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TRANSCRIPT

Factoring in volatility.

2022 was yet another year filled with volatility and uncertainty with rising inflation, interest rates, geopolitical turmoil and slowing economy. We can already see a challenging macro environment entering 2023, with continued economic slowdown and recession fears. Joining us today are Ben Garland, EMEA Head of Factor Index Products at MSCI and Stefan Poechhacker, EMEA Lead Factor Strategist at BlackRock who will share insights on the market performance and looking under the hood through the lens of factors.

Starting with you Ben, how would you see the year that almost passed and the current market dynamics. And what are some of the highlights that you would like to share with our audience?

2022 has certainly been a very challenging year for investors on many levels, but the sell-off in equities has not been uniform across the board and this dispersion of returns provided opportunity for differentiated performance. One way to group stocks is by factors, like value, low volatility, momentum, or quality, to name a few. When we view global equity markets through a factor lens, we have seen some very interesting themes emerge this year.

Firstly, the dispersion across style factors has been very large this year. While the broad MSCI World Index was down around 14% to the end of November, several style factor indexes have experienced much lower, mid-single digit drawdowns, effectively outperforming the broad market by around ten percent, or almost 12% in the case of the MSCI World High Dividend Yield Index. Value and Minimum Volatility were other examples of strong performing factors in 2022.

A significant characteristic of this year's Factor story has been the violent rotation in performance, with the best performing factors over the past five years, namely Quality and Momentum, underperforming the MSCI World Index to the end of November, while the strongest performers in 2022 – Yield, Minimum Volatility and Value –had all lagged the broad market over the past five years. This shock to the status quo of factor performance has served as a stark reminder to investors that Factors really do matter and as a bare minimum measuring and monitoring factor exposures is a must for all prudent investors.

Dividend Yield and Minimum Volatility, typically more defensive factors, have outperformed the broad market fairly consistently year to date, as macro uncertainty and deteriorating market sentiment have largely been a constant in 2022.

For a couple of style factors however, it has been something of a year of two halves in terms of performance regimes. Most of the year-to-date outperformance from the Value factor occurred during the first half of 2022, as fears of inflation and rising rates emerged, and shorter-duration Value stocks rallied strongly in the spring and early summer. Momentum however suffered a shock in the first half of the year as the cycle shifted and sentiment deteriorated amid geopolitical uncertainty. But as the macro backdrop has stabilized into more of a steady-state regime, Momentum Indexes outperformed in the second half of the year.

Stefan, what role do you think factors have played in this turbulent market environment and which factors provided some cushion?

Thank you, it's great to be here today. As we head into 2023, it's time to reflect on the past year – and it has certainly been an eventful one.

Investors have been telling us that -- unsurprisingly -- two of their most pressing concerns are inflation and the economic slowdown.

Let's start by looking at the inflation story:
We believe that value is an underappreciated inflation hedge. When we look at historical data since 1926 and split the period into low and high inflation regimes, we see that value tends to benefit as inflation rises. Value strategies may be well-positioned in times of high inflation because the cashflows of value stocks tend to be concentrated in the near-term. In contrast, growth stocks aim to achieve their highest payouts, earnings, and cashflows in the future. When discount rates increase, due to high inflation and high interest rates, this tends to result in shrinking the long-dated expected cashflows of growth stocks, meaning that value stocks may look relatively more attractive. We've seen the same dynamic play out over the past year, with the value rotation accelerating and more than $5bn added to Value ETPs in January and February 2022.

If we had to pinpoint a moment when sentiment turned, it would certainly be the war in Ukraine and rising concerns about an already fragile economy. From this point, investors were asking themselves yet another factor question: "How do I reduce my overall portfolio risk?"
Min Vol, which we see as a risk mitigation factor, was the intuitive answer for so many. Clients looked to it as a safe haven, with a strong uptick in ETP inflows.

Another element that makes Min Vol so attractive, in our view, is that it's very difficult to time the market bottom. Many investors have asked us for our view on cash, but the problem with Cash is that you are not participating on market upside. We like min vol for its positive skew, which means that min vol tends to capture meaningfully less downside than the broad market – but it also participates in much of the upside when the market rallies. Min vol -in that sense-does *not* behave like an equity-plus-cash portfolio. Given these characteristics, as you can imagine, we think this turbulent year has offered ideal conditions for min vol.

Staying with you Stefan, as we enter the new year and are already seeing recession concerns, what do you expect in the times to come?

Great question, for BlackRock, recession remains our base case, especially in Europe. Although we're tactically underweight equities overall, we do see opportunities in being selective. We continue to like Min Vol for its risk mitigation capabilities, and we've also moved Momentum to supportive. Momentum increased its exposure to both Health Care and Energy, and since the last rebalancing, we've seen stronger sentiment towards the factor relative to the broad market.

Now, if we look at the period from 1970 to 1985 — the last time we saw persistently high inflation alongside low economic growth – the stand out factors were low volatility, momentum and value. Less volatile stocks have historically benefitted in periods of high volatility and volatile GDP growth. Inflation today is both pervasive and sticky. If high inflation is here to stay, some companies will be better than others at adapting to this environment. As price pressures persisted in the 1970s, momentum strategies were able to ride this trend. There's a risk we may be entering a new regime of persistent, high inflation today.

Let me also briefly touch on dividends, 2022 is set to be a record year for dividend-seeking ETPs, with $65.3B of inflows globally, trumping the $48.1B added across 2021. A quality overlay may help investors avoid exposure to companies with high but unsustainable yields, and allocate only to those that have the ability to maintain payments. Despite a challenging year for sustainable strategies, we've seen persistent appetite for sustainable from European investors in particular. In fact, investors voted in favor of changing our traditional quality income range to a sustainable quality income strategy. We worked closely with our partners at MSCI to reflect this preference in our Factor + ESG range.

Ben, how does MSCI help investors seeking to incorporate Factor + ESG exposure in their portfolio?

As I mentioned before, the abrupt factor rotation in 2022 has reminded many investors of the importance of understanding and managing Factor exposures within an equity portfolio. This has sparked a renewed interest from clients in understanding the role factors can play in helping build more resilient portfolios and MSCI's Factor team has been overwhelmed with client questions and research projects. At the same time, incorporating sustainability goals into equity portfolios continues to be a huge trend globally and MSCI's ESG and Climate team has been at the forefront of this movement.

At the intersection of these two themes, my team has worked with many clients this year to construct Factor + ESG or Climate indexes that combine sustainability targets with high exposure to style factors without compromising on either goal. These two themes aren't always aligned and can introduce competing objectives, especially where a simple two-step approach to index construction is used – by this I mean imposing an ESG or Climate overlay to an existing Factor index or applying a Factor methodology on top of an ESG / Climate index. In such cases we often found that the outcome was sub-optimal from both sustainability outcomes and factor degradation, when compared to the pure-play factor or sustainable indexes.

When combining Factors with ESG and/or Climate, at MSCI we tend to adopt a more sophisticated approach, leveraging our decades of experience in solving complex portfolio construction problems, integrating both the Factor and Sustainability goals into a single-step portfolio construction approach. So, while challenges to combining factors and sustainability do exist, particularly when using a simple overlay approach, MSCI's one-step construction methodology has delivered meaningful improvements to ESG and or Carbon profiles, with minimal degradation of factor exposures. Accordingly, we have seen many new products come to market in the past year in this "Factors Plus" space and predict the trend to continue into 2023.

Stefan, anything you would like to add or key takeaways to share with the audience.

There are a few other points I'd like to highlight on the sustainable side.

-YTD sustainable exposures accounted for 60% of all UCITS ETP flows, outpacing the record 50% share recorded in 2021.
-These inflows have persisted despite the challenges faced by sustainable indices this year, and changes in the regulatory space.

-The structural robustness of flows suggests that investors are continuing to move from standard ETPs into sustainable exposures.

BlackRock committed to supporting a sustainable future in early 2021, when we announced a number of steps to help clients navigate the transition to net zero. Our iShares Factor range is no exception and we are looking to extend it to include new Factor strategies with sustainable enhancements in 2023. So, watch this space.

Thank you, Ben, and Stefan for all the insights. It was great talking to you.

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