White paper

TIAA GLOBAL ASSET MANAGEMENT

Finding investment opportunities in macro-driven stock markets

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Executive summary

- Stock prices have been highly correlated since the financial crisis, influenced more by sentiment, macro events and a massive shift to index strategies than underlying fundamentals.
- We believe that individual stocks, however, will continue to outperform or underperform broad markets over time, presenting plenty of alpha opportunities for disciplined investors.
- We see compelling growth and income investment opportunities currently in the defense, energy and video game industries.
- Investors should consider active equity strategies as part of a well-diversified portfolio, while weighing the selection of their managers carefully.

Investor sentiment and macroeconomic events have influenced short-term swings in stock prices over the last several years, causing equity correlations to remain elevated since the financial crisis (see Figure 1). In recent months, markets have vacillated widely in response to macro events including currency volatility, falling commodity prices and the potential for interest rate hikes. Historically speaking, episodes of elevated correlations have tended to be short lived—but the rise of passive and exchange-traded funds (ETFs) has also contributed to these challenging conditions for active managers. Over the five-year period ending December 31, 2015, for example, only 15% of large-cap equity managers beat their respective benchmarks.[1]

BUILT TO PERFORM.
CREATED TO SERVE.

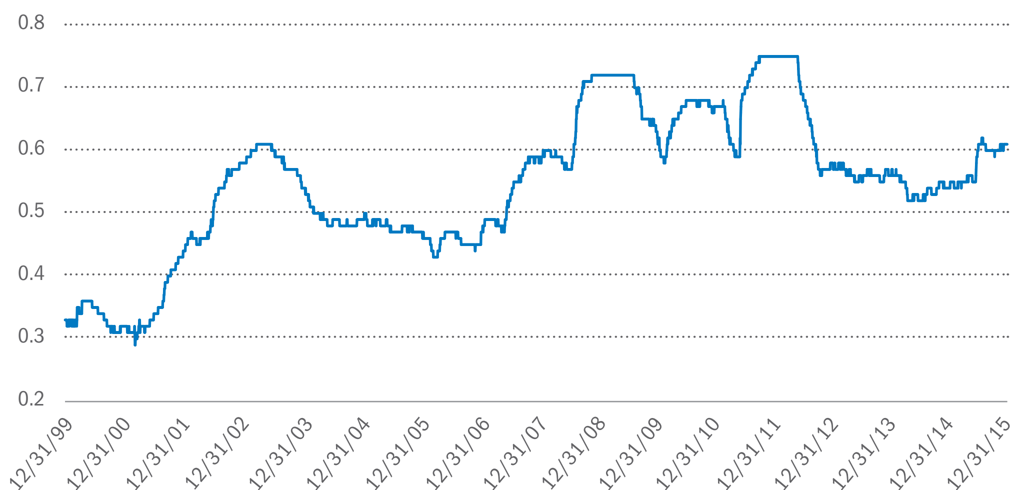
These factors have led to a challenging environment for active stock pickers. Figure 1 shows how U.S. large-cap stock correlations have remained higher than usual since the financial crisis.

At TIAA, we see plenty of opportunities for active managers to outperform. In U.S. large-cap companies, for example, we believe there are compelling current opportunities in the defense, video game and energy sectors. Whether conditions for active stock pickers improve or not, we believe the market will reward companies who perform well and punish those who don't. Actively managed strategies with experienced managers, analysts and a disciplined process backed by fundamental analysis should continue to deliver value for investors in the future.

Equity correlations remained historically elevated since the 2008–09 financial crisis.

Figure 1: Equity correlations

S&P500 250-day correlation, 2000–2016



Source: Strategas Research Partners

A broad shift to passive

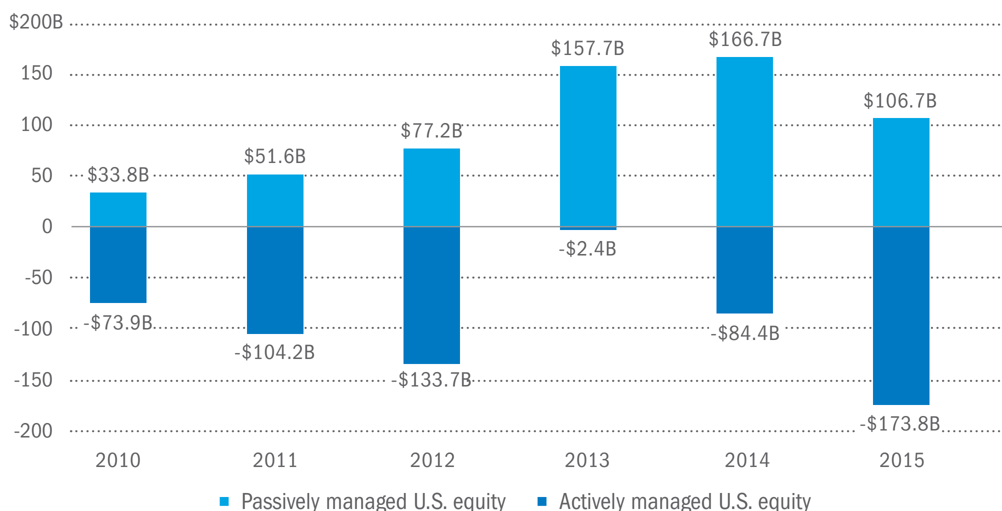
The shift to passive investments, including mutual funds and ETFs has been dramatic, especially in U.S. large-cap equity strategies in recent years. About 40%, or $1.7 trillion, of all registered fund assets invested in U.S. large cap stocks were passively managed in 2015.[2] Nearly $600 billion has flowed into passively managed U.S. equity strategies since 2010, while about $570 billion has flowed out of actively managed U.S. equity strategies over the same period. Figure 2 below shows this dramatic swing.

These trends suggest that investors and their advisors believe active management no longer delivers value. We believe passive investing is valuable as a source of broad exposure to a diversified portfolio, usually at a low cost, and that good active managers are also valuable, as they can potentially offer higher performance with less risk.

Assets have poured into passively managed funds in recent years.

Figure 2: Asset flows

Flows to active and passive US funds 2010–2015



Source: Morningstar Direct data, as of March 2016. Annual flows are industry estimates.

Benjamin Graham's weighing machine

Benjamin Graham, a pioneer of fundamental stock analysis, likened short-term stock prices to a voting machine and long-term prices to a weighing machine. Investors, his theory held, voted on the popularity of companies in the short term, while over the long term the market correctly "weighed" their substance by taking fundamental factors such as earnings, profit and cash flow into account. In today's markets, investors are voting on stocks as a group from day to day, moving in and out of the asset class in reaction to the latest headline or macro event such as rising interest rates, unfavorable employment news or China's changing economic outlook.

The weighing machine still works, however, and individual company performance still matters. Experienced managers supported by seasoned equity analysts can sort through the noise and find undervalued companies while avoiding overvalued ones. This is especially true during downturns, when underperforming companies often run into trouble and potentially lose more value versus stronger competitors and the overall market. Fundamental stock

We see positive signs for equity investments across several industries, including energy, defense and video games.

picking skills are particularly helpful during these periods—and can often add more value during downturns than during bull markets. While rising tides tend to lift all ships during bull markets, the opposite is true when volatility rises and prices decline. Markets tend to punish weaker, underperforming companies. While even the best companies can lose value during such periods, they tend to lose less. Investors exposed to the total market via an index strategy or ETF have exposure to all companies, which means there is no flexibility to position a portfolio and avoid companies that run into trouble, or take advantage of market volatility to add to core positions. The fully invested nature of index funds means they offer no downside protection during market declines, nor are they able to tilt their holdings to more defensive or stable stocks in times of heightened economic stress.

Finding investment opportunities in challenging markets

While markets have been volatile in recent months, we see opportunities across several industries, including defense, energy and video games.

In the defense industry, some of the largest manufacturers will benefit from a Pentagon budget focused on several big-ticket contracts and modernization efforts. The industry is experiencing tremendous growth in unmanned aircraft sales and cyber security services, which are increasingly being marketed to non-military entities such as banks and financial services companies. Some of these companies, such as Raytheon and Lockheed Martin, are also significantly growing international sales, which may now approach 30% annually in some instances.

These are positive trends for defense company stock prices—but not all defense contractors will win out. Northrop Grumman won an $80 billion contract last fall against some of its larger rivals to produce a long-range strike bomber, a win that significantly boosts the company's earnings power potential over the next five years.

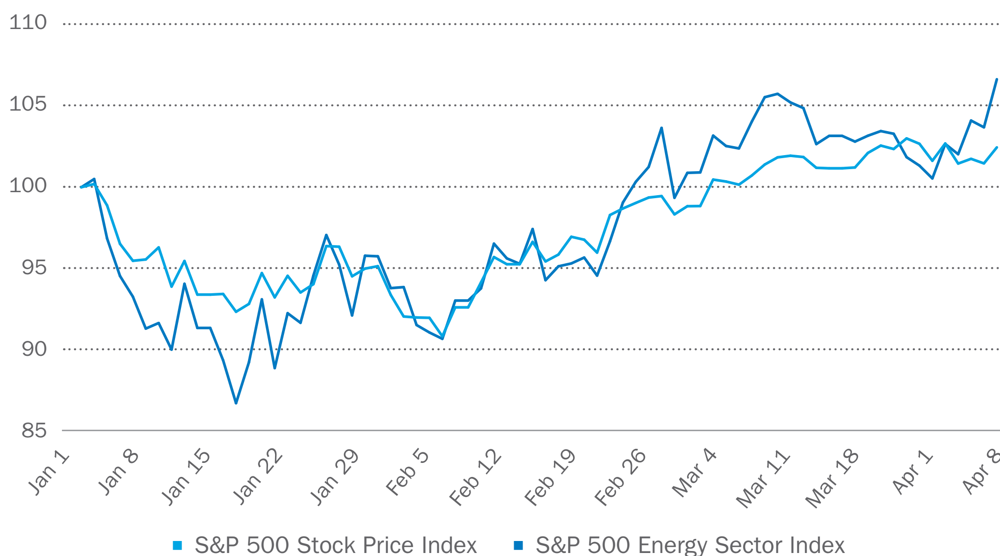
The video game industry is also attractive, as it is in a favorable cycle that includes new hardware releases and new releases of some top-selling names. Digital downloads are also driving sales and helping push profit margins up. Digital game downloads continue to gain traction and are now approaching near 50% of industry revenues. Releasing new hardware and the continued digital expansion is making some of these companies more profitable.

There is also strong potential for a takeoff in virtual reality for some of these companies. Video game companies that move their game delivery mode—from traditional personal computers and game consoles to mobile devices of business—will experience the strongest growth potential.

The energy sector has outperformed the broad equity market year-to-date.

We have also seen many equity investment opportunities arise in the energy sector as a result of ultra-low oil prices that took root over the last few years. Low levels in oil prices have led to cutbacks in production, with US production now declining. At the same time, emerging and developed markets are responding to lower prices, resulting in improving global demand trends. Equity prices for energy stocks have begun to improve as a result of the better supply/demand environment, which is reflected in the energy sector outperforming the S&P 500 year-to-date (see Figure 3). Valuations are still attractive for companies that have access to high-quality reservoirs in the Permian Basin,[3] in addition to some new, emerging opportunities in Oklahoma.

Figure 3: Energy sector has outperformed the broad market year-to-date



Source: Haver Analytics, daily market data Jan. 1 2016–April 12, 2016

Quality stocks will prevail in the long term

Stock correlations may remain elevated in the coming months or even years, making conditions for active managers challenging. We see plenty of opportunities for active managers to add value, however. Graham's long-term weighing machine will continue to reward high-quality companies while punishing the poor performers whether correlations are high or low. Quality will always outperform over the long term.

For more information about growth and income equity investing strategies, visit Nuveen.com or call 800-752-8700.

While active managers as a group have performed poorly over the last five years, some have demonstrated strong, consistent performance, showing the benefits and value of the approach. Investors and their advisors should seek out active managers who have demonstrated these skills over time. For more information about growth and income equity investing strategies, visit Nuveen.com or call **800-752-8700.**

Appendix

Top 10 Holdings Growth & Income Fund as of 3/31/16

	Market value ($)	% of net assets
Apple Inc	$177.7M	3.72%
Alphabet, Inc (Class C)	$151.7M	3.18%
Microsoft Corp	$130.8M	2.74%
Facebook, Inc	$96.1M	2.01%
Home Depot, Inc	$87.4M	1.83%
Coca-Cola Co	$82.0M	1.72%
General Electric Co	$78.5M	1.64%
PepsiCo, Inc	$71.6M	1.50%
Amazon.com, Inc	$71.2M	1.49%
Philip Morris International, Inc	$65.9M	1.38%

1. SPIVA U.S. Scorecard as of 12/31/2015
2. TIAA analysis based on Strategic Insights Simfund data and Morningstar asset class classifications, as of 9/30/15.
3. The Permian Basin is an oil and gas producing region in western Texas and southeastern New Mexico.

TIAA Global Asset Management provides investment advice and portfolio management services through TIAA and over a dozen affiliated registered investment advisers. Nuveen Investments is an operating division of TIAA Global Asset Management.

You should consider the investment objectives, risks, charges and expenses carefully before investing. The TIAA-CREF Growth & Income Fund is subject to the risk that the market prices of portfolio investments may fall rapidly or unpredictably due to a variety of factors, including changing economic, political or market conditions, and the risk that large-capitalization companies are more mature and may grow more slowly than the economy as a whole. Please call 877-518-9161 or log on to TIAA.org for product and fund prospectuses that contain this and other information. Please read the prospectuses carefully before investing.

Holdings information is as of 3/31/16 and may not reflect current allocations.

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