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TRANSCRIPT

Factor Strategies with ESG Integration

Featuring:

Anthony Kruger, EMEA Head of Factor ETFs, BlackRock

Hitendra Varsani, Executive Director Global Solutions Research, MSCI

Interviewer:

There is a growing demand for ETFs and also for ESG, and that's all taking place at a time when there is a huge amount of sector and factor rotation taking place in the market. So what does that all mean for you and your clients, and how can you use these changes to get better investment returns and control risk? Well, to discuss that, I'm joined today by Anthony Kruger. He is EMEA Head of Factor ETFs at BlackRock. And I'm also joined by Hitendra Varsani, Executive Director Global Solutions Research at MSCI. Gentlemen, welcome to the show. Hitendra, let's start with you. What are some of the major rotations that investors have experienced in the last few months, and what's been driving those?

Hitendra Varsani:

So overall, global equity markets have had a fifth consecutive quarter of positive returns. And our studies have shown that style factors have been more important in driving the underlying rotation in the market more than industries and countries. And this is both apparent in developed markets, and is being increasingly important in emerging markets as well. Now with the reopening of economies and the rollout of vaccines, value has demonstrated very strong performance in leadership in the first half of this year, and that very much started on November the 9th, what some people call Pfizer day last year. That's when the efficacy of the Pfizer COVID jab was announced to the world. Now the rotation from growth into value has resulted in a higher value exposure in our momentum indexes. In fact, MSCI momentum index has the lowest valuation that it's had since 2009. Now overall, as equity markets have gone from strengths to strength in the most recent quarter of this year, investors have been favoring stocks that have higher profitability, low earnings variability, high ESG, and hence somewhat showing a defensible, more resilient stance as the market has gone higher.

Interviewer:

And Anthony, what are your thoughts on rotations? How have your clients been reacting or responding? And are you seeing any difference between what's going on in EMEA and for so--a more global perspective?

Anthony Kruger:

It's great to be here today, and I can't help but reflect that if you had asked me that question a year ago, you probably would have said something like, "Is value dead, or can we still believe in factors?" And probably rightly so, because we were in the longest deepest drawdown in values history. And I think a lot of investors had given up, or were short, or very underweight the factor. Now on the vaccine news, there was a seismic shift in the markets, and some call it ‘a black swan event’. But I would have probably described it a bit more like a big gray elephant. It was there, it was in the room, and then it stampeded. And it was very painful and caught many investors off guard. Now since then, value is in cyclicals having roaring back into favor at a pace faster than expected. Faster than the tech bubble and faster than the financial crash. Now despite the recent pullback, we have-- still have value being the top performing factor year to date. And we can still see this across global exposures, US, Europe, and emerging markets. Now clients have reacted by buying over 10 billion dollars in [inaudible] factor ETFs. And ETFs were the perfect vehicles for them to get exposure being liquid, efficient, tradeable vehicles. Now it originally was focused on US value, but that has broadened out now into European and global value, and we actually see investors starting to buy quality as Hitendra mentioned earlier.

Now the key to this trade continuing is the growth or the opportunities of the reopening. And it’s kind of like a tug of war between the digital and the physical, or the disrupter versus the disruptee. And this will rarely drive rates and inflation and what the markets will do over the next few months. Now as an example, if we took a basket of physical stocks, think about names like Host Hotels, or Expedia, or Carnival Cruise Lines, that basket of stocks is up 43% since the vaccine announcements. If we contrast that with a digital or social distancing basket, think about names in that one being Zoom, Amazon, or Netflix, that basket is down 16%. So we are seeing a bar-belling approach from clients. They have traded value ETFs to get exposure to the physical or reopening trade. But they also still like tech and some of those quality exposures. As-- well, all our lives have changed and there’ll be a longer structural trend kind of as we go forward from here.

Interviewer:

Well, let’s move on now to ESG. Hitendra, I know that MSCI has done a lot of research on this as a topic. But what are some of the conclusions that have dropped out on what impact it’s had on risk and return characteristics of portfolios?

Hitendra Varsani:

That’s a great question, and there’s a couple of points you know here as we just start off this response. So the first is, just looking at ESG on a stand-alone basis, and then second, thinking about how ESG integrates with other strategies for example factors. Now let’s start with ESG on a stand-alone basis. Using our long term research, empirical work that we’ve done, we’ve recognized that stocks with higher ESG ratings have certain characteristics. There’s three main highlights here. One is stocks with high ESG have stronger cash flows, more stable, long term earnings, and also higher earnings growth as well. Second, a basket of ESG highly rated stocks typically have less systematic risk than their weaker counterparts, and this results in higher valuation. And then thirdly, high ESG stocks typically have less exposure to severe incidents. They have lower levels of idiosyncratic risk. Now what does this mean in practice?

So in effect during crisis periods, stocks with higher ESG characteristics have shown more resilience and last year was no exception. Many of our ESG linked indexes outperformed the broad market over 2020, and this led to an improvement in risk adjusted returns over a longer dataset. Now secondly, when ESG is considered with factors, there's a few things to know. Firstly, what is the sensitivity of factor exposure to an improvement in ESG exposures? Now there are some factors that are less sensitive, quality, minimum volatility, and then there are other factors that are slightly more sensitive, value and momentum. But overall one key conclusion is, for a 20% improvement in ESG, all factor strategies can maintain a high level of exposure. So in a nutshell, ESG can be integrated into factor strategies without having or impairing factor exposures.

Now finally, an increasing number of clients that we speak to are looking to disentangle the risk return of ESG to other factors. Now the concept of-- or the typical narrative is ESG is a quality factor. It's a large cap factor, it's a develop market factor. And while it may have that bias, if we include ESG as a factor, we can disentangle ESG in its purest form and evaluate its risk return characteristics. And overall what we found across global markets that ESG has added performance particularly over the last two to three years as we've seen this train and accelerate within the investment community in terms of adoption.

Interviewer:

Well, given that Anthony, how is BlackRock helping its clients to integrate ESG into their investment process?

Anthony Kruger:

Well, I think we can all agree that sustainable investing has grown from a niche business into the mainstream. And indexing is expanding the markets. As clients turn to ESG not only for values, but for risk management, for performance, or for portfolio construction, investors have demonstrated emphatic demand for sustainable ETFs putting 88 billion dollars into those strategies in 2020 alone, triple the year before. So ETF and index innovation democratize investing by giving investors efficient, tradeable and transparent investment vehicles. Now that industry is driving the sustainable revolution, we are working with index providers to give investors more choice. From avoiding companies that may not align with their values to integrating ESG considerations or reducing the carbon profile to meet some climate goals.

Now for example, our iShares factor ESG ETFs, they avoid certain controversial companies by screening them out, but they also integrate ESG scores and boost the ESG profile while reducing the carbon emissions by at least 30%. An investor using our iShares USA value ETF can be confident that it delivers the value profile that they are expecting. Now as Hitendra mentioned, that is critical when investors use factor ESG ETFs, that they can rely on it, still maintaining that risk return profile. Now I believe we are on the cup of a long term trend of investors using factors and ESG together to build more robust portfolios.

Interviewer:

Well, just sticking with the E of ESG, Hitendra, this is the year of [inaudible] 26, could you talk us through your thoughts around exposure, things like climate change, some of those other key trends that are so much in the news at the moment.

Hitendra Varsani:

The climate change continues to be a key and growing concern amongst many investors. We've seen increased demand for data and solutions that can help investors align with various regulatory frameworks around the globe. Investors have increasingly been looking at stress-testing their portfolios under different climate scenarios. Now a natural starting point for investors, and a strong trend that we've seen over the years is simply to reduce the carbon exposure of their portfolios. MSCI have various carbon indexes that address both carbon emissions as well as reserves linked to fossil fuels. Now more recently, the technology to reduce carbon has extended to other indexes as well. It's extended to ESG indexes, it's extended to factor indexes, and this follows a similar manner to the point Anthony made about integrating ESG into factors. So let's take an example. Value factor indexes may have had a lower climate profile compared to the parent index on a historical basis. By having explicit controls around carbon reduction, the resulting indexes could have a much improved climate profile relative to the parent index while still maintaining high exposure to the value factor.

Interviewer:

Well, we are pretty much out of time. So Anthony, could you finish off for us by giving us some thoughts on future trends, and pulling some of these themes and ideas together that you and Hitendra have been talking about?

Anthony Kruger:

Sure, I mean, we've talked today about two key areas of innovation, sustainability and factors. And there's a huge structural trend in the markets towards sustainable solutions, but we also know that factors are long term drivers of return and help investors build more resilient portfolios. The coming together of these two worlds has brought investors the opportunity to meet their ESG or climate considerations, but also integrate factors to help build their portfolios.

Interviewer:

We are out of time and have to leave it there. Anthony Kruger, Hitendra Varsani, thank you both very much.

Anthony Kruger: Thank you.

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