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TRANSCRIPT

Factor Trends in Q2 2020: Factors in Focus

*Featuring: **Mark Carver**, Head of Equity Factors at MSCI and **Hitendra Varsani**, Executive Director, Core Research*

Mark Carver: Hello, this is Mark Carver, head of Equity Factors at MSCI and I'm joined today by Hitendra Varsani from our Equity Core research team for our quarterly Factors in Focus discussion. Equity markets were very strong in the second quarter. In fact, off of the March bottoms, we saw MSCI World, MSCI USA and MSCI Europe all rally above 30%. There was particular strength in a couple of factors, both in our risk model and our index factors. Most notably momentum and quality and even specific dimensions of quality. Hitendra, given this backdrop, what are the latest insights that you had from our MSCI Factor research?

Hitendra Varsani: Well Mark, despite a sharp recovery in markets, the MSCI Global Equity Market model currently has elevated levels of forecast risk around 27%, and typically that's between 10 and 15%, while investors remain cautious about the risks of a second wave of COVID-19 and uncertainty over the long-term impact. But what insights can we extract from our market model? Over the last quarter we've seen strong dispersion amongst factors. Technical factors such as high volatility, high reversal, liquidity and momentum have dominated along with the recovery and low size. While some fundamental factors such as value have shown a mixed picture as investors look for clarity as we transition through this uncertain environment. Profitability and ESG have added gains to the previous quarter. Now let's look at our indexes. The MSCI ACWI index delivered a headline return of 19.4% over the second quarter. Developed markets outperformed emerging markets. USA outperformed Europe. And as you mentioned earlier, quality and momentum outperform. Overall, we see strong dispersion in regional factor index performance, and this may indicate that these countries and regions could be at different points in the recovery cycle and investors are taking a more nuance view. For example, low size outperformed in USA and Europe and that similar pattern to what we saw in Asia in Q1. Now it's hard not to mention Asia ex Japan momentum outperformed its pair in index by a staggering 23%. Amongst credit factors, we've seen a classical pro-cyclical recovery. Factors such as value, carry, low size outperformed in line with their historical patterns.

Mark: It's really interesting that you talk about this regional dispersion in the differences that we see within the particular factors, where we note that on the clients side, more and more asset owners and institutional investors more broadly are taking a more nuanced view in an asset allocation framework. Where once upon a time it was stocks, bonds, cash, and then we went toward regional bias, over and underweights, and today we see that clients are taking specific implementation choices at the regional level. And so, for example, you didn't mention this, but value in the second quarter in Europe was very strong. Quite different than what we saw value do in other parts of the world. So, for that investor that took that more nuanced view, and said how do I want to take or implement that exposure at the regional level, it's a way to enhance that overall asset allocation framework.

Hitendra: Absolutely.

Mark: Let's talk a bit about the strong rally where there's obviously good news for investors is to get a strong rally but then that also has implications for valuation. So, what does this mean for the valuations of factors and then markets more generally?

Hitendra: Sure. So clearly markets have had a strong rally, but what does that mean in terms of valuations? If we turn back the clock and look at where we were at the beginning of the year, the ACWI price to Ford earnings was 16. During the peak of the crisis at the end of March, valuations fell to 13, clearly depressed. And now we're at staggering 19 and ACWI is still 10% below its peak. So effectively, prices have elevated whereas earnings expectations have gone the other way. They've been revised down. And so, from an absolute valuation point of view, where does that leave us? The most expensive we've been on a Ford earnings basis for several years if not more than that.

Mark: So Hitendra, that point around valuation obviously differs across regions, across particular factors. One of things we often hear in the media and sometimes from clients is around the trendiness of style factors. And I think they ask that because of the mainstreaming of factors. Your team has done a lot of work in this area. Tell us what you find.

Hitendra: Sure. So, momentum has received a lot of attention in the recent environment. It's had very strong performance over the last few years and it's shown unusual characteristics this year. So, momentum performed well during the market downturn and continued to perform throughout the second quarter with a few bumps here and there. And that's largely driven by a bias towards technology. Now momentum as a factor has significant rotation features across sectors, across countries, across regions and within research we've evaluated how persistent is the stall factor in momentum. Our research has shown that there's persistent outperformance in factor momentum over the last, let's say 15 years and factor momentum has also outperformed year to date as well.

Mark: So that's a good lead into the adaptive indicators. You and the team have done a lot of work around an adaptive framework. What do these indicators look like today?

Hitendra: So, our adaptive indicators is centered around four pillars: Macro, Valuations, Momentum, and Market Sentiment. From a macro perspective, market indicators are in contraction and so the bias is towards defensive factors. However, valuation, momentum, and sentiment are pointing towards low size in those three categories. So overall, the picture has a procyclical bias towards value and low size. And these are typically the factors that tend to work in an early stage recovery. But it will be interesting to see how this actually plays out.

Mark: So, you would observe looking at small cap indexes, equal weighted indexes for evidence that the low size effect is starting to play out and that there's a broader recovery across markets. So, you'd see greater breadth in equity markets for example.

Hitendra: That's right. And then as we discussed earlier, clients may want to take a more nuanced view and look at what stage of the recovery are various countries and regions in and perhaps there's more opportunity on narrowing down on a particular market. So, Mark, tell me, what are some of the trends that you're seeing amongst our clients on a global basis?

Mark: So, I think the two biggest trends are first, what I was hinting at earlier, which was around the increase adoption of factors through the asset allocation framework. Where clients are saying I want to be more deliberate in the way I take exposure in a particular geography, maybe even a sub-geography. And that's different that what we observed even 24 months ago. The next biggest trend is probably not surprising to you or any of our listeners which is the increased adoption of ESG. We have talked a lot in this forum about the resilience of factors but we're hearing more and more demand and adoption for ESG. And this means ESG as a factor, ESG as part of a risk model set up. And so, we introduced this quarter a new risk model, GEM + ESG, and this model allows investors who are implementing ESG for the first time to have objective evidence of the impact of that ESG implementation. How much exposure do you have in ESG? What did that mean for your risk and return? And it's allowing investors to cleanly look at ESG next to the traditional style factors and it supports this clear trend that we're seeing which is the mainstreaming of factor investing and the implementation of ESG in an asset allocation, and particularly in an equity framework. Okay, I think we will wrap it up there. I want to say thank you Hitendra as always for a great discussion. We have a lot more to say on this topic. Hitendra has a blog that is posted to the MSCI website. We're also going to be hosting two webinars. One on the broader implications of COVID and one specifically on ESG and you will see that on the MSCI website or from your MSCI representative. Thank you all for listening. We look forward to talking to you next quarter.

Hitendra: Thanks Mark. Thanks everyone.

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