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TRANSCRIPT

Factors: Risk Sentiment

*With **Mark Carver**, Managing Director, Global Head of Equity Factor Products and **Hitendra Varsani**, Executive Director, Core Research*

Mark Carver: Hello, I'm Mark Carver, head of Equity Factors at MSCI and I'm joined today by my colleague, Hitendra Varsani, from our core research team. Despite these unprecedented times that we're all living in, we maintain our commitment to try to get out research insight and information to all of our clients in different venues. So we're trying something new today, I'm coming to you from suburban Connecticut, Hitendra is in London, but we want to make sure that we use every opportunity we can to get information to our clients to help you make more informed investment decisions. Hitendra I wanna bring you into the conversation. Let's start with the obvious, markets have been unprecedented in the first quarter, what are the two or three key takeaways that our listeners should have from this market?

Hitendra Varsani: So Mark, so during these fast markets, risk management is critical. There's an increased focus on understanding the key drivers of risk return and portfolio exposures. Through the lens of our global equity market risk model, we've looked up the performance of factors through a crisis. In our latest research factors and focus, risk sentiment and factor dynamics, just published... we give an overview of these trends in factors. Overall, defensive factors and ESG have outperformed and if we dig a little bit deeper, what do we see? Well, there's been supply chain disruptions across markets globally. There's been demand shocks as national countries have been partially shut down. During these times, stocks that have had strong balance sheets, resilient cash-flows, more profitability and higher ESG characteristics have fared much better than those that don't.

Mark Carver: Do we see the same trend in the factor index side?

Hitendra Varsani: So factor indexes have been designed to be investable, have high capacity and managed turnover, and what we found overall is factor indexes have performed in line with what we would expect based on the pure factor returns. So just to give you some numbers to put things in context, the MSCI Equity Index has a drawdown of 21.3% over the first quarter, the Minimum Volatility Index has outperformed by 5.4%, Quality by 5.9% and Momentum by 6.3%. So the fly to defensive is very much apparent in our factor indexes as well.

Mark Carver: So Hitendra, that's a very good equity view, but what do we see when we look beyond equities and to other asset classes?

Hitendra Varsani: So we also attract the performance of corporate bond indexes and corporate bond factor, as well as ESG indexes. And the trends that we've seen amongst corporate bonds is very much similar to what we've seen in equities. So factors such as low risk and high quality as well as those issuers that have had high ESG characteristics where there'd be ratings or trends have also outperformed their peers. So we're seeing a consistent story across both markets.

Mark Carver: So let's sort of change the tempo a little bit and let's think about this crisis as it relates to sort of past periods. I know six or seven weeks ago a lot of people thought that what we would experience was more similar to SARS or maybe the H1N1 crisis, but it's quite different. So what are the characteristics that make this market environment different from past periods of crisis and drawdown?

Hitendra Varsani: So this healthcare crisis is new than economic crisis is not new and we have a number of historical episodes of heightened market volatility with equity market drawdowns. The question is how can we measure some of the characteristics of these markets? We turn to the VIX and we look at the level of the VIX and also the shape of the VIX curve. During normal times where volatility is contained, the VIX is upward sloping. Over the last few weeks, we've seen significant inversion of the VIX, where the shortened VIX has overshot more medium-term VIX levels. But what does this mean for factor performance? When we look at how factors have performed through history during previous episodes of VIX inversions, heightened levels of market uncertainty and we found barely consistently there is a flight to defensive, so minimum volatility has outperformed during these times. Typically, the quality index has outperformed, high dividend yield index has typically outperformed and value and low size often suffer in the past. What we've seen year to date is a very similar pattern. But what's different about this time versus previous episodes of high risk? The biggest surprise that's caught many investors eye is how well momentum has performed. Momentum is one of the leading factor index performers year to day. Why is that the case? Typically momentum should falter during volatility spikes 'cause there's an inflection in terms of how sectors move, or stock moves, countries move... what we've highlighted in our previous research is momentum has had defensive characteristics. It's had a low beat to bias due to the consistent outperformance of these particular segments over the last couple of years. And that's been one of the major surprises.

Mark Carver: Well, the question I think sort of beyond the surprises is, you know, where do markets, where do investors go from here? In your factors in focus, in a lot of the work you've been doing is around this adaptive model. Can you explain that model and is there anything that investors can draw from that model?

Hitendra Varsani: So the objective of the adaptive multi-factor model is to help investors make more informed, better investment decisions through their factor allocations over time. And so our model is centered around four pillars, the macro environment, the valuations of the factors themselves and it's during certain times some factors can become relatively expensive, typically to where they've been in the past. We look at factor trends, which factors have been working over the recent history and the fourth pillar is centered around market sentiment, clearly during risk on, risk off regimes, factor behavior is very different. Now, what do we see today, to answer your question? Well, we refreshed our numbers in factors and focus till the end of March and we find overall, our adaptive model is overweight, minimum volatility and overweight quality.

Mark Carver: As people might expect given the environment.

Hitendra Varsani: Exactly, so the model has adapted to the changing market conditions that we've been experiencing over the last few weeks. So Mark, let me turn it to you now. You speak to some of the largest asset owners across the world, key decision makers-- so what are you hearing on the ground?

Mark Carver: Yeah, actually I think in truth one of the best things about my role is that I get to talk to clients in every part of the world. And these are clients from asset owners, sovereign wealth funds and I think there are two big themes on everybody's mind. And the first is where you started actually the conversation which is risk management. The difference in that conversation today versus the past is that clients are more interested in responsive risk. Where things like our trading models that have daily forecast horizons are much much more interesting to clients today because they're figuring out how do they get through this crisis and how do they better understand the risks that are present in their portfolio. The other piece of risk management is, you know, how do they think about the exposures that they have in their portfolio relative to the industry. So a lot of clients are asking us about factor crowding. Factor crowding is you know very well Hitendra is really about tail risk and the potential for drawdown. So those are the sort of big risk management topics that we're speaking to clients about and they're keenly interested. The other thing is confirmation of our factors behaving the way you would expect. You said it really well, in this environment, defensive factors are doing quite well... people would expect that. But then there are some things like momentum where people might not expect it to be doing as well as it is. So we're digging into that with clients and talking about why and as you know, you know, one of the reasons why momentum is doing well is its negatively correlated to things like residual volatility and beta. They're more, you know, high volatile factors. And so as a consequence it's holding up reasonably well. But that really isn't about confirming, you know, the factors are doing what they're supposed to and what people would intuit and then helping clients understand what tools do we have to help them make more effective decisions that's why our risk management and our factor models are of keen interest. So maybe I'll just actually conclude with that. The fact of the matter is we are committed at MSCI to being with you during this crisis, to being together with you by sharing insight. We have our homepage, msci.com/coronavirus that has a lot of the research that Hitendra and others are producing. We would also ask you to reach out to your MSCI representative if you want more information about the way our models are performing, our indexes, cause we are committed to being together with you through this crisis. So with that Hitendra, thank you so much for joining me for this conversation today and thank you to everybody for listening.

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