INVESTORS BRACE FOR A DOWNTURN AND LOOK TO THE LONG TERM

By Julien Ghesquieres, Jeff Kotzen, Tim Nolan, Alexander Roos, Gregory Rice, and Hady Farag

INVESTORS BELIEVE THAT A recession is increasingly imminent. According to BCG's tenth annual investor survey, conducted in October 2018, their 12-month outlook is considerably more negative than it was just a year ago. And many investors said that they are responding to the looming economic downturn by taking a more defensive, value-oriented approach to their investment decisions. To stand out from the pack and allay investors' concerns, companies must take the right steps to prepare for and ultimately withstand significant economic headwinds without sacrificing long-term value creation.

BCG has surveyed investors every year since 2009 to understand their views on global equity markets and priorities for shareholder value creation. There were 260 responses to the 2018 survey. Approximately 80% of the survey respondents were portfolio managers, and 20% were buy-side and sell-side analysts; 48% focused on the US, while most of the others focused on Europe or invested globally. Collectively, these respondents directly manage more than $500 billion in assets and represent firms that manage $12 trillion to $15 trillion in assets. Here is what we learned.

Short-Term Concerns Intensify

Investors' apprehensions about equity market conditions have increased significantly since the 2017 survey. (See "Increasingly Concerned Investors Seek Long-Term Value Creation," BCG article, December 2017.) More than one in four respondents (27%) are bearish or extremely bearish about the market's potential over the next 12 months, up from one in five (20%) in 2017. The decline in bullishness was even more pronounced. Only one-third (33%) of investors remain bullish or extremely bullish about the market's potential for the next 12 months, down from nearly one-half (46%) in 2017.

The fact that the survey was conducted in October, when markets suffered heavy losses, likely affected investor sentiment. It appears that the responses foreshadowed the more dramatic losses through the end of the year and highlighted more fundamental concerns. Recession fears and high valuations have also undermined investors' confidence. Nearly three-quarters (73%) of respondents said that they expect a recession within the next 24 months, up from about one-half (53%) in 2017. Two-thirds (67%) believe that markets are overvalued, in line with the share in 2017 (68%). In comparison, only 29% of investors in the 2016 survey said that they believe that the markets were overvalued.

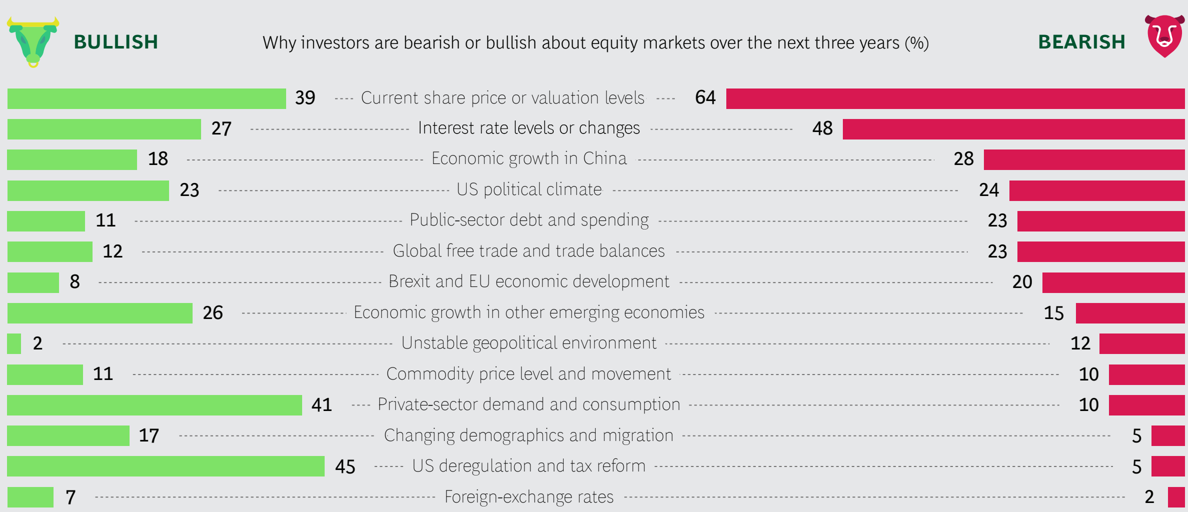
Among self-described bears in the 2018 survey, nearly two-thirds (64%) cited market overvaluation as the reason for their pessimism. (See Exhibit 1.) A number of other factors are contributing to the increasingly bearish sentiment. Nearly one-half (48%) of bears cited interest rates and nearly one-quarter (23%) pointed to concerns about global free trade and trade balances. Bears' other macroeconomic concerns include public-sector debt and spending (23%) and European economic development in light of Brexit (20%).

In contrast, nearly half (45%) of the self-described bulls cited US deregulation and tax reform as a source of their positive outlook. Approximately the same share (41%) pointed to strong private-sector demand and consumption. Together, these responses highlight the great extent to which fundamental macroeconomic developments influence investors' expectations in the context of today's market conditions.

Reflecting valuation concerns, investor expectations for total shareholder return (TSR) remain at historically low levels. Survey respondents' expectation for average annual TSR over the next three years was 5.6%. This almost exactly matches the TSR expectation level of 5.5% per year reported in our 2016 and 2017 surveys—the lowest level we have recorded since we began tracking TSR expectations in 2010. Respondents said that they anticipate that 4.3% of the 5.6% expected TSR will come from earnings growth, along with 2.1% from dividend yields and 1.2% from share repurchases. This implies a 2.0% expected average annual decline in valuation multiples over the next three years, and this, in turn, implies an approximately 1.3-point reduction in the S&P 500's average P/E multiple over three years. As a result of recent market corrections, this valuation reduction has already materialized.

These concerns appear to have led investors to take a more cautious approach to investment analysis and decision making. By a ratio of approximately 2 to 1, investors reported spending more time making in-

Exhibit 1 | Nearly Two-Thirds of Bears Are Concerned About High Valuations
Interest rates, trade, and commodity prices are also fueling bearish sentiment



Source: BCG survey of 260 investors, October 2018.
Note: Because respondents could select multiple answers, the percentages do not total 100. Among the respondents, 85 were bearish, and 92 were bullish.

vestment decisions, taking a more value-oriented approach, and exiting positions more quickly. (See Exhibit 2.) More than one-third (37%) of respondents said that they had adopted a slower and more deliberate investment approach over the past three years, compared with only about one-fifth (21%) who said that they had adopted a faster or more ad hoc approach.

At the same time, 43% had become more focused on value, whereas only 20% had become more focused on growth. More than one-third (35%) said that their investment horizon and holding periods had become shorter or much shorter, compared with only 16% who reported that they had shifted toward longer periods.

Long-Term Value Creation Is the Top Priority

With short-term concerns intensifying, investors' top priority for companies remains long-term value creation. The vast majority of respondents (82%) said that they want companies to prioritize long-term value creation over short-term results. Nearly one-half of respondents (48%) said that they actively consider environmental, social, and governance factors in their investment decision-making process, because these factors drive long-term performance. (See Exhibit 3.)

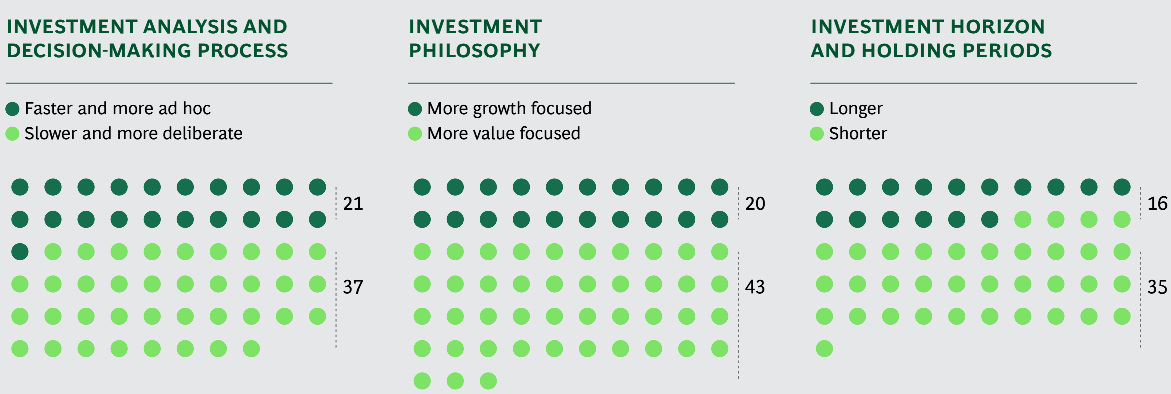
Investors believe that management teams have an opportunity to increase the alignment of their business, financial, and investor strategies. Respondents said that only 50% of the companies they invest in or follow have properly aligned business, financial, and investor strategies. As Exhibit 3 illustrates, respondents' top preference for a healthy company's deployment of capital and free cash flow (beyond existing dividend and debt service commitments) remains organic investment—64% in 2018 versus 66% in 2017. (Percentages indicate the share of respondents who selected an option first or second.)

Of the respondents, 39% cited M&A as a preferred use of cash in 2018, down from 48% in 2017. Investors' preference for further increases in dividends has also declined (to 22%, down from 30% in 2017). Nevertheless, in answering another survey question, one-half (49%) of the respondents said that their fund requires equity holdings to pay a regular dividend. And 24% of respondents said that they require dividend yields that at least match the market average.

Respondents' preference for building cash on the balance sheet nearly doubled (to 21%, up from 11% in 2017), while the share of respondents looking for retirement of debt also increased (to 32%, up from 26% in

Exhibit 2 | Investors Have Grown Increasingly Cautious
They favor a more deliberate, value-focused approach and shorter investment horizons

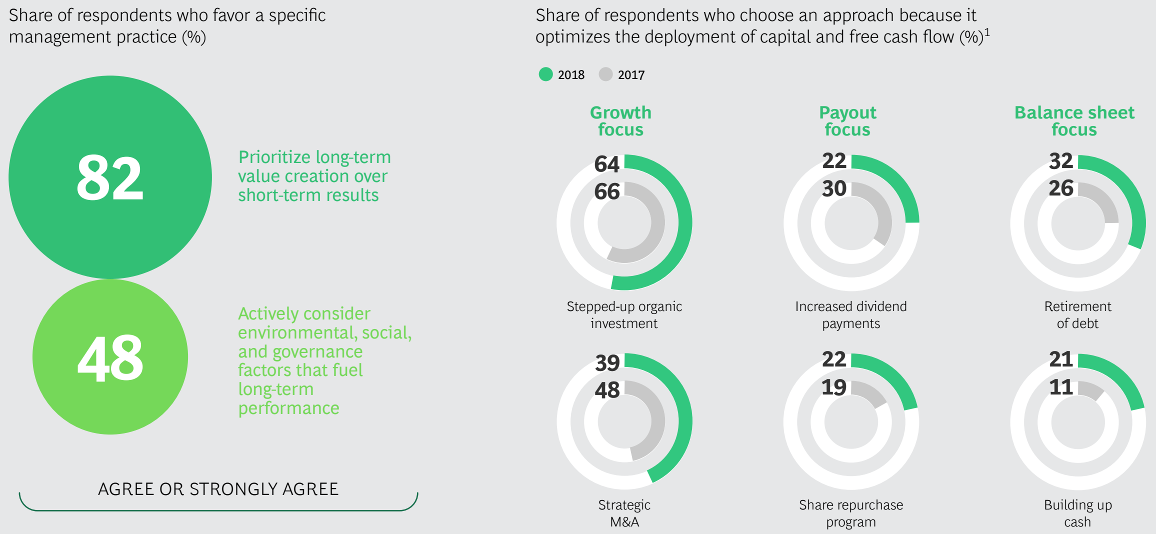
Share of respondents who have changed an approach over the past three years (%)



Source: BCG survey of 260 investors, October 2018.
Note: The percentages do not total 100 because "no change" responses have been omitted.

Exhibit 3 | Investors Are Focused on the Long Term

Stepping-up organic investment remains the top priority, with balance sheet health gaining importance



Sources: BCG surveys of 250 investors, October through November 2017, and 260 investors, October 2018.

[1]Respondents were asked to consider only healthy companies that generate strong free cash flow (beyond dividend and debt payment commitments). Percentages indicate the share of respondents who ranked an option first or second.

2017). While building up cash balances to prepare for possible headwinds has gained importance, companies should be aware that high cash balances might attract the attention of activist investors.

In a highly dynamic and complex business environment, investors want companies to deploy their resources to drive innovation and support businesses that have the potential to achieve competitive advantage and deliver strong and sustainable value creation. Respondents said that nearly one-half (48%) of companies should be more aggressive in pursuing investments in R&D, and 40% should take a more aggressive approach to differentiating capital allocation across different lines of business.

In order to deliver strong and sustainable TSR over time, investors continue to see more room for the companies they own or follow to improve key strategic management processes. For example, capital allocation was cited most often (43% of respondents) as an area with significant or very significant potential for improvement.

Other management processes needing improvement are risk management (38%), strategy development and planning (37%), and compensation and incentives (34%). In addition, 73% of respondents said that companies should give at least annual guidance on earnings per share.

It Is Crucial to Focus on Both Short-Term Resilience and Long-Term Value Creation

The findings from the 2018 investor survey point to the need for executives to strike the optimal balance between building resilience against short-term headwinds and making long-term decisions that secure advantage in the commercial and capital markets.

Building resilience is different from preparing for a full-blown crisis. A company must aggressively and thoughtfully manage its cost structure and balance sheet—but not at the expense of long-term value creation. This means making tough and fact-based decisions in key areas to increase profitability and free cash flow, while simultaneously investing in critical capabilities that set a strong foundation for future growth and profitability.

Furthermore, strong free cash flow and a healthy balance sheet position a company to take advantage of the opportunities that typically arise during an economic downturn or a full-blown crisis. When struggling players are forced to sell, companies with strong and resilient business models and healthy financial positions are generally well positioned to acquire critical assets—usually at valuations that are much more attractive than those before the crisis.

BCG research reinforces this by showing that deals made in a weak economy perform better than those made in a strong economy. (See "As Prices Peak, Should Dealmakers Wait for the Next Downturn?" BCG article, March 2018.)

To guide their efforts effectively, companies should develop a detailed and action-oriented roadmap for strategy and value creation that outlines plans for navigating various macroeconomic and industry scenarios, including severe downturns. A rigorous roadmap should align the company's business, financial, and investor strategies. By anticipating and planning for various scenarios, a company should have much greater control of its destiny during challenging economic times and position itself to accelerate out of the downturn. Those companies that succeed will achieve advantage and generate strong and sustainable TSR. (For more on driving strong and sustainable TSR, see "Ten Lessons from 20 Years of Value Creation Insights," BCG article, November 2018.)

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