How we cover equities

Our CIO framework

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Contents

The CIO global equity framework
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Introduction

Foreword

One of the most important lessons I have learnt in over two decades as an equity investor in a macro fund is surprising given our industry's structure.

In 1999, as a new trader, I was welcomed into the firm with a copy of Larry Livingston's "Reminiscences of a Stock Operator." On my first read through, I circled the phrase "A stock operator has to fight a lot of expensive enemies," not fully aware of who or what these "expensive enemies" were.

Over the next 25 years while working in different investing roles, I made sense of it: They are the blind spots that emerge when analyzing the market from a single perspective. The stock market is elusive—once you think you have understood its drivers, they change.

In the late 90s, equity investors had to understand the transformational power of the internet. Then, in the 2000s, the stock market rewarded those who pivoted their focus to the impact of higher rates and company valuations.

More recently, investors had to contend with higher interest rates, the result of the enormous fiscal and monetary stimulus unleashed during the pandemic. This shifted the digital acceleration narrative to one about the higher opportunity cost of capital. It also sparked the regional banking sector crisis in early 2023, which was in large part the echo of the idea (or hope) that real rates would forever be zero. Fundamental analysis of bank balance sheets, especially the duration mismatch between assets and liabilities, helped draw awareness to the potential for broader financial risks.

Now, with the launch of ChatGPT, we are in the era of generative AI. This technology has ushered in an innovation cycle that, in the eyes of the stock market so far, has trumped the expected slowdown in economic growth.

It's difficult to predict when the market perspective will shift. Having multiple relevant perspectives in mind helps navigate this dynamic. For equity investing, I have found the three most relevant perspectives to be: 1) macro, 2) micro (including company-specific drivers), 3) transformational (structural changes). What is interesting is that these views are isolated from each other by the institutional structure of our industry—there are macro funds, equity funds, and sector funds, each looking at the market from a siloed perspective.

In my experience, a combination of these three investment perspectives is key to achieving superior equity returns. Seeing multiple perspectives is like juggling balls in the air—it requires focus. A framework helps keep these distinct viewpoints in focus. The three perspectives—macro, micro, and transformational—serve as the pillars of our new global equity framework.

Ulrike Hoffmann-Burchardi
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Chapter 1

Macroeconomics

How macro factors affect stock performance

The state of the economy—measured by GDP, unemployment, and inflation—as well as fiscal and monetary policies impact equity markets. Of these, real GDP growth has the largest influence on stock prices. For the US, according to our analysis, real GDP growth explains over 21% of quarterly S&P 500 returns over the last 30 years (excluding 2020 data).

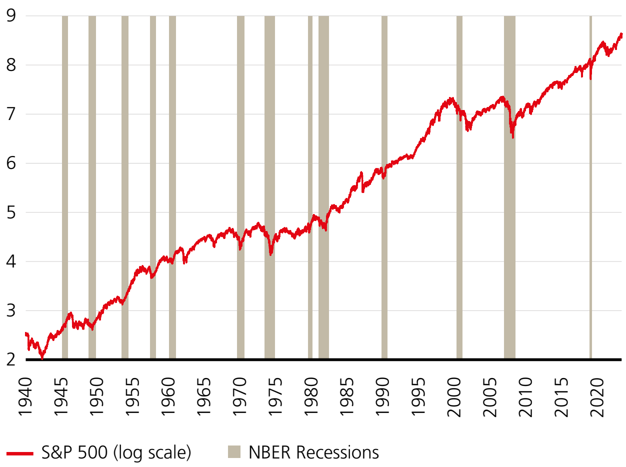
Another way to look at the impact of economic growth on equities is to analyze recessionary periods. Equities rarely go down significantly outside of a recession. A drawdown larger than 20% only happened three times since 1945 without a recession taking place within 12 months (before or after). The bear market of 1966 was caused by rising inflation in the wake of increased government spending. In 1987, a combination of rising rates, program trading, and portfolio insurance triggered "Black Monday," when the Dow Jones fell by 22.6%, the largest one-day percentage decline in history. More recently in 2022, a combination of post-COVID stimulus, supply chain disruptions, and soaring commodity prices led to an inflation spike. This forced central banks to rapidly increase rates, ultimately resulting in a drawdown of over 20% for the S&P 500.

From a top-down lens, one of the most important factors for making equity market calls is therefore anticipating the direction of economic growth.

Figure 1

Significant drops in equities usually coincide with recessionary periods

S&P 500 returns and US recessions since 1940



Source: Bloomberg, UBS, Aug 2024

Figure 2

An overview of drawdowns, recessions, and growth

Focusing on drawdowns beyond 20% for the S&P 500 since 1945

Start	End	Max DD	Recession +/- 12m	Recession start	Recession end	Real GDP change
29.05.1946	19.05.1947	-28.5%	yes	1Q 1945	4Q 1945	NA
02.08.1956	22.10.1957	-21.6%	yes	3Q 1957	2Q 1958	-2.0%
12.12.1961	26.06.1962	-28.0%	yes	2Q 1960	1Q 1961	-0.7%
09.02.1966	07.10.1966	-22.2%	no			
29.11.1968	26.05.1970	-36.1%	yes	4Q 1969	4Q 1970	-0.7%
11.01.1973	03.10.1974	-48.2%	yes	4Q 1973	1Q 1975	-2.2%
28.11.1980	12.08.1982	-27.1%	yes	1Q 1980	3Q 1980	-1.9%
25.08.1987	04.12.1987	-33.5%	no			
24.03.2000	09.10.2002	-49.1%	yes	1Q 2001	4Q 2001	0.2%
09.10.2007	09.03.2009	-56.8%	yes	4Q 2007	2Q 2009	-3.2%
19.02.2020	23.03.2020	-33.9%	yes	4Q 2019	2Q 2020	-9.2%
03.01.2022	12.10.2022	-25.4%	no			

Source: Bloomberg, UBS, Aug 2024

The relationship of equity markets with real rates is more nuanced. On average, there is no statistically significant relationship between real rates and equity market returns. However, when inflationary expectations pick up, the correlation between real rates and quarterly returns turns negative, even if not statistically significant.

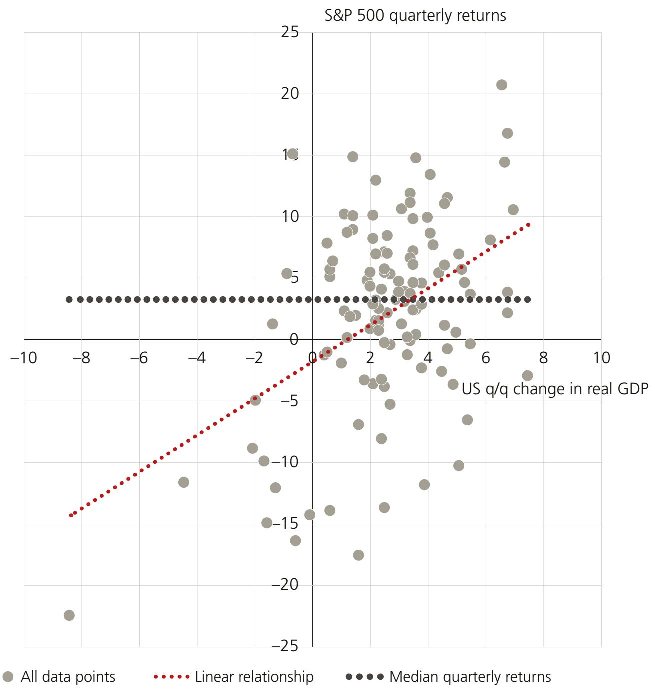
Just because the linear relationship between equities and real rates is weak does not mean that rates are not important for equities. At turning points in monetary policy, rates and the dot plot play a critical role for equity returns. One such turning point was 30 November 2021, when Federal Reserve Chair Jerome Powell no longer used the word "transitory" to describe the high rate of inflation—a clear sign that the Fed was shifting to tighter monetary policy. Ten-year interest rates rose from 1.5% to close to 4% over the course of 2022, while the S&P 500 declined 25%.

> Just because the linear relationship between equities and real rates is weak does not mean that rates are not important for equities.

Figure 3

Relationship between S&P 500 quarterly returns and US quarterly real GDP growth

Non overlapping data. Sample period between 1994-2024 (excl. 2020), in %

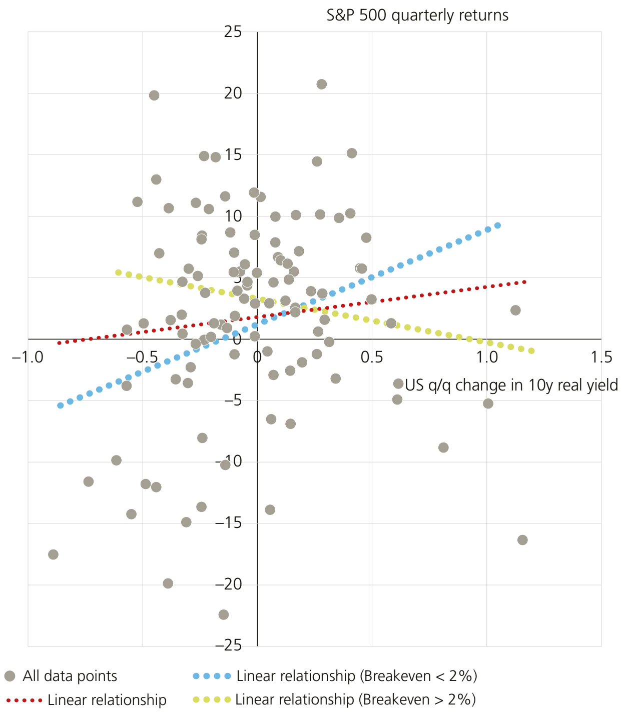


Source: Bloomberg, UBS, Aug 2024

Figure 4

Relationship between S&P 500 quarterly returns and 10-year US real yields quarterly changes

Non overlapping data. Sample period between 1998-2024, in %



Note: Breakeven = 10 year break even inflation rate
Source: Bloomberg, UBS, Aug 2024

Chapter 2

Micro fundamentals

How company-specific factors affect stock performance

The one statistic that is worth a frequent reminder is that 1% of firms have created more than 80% of net wealth in the global equity markets over the last 30 years[1]. Fig. 5 shows just how concentrated the contribution to equity market returns has been.

Figure 5

Wealth created by the best-performing 1% of global firms

As a % of total net wealth created. Sample period: 1990 - 2020

Sample	Number of firms	% of net wealth created
Global	638	80.4%
Global (excl. US)	463	90.1%

Source: Bessembinder, Hendrik, et al. "Long-term shareholder returns: Evidence from 64,000 global stocks." Financial Analysts Journal 79.3 (2023): 33-63.

This result holds globally as well: a mere 2.4% of US companies and 1.4% of non-US firms account for 100% of stock market returns[1]. The same finding has been corroborated over longer periods for the US stock market[2].

The top wealth creator globally has been Apple, followed by Microsoft and Amazon. All three are US companies that have harnessed the power of technological innovation to create scale platforms under visionary CEOs. Our company-specific lens aims to identify incumbents that are well positioned to continue to compound their current competitive advantages and new companies that may reach a similar scale.

> A mere 2.4% of US companies and 1.4% of non-US firms account for 100% of stock market returns.

Figure 6

Wealth created by the top 10 best-performing global firms

As a % of total global net wealth created. Sample period: 1990 - 2020

Firm Name	Wealth created (USDm)	Accumulated % of global net wealth creation
APPLE INC	2,674,231	3.53%
MICROSOFT CORP	1,910,158	6.06%
AMAZON COM INC	1,569,085	8.13%
ALPHABET INC	979,133	9.43%
TENCENT HOLDINGS LTD	691,671	10.34%
TESLA INC	639,266	11.19%
WALMART INC	568,713	11.94%
FACEBOOK INC	553,675	12.67%
SAMSUNG ELECTRONICS CO LTD	540,605	13.38%
JOHNSON & JOHNSON	535,317	14.09%

Source: Bessembinder, Hendrik, et al. "Long-term shareholder returns: Evidence from 64,000 global stocks." Financial Analysts Journal 79.3 (2023): 33-63.

[1] Bessembinder, Hendrik, et al. "Long-term shareholder returns: Evidence from 64,000 global stocks." Financial Analysts Journal 79.3 (2023): 33-63.

[2] Bessembinder, Hendrik, "Shareholder Wealth Enhancement, 1926 to 2022", June 17, 2023

Chapter 3

Structural transformation

How transformational factors affect stock performance

Historically, the stock market has mirrored transformational structural changes. The make-up of the Dow Jones Industrial Average reflects how the world has changed over the last 127 years. The name of the index itself speaks to its origins: When it was created in 1896, the world had been transformed by the Industrial Revolution. The invention of the open-hearth furnace by Siemens in 1860 allowed for the mass construction of steel, crucial for industrialization and infrastructure expansion. By 1920, a third of the index was made up of steel companies. Over time, with the advent of the automobile following the Benz patent motorcar, automotive companies became prominent in the index, rising to a third of the constituents by 1930. In the 2000s, internet companies and, in the wake of recombinant DNA, pharma companies took a larger share of index membership (see Fig. 7).

Today, we think there are three transformational innovation opportunities (TRIOs) that will drive equity markets in the coming decade: artificial intelligence, power and resources, and longevity.

From 2023 to today, the most dominant structural innovation has been generative artificial intelligence (AI), unleashed by the launch of ChatGPT in November 2022. About half of the appreciation in the MSCI World Index since then has been driven by leading AI companies. The dividing line between winners and losers inside the technology, consumer, and communication services has equally been delineated by AI.

Besides AI, in this year and last, electrification has driven most of the returns for the energy, industrials, utilities, materials, and real estate sectors, whereas GLP-based obesity drugs have been responsible for the biggest gainers in health care. Of the top 10 best performing stocks in the S&P 500 during the first half of this year, five benefit from AI, three from power and resource innovation, and one from longevity—combined, they make up close to 40% of the stock market's entire appreciation.

All three of these transformational drivers—AI, power and resource innovation, and longevity—are likely to impact global equity markets over the next decade.

It is surprising that this perspective of structural change is the least institutionally acknowledged. While there are many "macro" funds, there are few "structural alpha" funds that invest into the largest transformational structural trends of our times. We see an opportunity to closely align our equity investment decisions with the alpha opportunity stemming from new transformational innovation.

All three of these transformational drivers—AI, power and resource innovation, and longevity—are likely to impact global equity markets over the next decade.

Figure 7

How structural transformation has affected the Dow's composition

Structural transformation	Years	% DJ constituents (max)	Trigger event
Industrialization (steel constructions)	1896-1920	33%	Open hearth furnace (Siemens patent 1860)
Automotives	1900-1930	30%	Benz patent (1886)
Electrification	1910-1930	20%	Tesla AC polyphase system (1893)
Internet era	1990-2024	10%	WWW (1989)
Health care	2000-2020	17%	Recombinant DNA (1974), Orphan drug act (1983), PFUFA (1992)

Source: UBS

Figure 8

AI, power and resource innovation, and longevity drove the US market rally in the first half of the year

Top 10 best performing S&P 500 stocks in 1H24

Firm Name	% of S&P 500 net market cap gains	1H24 performance (%)
SUPER MICRO COMPUTER	0.5%	188.2%
NVIDIA	30.2%	149.5%
VISTRA	0.3%	123.2%
CONSTELLATION ENERGY	0.4%	71.3%
GE AEROSPACE	0.6%	56.2%
ELI LILLY	5.1%	55.3%
MICRON TECHNOLOGY	0.9%	54.1%
NRG ENERGY	0.1%	50.6%
CROWDSTRIKE HOLDINGS A	0.5%	50.1%
ARISTA NETWORKS	0.6%	48.8%

Source: Refinitiv, UBS

Chapter 4

Global equity preferences

Bringing our three perspectives together

Our equity preferences are the prism through which we identify the areas of the stock market with the highest return potential.

There are many ways to group stocks. Country, industry, and style have been the dominant criteria to create baskets of stocks, largely a legacy of the factor modeling framework of the 1970s.

However, when we break down the performance of the stocks in the MSCI All Country Index over the last 21 years, we find that only 24% of returns stem from country, industry, and style factors and most of the stock performance comes from company-specific factors. Of these, style factors, such as value, growth, small cap, and large cap, only account for 3% of returns (see Fig. 9).

For our global equity preferences, we therefore focus on country and industry groupings as categories while dedicating more attention to structural innovation and tactical opportunities backed by strong company fundamentals, based on a universe of liquid, commonly known global stock indexes (e.g. MSCI AC World) and industry classifications (e.g. International Standard Industrial Classification). For each of these categories, we also highlight our top stock picks to capture the most stock-specific return upside.

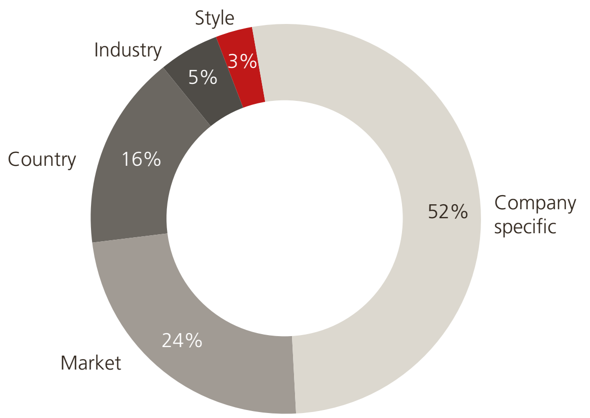
We rate our preferences along a five-point grid from Least Attractive, Unattractive, Neutral, Attractive, to Most Attractive based on the strength and conviction of our return forecasts over the next 12 months. These preferences do not take into account the likely volatility of returns or how these preferences are correlated with each other. Many of the stock groupings have overlaps in their members. This means our preferences can reflect the same view in different stock baskets. For proper portfolio construction, it is key to take into account both the risk of and correlation between our preferences.

Our equity preferences are the prism through which we identify the areas of the stock market with the highest return potential.

Figure 9

Stock return contribution by factor

Return attribution for MSCI ACWI constituents from 2002 to present based on median using the Axioma risk model



Source: UBS analysis

Chapter 5

Our equity shelf

How we will keep you updated

We will present our views on equities in three contexts.

Region / sectors / sub-sectors

We believe that a global, style-agnostic approach to investing will offer the greatest potential for returns in the years ahead. We will continue to provide our views on the major regions and sectors. Countries and sectors are relevant segments, they account for about one fifth of returns within the factor framework. We also see investment opportunities in sub-sectors such as the luxury consumer segment, which exhibits differentiated pricing power and high barriers to entry and can span different industries.

For each major region and sector, we will also continually update our top picks—stocks that we believe offer the best prospects in that segment—and the broader list for investors looking to build more diversified single stock exposure to that region or sector.

Transformational and long-term opportunities

Transformational innovation opportunities

Idiosyncratic alpha, which is often driven by a firm's exposure to some of the most important transformative innovations of the time, has become one of the biggest drivers of equity market returns. The performance of companies exposed to AI and obesity in recent years reflects this trend.

We see three "Transformational innovation opportunities"—the TRIOs—that we believe will generate alpha in the years ahead. These are AI, Power and Resource Innovation, and Longevity, areas that we anticipate the greatest upside, based on our assessment of the addressable market and of the potential for companies to earn meaningful profits.

For each TRIO, we will continually update a stock list of companies and top picks that we think are best positioned to perform in each space. We will also update our views on which TRIO is best placed at the current point in the cycle.

Longer-term investment opportunities

TRIOs cover broad areas of potential opportunity and could encompass many themes or sub-industries. For example, within the broad AI opportunity set, we see opportunities in areas like data, cybersecurity, and fintech.

"Longer-term investment" (LTI) ideas cover these more specific opportunities. While, by virtue of its longer-term nature, our LTI shelf will not change much month to month, we will endeavor to share our views on which LTIs look best positioned at that moment.

For each LTI, we maintain a broad list of companies with the most material exposure to it. And when specific opportunities emerge, we will provide more focused list of relevant stocks with the highest potential to profit from them.

Tactical opportunities

In the shorter term, tactical opportunities can arise based on, for example, changes in macroeconomic policy, shifts in currency markets, a new geopolitical situation, or economic trends.

For each "tactical opportunity," we will update a stock list and top picks for investors looking to build single stock exposure to that opportunity.

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