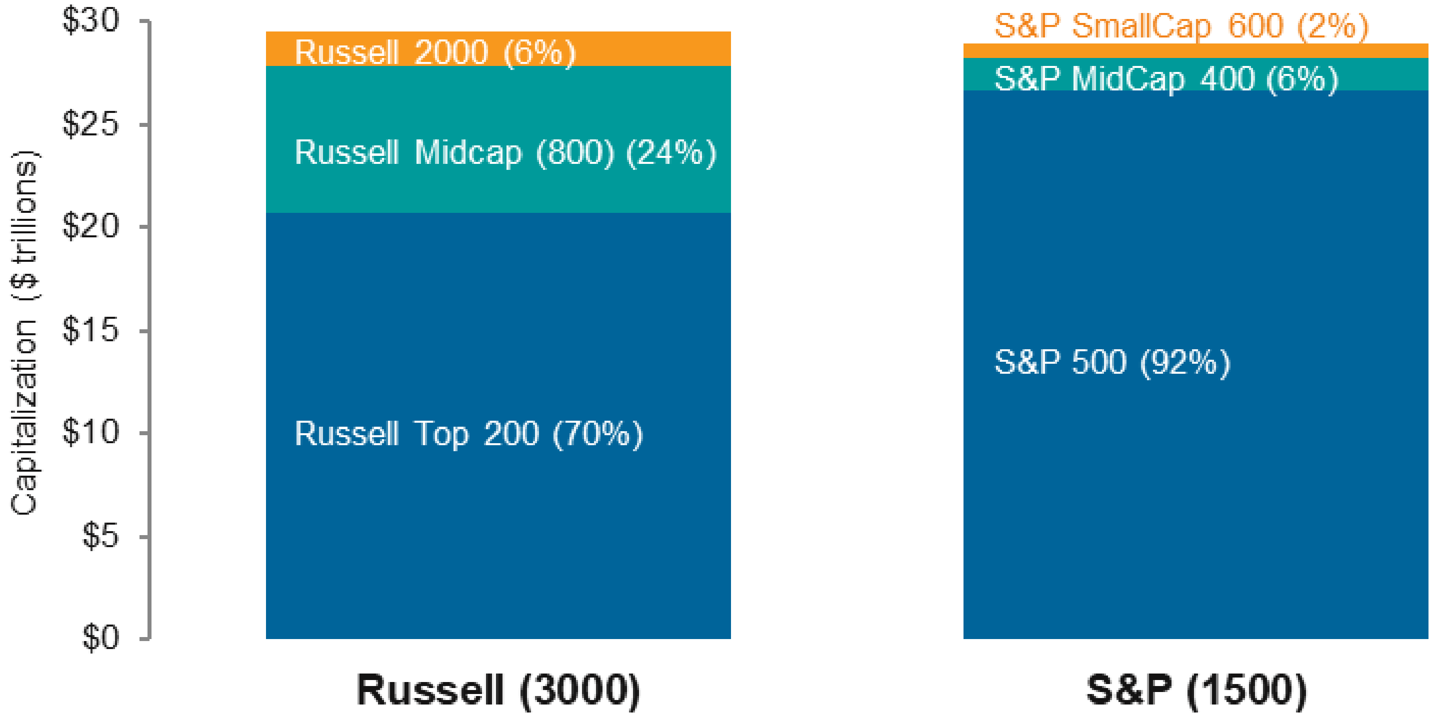
- Public equity is an investor’s ownership interest of a business or other type of asset. It is represented on a company’s balance sheet by subtracting the company’s assets by its liabilities.
- Companies can raise capital to grow its business by issuing publicly traded stocks to investors.
- Public equity is liquid, as most publicly traded stocks are available and easily traded daily.
- Stock market prices should reflect all available, relevant information about the actual value of the underlying assets of a business.

Breaking Down the Market

- Public equities can be broken down into various categories:
  - Capitalization: found by multiplying the total number of a company's outstanding shares by the current market price of one share. Equity Markets are divided by market cap into Large (greater than $10 billion), Mid ($2 to $10 billion), and Small($250 million to $2 billion).
  - Region: U.S. (domestic) and non-U.S. (international), developed markets vs. emerging markets. The current breakdown of the world equity markets is ~60% U.S. and ~40% ex-U.S. The international market is ~2/3 developed and 1/3 emerging markets.
  - Style: generally defined by the investment approach or objective, and characteristics of the business. Markets are divided by growth vs. value, cyclical versus defensive, etc.

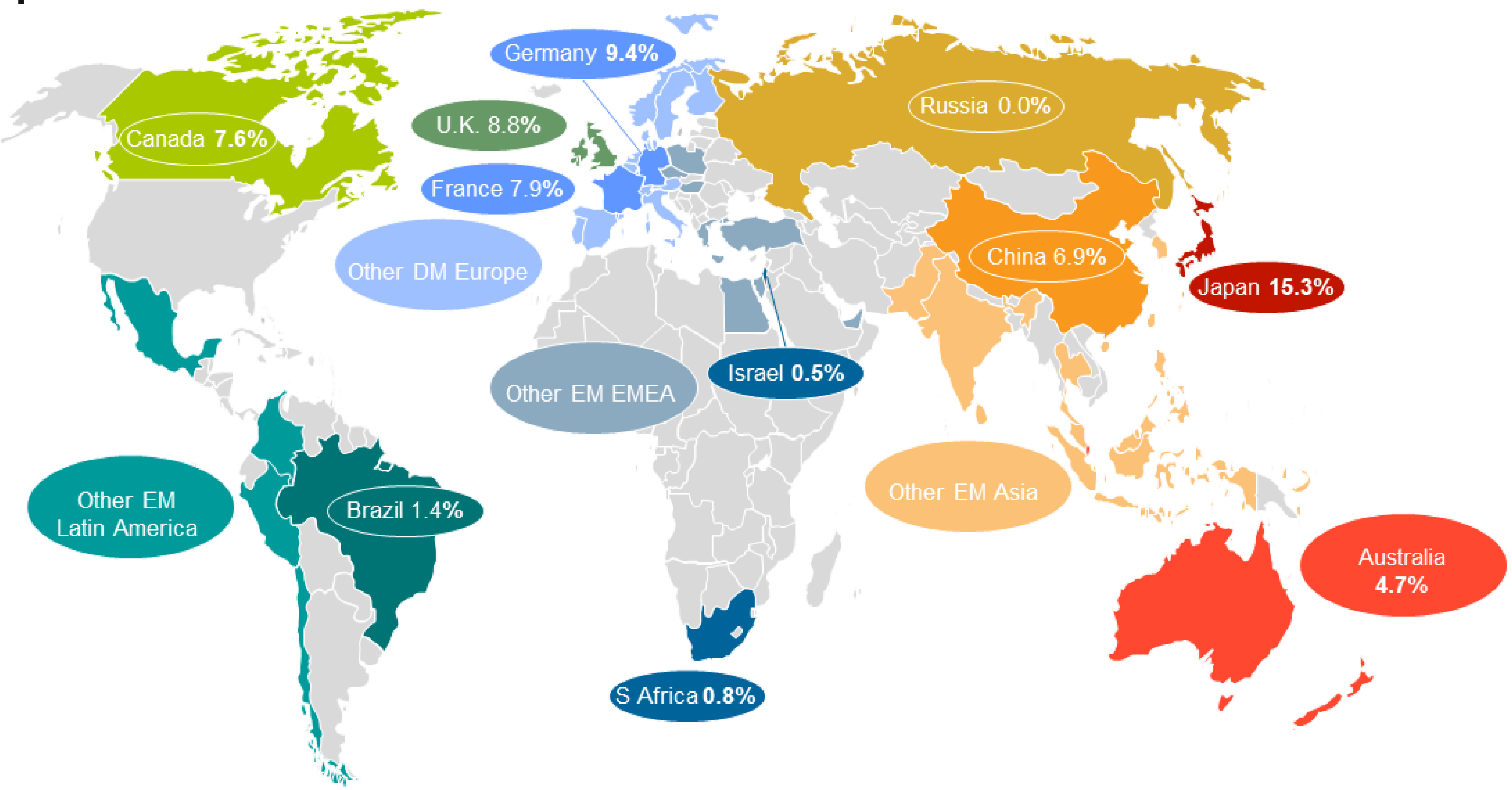
U.S Equity Benchmarks

- Russell's broad market index covers approximately 98% of the U.S. market with approximately 3000 securities; and the S&P's broad market benchmark captures approximately 96% of the market with about 1,500 securities.
- Despite their popularity with pundits, the Dow Jones and NASDAQ are relatively concentrated and rarely used amongst institutional investors.



Non-U.S Equity Benchmarks

- MSCI ACWI ex US Index: includes large and mid cap stocks in developed (EAFE) and emerging markets (EM).
  - Total market cap = approx. $26 trillion or 85% of companies by market cap listed outside the U.S.
  - 67% developed markets
  - 33% emerging markets



Source: MSCI country weights as of 03/31/2024

Equity Investing Styles

- Value Investing: strategies that seek companies that are undervalued relative to the market, with low price-to-earnings or price-to-book ratios.
- Growth: strategies that seek companies experiencing faster growth in revenue and earnings relative to the market, with high price-to-earnings or price-to-book ratios.
- Quantitative Investing: strategies that utilize a statistical model to systematically rank securities based on criteria that have been identified by managers to generate excess returns. Aims to remove human emotion and subjectivity.
- Fundamental Investing: investment approach that focuses on identifying the intrinsic value of a company through intense financial statement analysis, speaking with company management, evaluating macro trends, and determining where there is unrecognized value.

Why Invest in Public Equity?

- Public equity historically has offered higher long-term returns than all asset classes, other than private equity.
- Stocks tend to offer long-term protection against price inflation, However, they do not necessarily provide short-term inflation protection.

Returns for Periods Ended December 31, 2023

	Last Quarter	Last Year	Last 3 Years	Last 5 Years	Last 10 Years	Last 15 Years	Last 20 Years	Last 25 Years
Russell 3000 Index (Broad US)	12.07	25.96	8.54	15.16	11.48	13.84	9.67	7.74
Russell 1000 Index (Large Cap US)	11.96	26.53	8.97	15.52	11.80	14.02	9.78	7.72
Russell 2000 Index (Small Cap US)	14.03	16.93	2.22	9.97	7.16	11.30	8.11	7.91
MSCI ACWI ex US Index (Non-US)	9.75	15.62	1.55	7.08	3.83	6.74	5.68	--
MSCI EAFE Index (Developed ex-US)	10.42	18.24	4.02	8.16	4.28	6.93	5.59	4.43
MSCI Emerging Markets Index (Emerging Markets)	7.86	9.83	(5.08)	3.69	2.66	6.56	6.83	--

Equity Returns

Equity Return = Capital Appreciation + Income +/- Valuation Adjustment

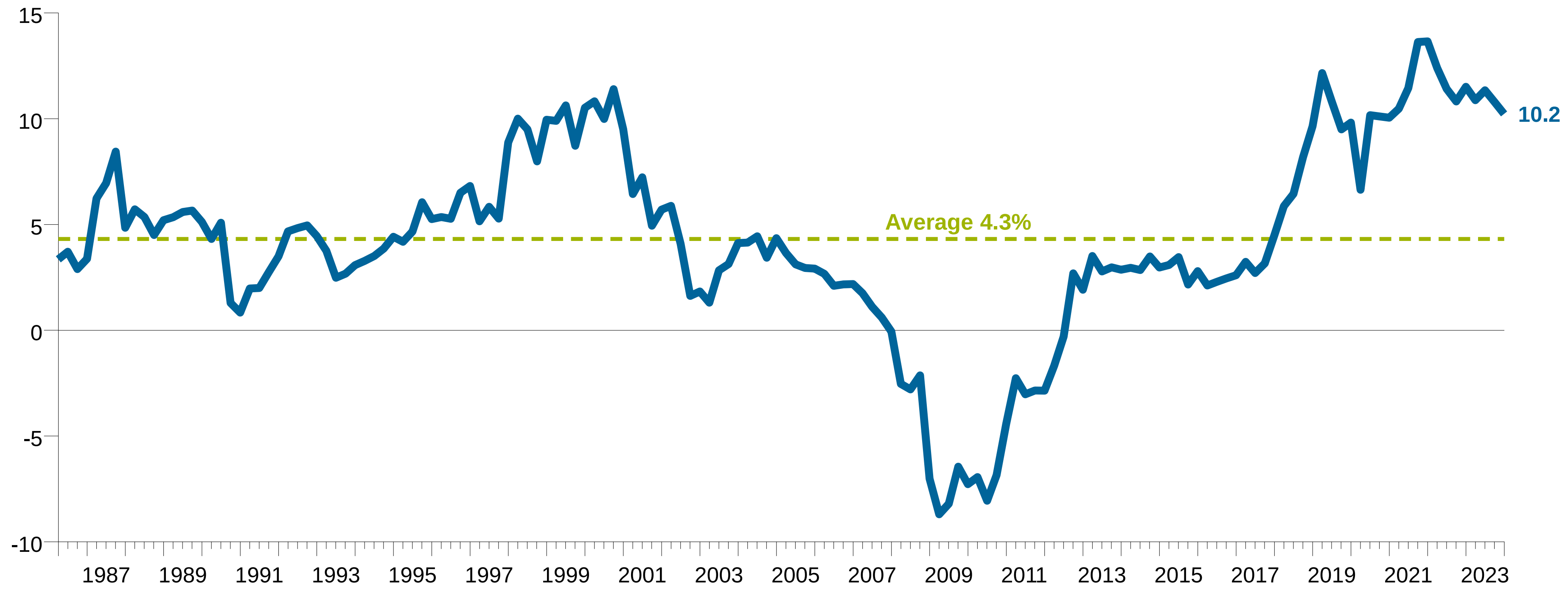
Components of Equity Returns:

- Capital Appreciation comes from a combination of real earnings growth and inflation.
- Income comes from a combination of dividends and share buybacks.
- Stock valuations are adjusted based on an investor’s discount rate. When discount rates increase, stock valuations decrease, when discount rates fall, stock valuations increase.

Equity Risk Premium

- The equity risk premium is the incremental return an equity investor expects to receive when investing in the stock market for incurring the additional risk compared to a risk-free investment like government bonds. The equity risk premium will fluctuate over time based on market fundamentals and investor psychology.

S&P 500 Rolling 40 Quarter Excess Return Relative to Bloomberg Aggregate



Sources: Bloomberg, S&P Dow Jones Indices

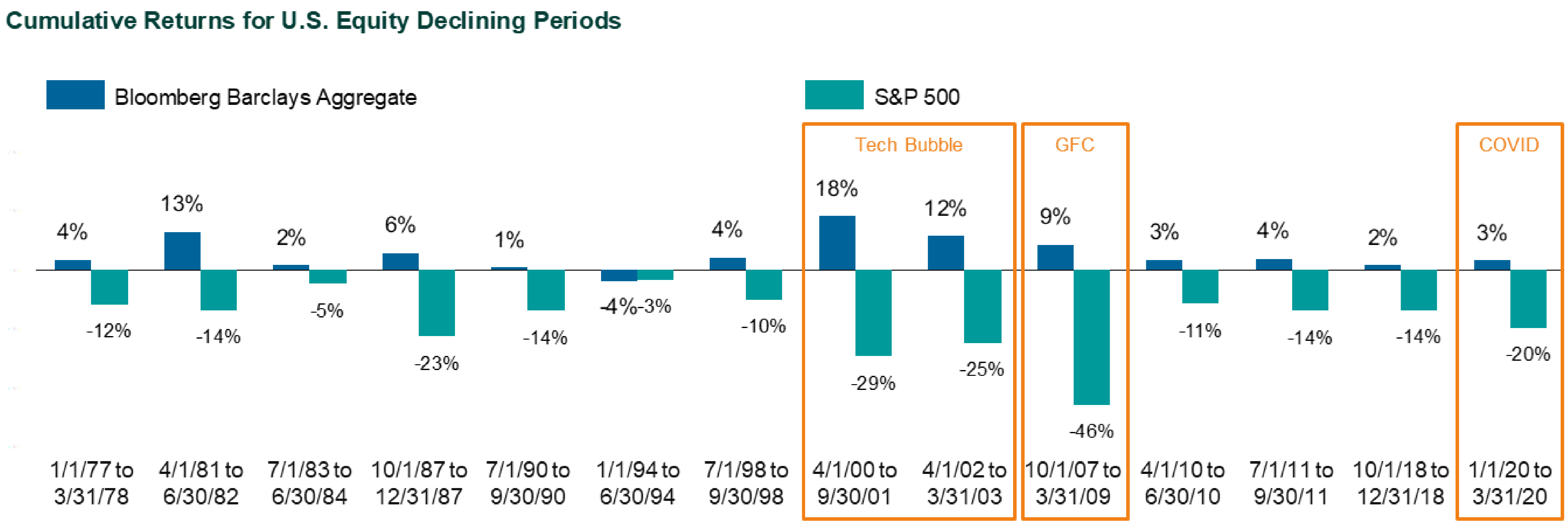
Why does Risk Matter?

- Beyond the negative psychology of experiencing large losses, the sequence of returns matter for public funds' equity portfolios. Compounding hard dollars means that more consistent performance (i.e. lower standard deviation) results in better outcomes. This is especially important for public funds experiencing negative cash flows.

	Average 10-Year Return	Standard Deviation	Compounded Return
Equity Portfolio 1	8.70%	17.00%	7.50%
Equity Portfolio 2	8.70%	20.00%	7.00%
Equity Portfolio 3	8.20%	17.00%	7.00%

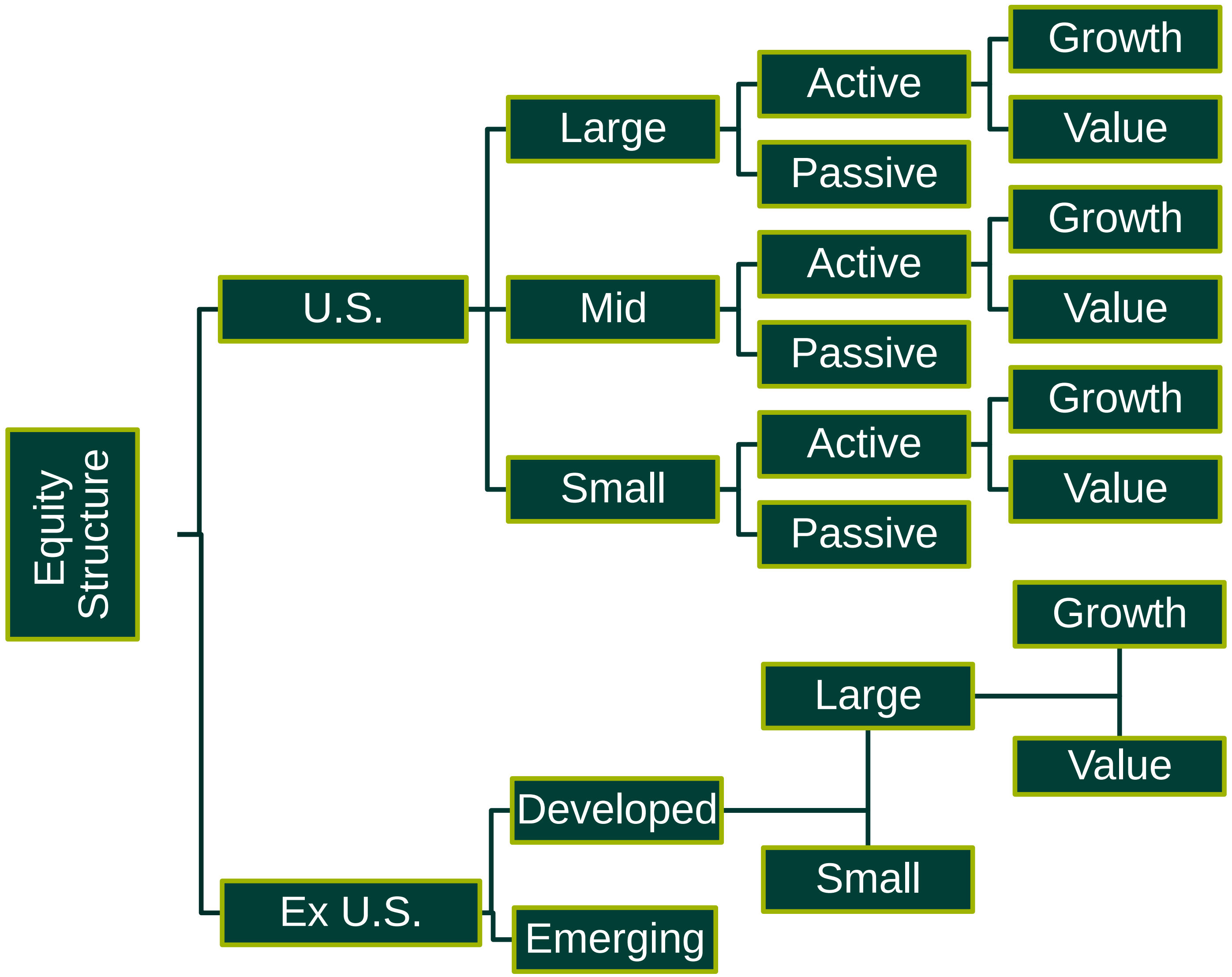
Equity's Role

Equity's role within an investor's asset allocation is to provide long-term growth. The role of fixed income is to serve as a low-risk, diversifying anchor against the growth of equity investments.



Equity Portfolio Structure

- When designing an equity portfolio, the typical starting point is neutral to the market (no biases). Deviations are warranted only where there are opportunities to strategically add value.
- Equity portfolios are typically broken down by:
  - Region
  - Market Capitalization
  - Style
  - Active versus Passive



Active versus Passive Investing

- Passive Investing: strategy that involves buying and holding a diverse portfolio of securities, typically aiming to match the performance of a specific market index. Passive investing incurs significantly lower investment management fees compared to active management fees.
- Active Investing: strategy that seeks to achieve excess returns (net of fees) relative to a market index by exploiting market inefficiencies through sector allocation and stock selection.

Average Annualized 3-Year Excess Return (gross) - Median Active Manager over last 20 Years (ending March 31, 2024)					
Large Cap vs. Russell 1000 Index	Mid Cap vs. Russell Mid Index	Small Cap vs. Russell 2000 Index	Non-U.S. vs. MSCI ACWI ex-U.S. Index	Developed vs. MSCI EAFE Index	Emerging Markets vs. MSCI EM Index
-0.11%	-0.32%	1.12%	1.23%	0.96%	0.95%

Evaluating Performance

- When evaluating active managers, they should have two benchmarks:
  - A market index, which represents the universe of securities the sub-advisor could buy (the passive alternative for achieving the same market exposure); and
  - A style group of sub-advisors who follow a similar investment strategy (the active alternatives to achieving similar market exposure).
- Over the long-term active managers, regardless of style, should outperform an appropriate market index or there is no value in paying active fees. Over the shorter-term, styles of investing will go in and out of favor and during these shorter periods managers can be most effectively evaluated against managers of similar style (style groups).

Evaluating Performance

- Equity portfolio attribution is determined by three factors:
  - Sector Allocation: relative return attributed to the manager's decision to over- or under-weight a sector relative to the index weighting.
  - Security Selection: added return contribution made by individual stock selection within a given sector.
  - Regional Allocation: relative return attributed to the manager's decision to over- or under-weight a country relative to the index weighting.

Attribution Effects by Sector vs. Russell 2000 Growth Index
One Quarter Ended September 30, 2020

Sector	Manager Eff Weight	Index Eff Weight	Manager Return	Index Return	Sector Concentration	Security Selection	Asset Allocation
Communication Services	2.93%	2.60%	(2.50)%	(1.32)%	(0.02)%	(0.07)%	-
Consumer Discretionary	13.29%	13.18%	26.13%	17.09%	(0.07)%	1.22%	-
Consumer Staples	1.30%	3.24%	(3.55)%	9.78%	(0.03)%	(0.20)%	-
Energy	0.00%	0.17%	0.00%	(6.00)%	0.02%	0.00%	-
Financials	8.12%	4.26%	3.47%	5.07%	(0.06)%	(0.10)%	-
Health Care	30.84%	33.35%	15.47%	4.38%	0.08%	3.41%	-
Industrials	14.57%	13.55%	12.55%	15.32%	0.08%	(0.37)%	-
Information Technology	22.37%	21.30%	2.24%	3.19%	0.01%	(0.23)%	-
Materials	1.89%	2.70%	9.03%	6.53%	0.01%	0.05%	-
Real Estate	4.70%	3.84%	14.77%	6.71%	(0.03)%	0.39%	-
Utilities	0.00%	1.81%	0.00%	(3.67)%	0.21%	0.00%	-
Non Equity	2.60%	0.00%	-	-	-	-	(0.51)%
Total	-	-	10.95%	7.16%	0.20%	4.11%	(0.51)%

Market Timing

Given the volatility of equity, it should be treated as a long-term holding. Timing the market is incredibly difficult and few investors have been consistently successful at moving in and out of public equity at the right time.

S&P 500 Index Best Days: 1994–2023

S&P 500 Index Average Annual Total Returns: 1994–2023

Sources: Ned Davis Research, Morningstar, and Hartford Funds

Key Takeaways

- Equity is a core building block for providing growth to any institutional investor's portfolio, exhibiting high return expectations with higher risk.
- Equity portfolios can be broken down by size (market cap), style (value versus growth), and region (U.S., ex-U.S., emerging markets). Investment managers can be broken down into active or passive. Active managers can be further broken down by their implementation style (quantitative, fundamental, etc.)
- Active equity managers should be evaluated relative to a benchmark (passive alternative) and peer group (active alternatives). Investors should evaluate performance based on both returns and risk.
- The equity market is volatile and investors should avoid timing the market. Open public funds have a near perpetual time horizon to absorb market volatility and equity should be treated as a long-term investment.