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TRANSCRIPT

Factors in Focus: Getting Active with Factors during Global Rotations

Featuring:

Hitendra Varsani, Executive Director, Global Solutions Research, MSCI

Jenna Dagenhart:

Global markets have been trending upward with the increasing number of vaccinations, and economies reopening. Joining us today to share insights on market rotation, performance through the lens of factors, flows into equity factor ETFs, and positioning going into Q3 is Hitendra Varsani, he's the Executive Director Global Solutions Research at MSCI. Hitendra, great to have you back with us. And we've seen a structural decline in volatility in the last year. Is this a challenge for active managers?

Hitendra Varsani:

Sure, so typically when market volatility falls, the dispersion among stocks also falls. And dispersion is a measure of the active opportunity set, so when the dispersion is high, the potential for capturing active opportunities is much greater as the spread between the winners and losers rises. Now in our latest research, Active Opportunities in Dispersed Markets, we highlight although the market volatility is grinded lower, we've actually seen a collapse in correlations between stocks. And that's kept dispersion elevated. And this trend is not just seen at global equity level, but we've also seen it in developed markets, emerging markets, as well as regional markets like EMEA and Europe.

Jenna Dagenhart:

So Hitendra, what's driving this dispersion?

Hitendra Varsani:

So over the various market cycles that we've looked at since the late 1990's, we found that during crisis periods dispersion has been driven by factors such as industry, countries, and styles, while during karma periods it's stock selection that mattered. But what's changed this time in the recent history? We found that the contribution of styles to overall factor dispersion is the highest it's been since 2003 when the tech bubble had burst. Now this reflects significant shifts that we've seen in leadership among styles. So from large caps to small caps, from growth and momentum into value over the last six months or so. Now within emerging markets, countries has structurally dominated factor dispersion. I mean, no surprise China, India, Russia, Brazil and other emerging market countries are very unique in terms of their characteristics. But what I find most interesting is the importance of style factors versus country factors has narrowed since our histories go back to the late 1990's.

Jenna Dagenhart:

Yeah, that's an excellent point, so with style factors contributing the most to the rotation, this provides a great opportunity for investment managers to be active in factors. Can you share some of the recent market highlights through the lens of factors?

Hitendra Varsani:

So with the reopening of economies and vaccine rollouts, we've seen strong rotation into the value factor. And this really started since Pfizer day in November 9th. And that performance in value continued throughout the first quarter of this year. Now over the second quarter, equity markets have gone from strength to strength. The AQI index is up 7.5% over Q2, and that's a fifth consecutive quarter of positive gains. And as markets have continued to gather strength, investors have favored stocks that have strong profitability characteristics, low earnings variability, and higher ESG exposure. And these underlying trends that we've seen amongst factors has been reflected in our factor indexes. So the MSCI quality index has outperformed the broad market over Q2. We look at AQI, it's outperformed by 200 basis points, at world 300 basis points, and at Europe level, even higher at 380 basis points. Now not only have we seen strong rotation amongst the factors, we've also seen strong rotation within the factors themselves, particularly momentum. Given by the strong performance of value over growth over the last six months, we've seen momentum and as May re-balance take higher exposure to value stocks. Now typically, these are two factors that are negatively correlated, momentum and value, and they provide diversification benefits. But with the strong performance and value, momentum has actually taken higher exposure and that may lead to higher correlations going forward. Now one thing to know is, we look at momentum as a factor, its valuation is typically much higher levels than the broad market. It's selecting stocks that are winning, but with it taking exposure to value, the valuation of the momentum factor is much lower now than it has been in the past.

Jenna Dagenhart:

Turning now to exchange traded funds, factory TFs have been one of the fastest growing segments of the ETF market. Hitendra, where did you see the strongest inflows and what are these flows signaling?

Hitendra Varsani:

So our recent analysis has looked into flows into Global Factor ETFs, and I think the first point to note is yield value and low size ETFs have seen the largest inflows among factor ETFs, gathering up to $50 billion year through to May this year. In other words, what does this mean? It means that investors have placed conviction into ETFs that have exposure-tive factors that typically do well during the early stages of recovery in the economic cycle. Now to answer your question, was there any signal that we could-- that we observed in factor flows? Simple answer is yes. In our recent research, Go with the Flow, we looked at when single factor ETFs have shown significant inflows or outflows relative to what they would normally achieve that's correlated well with active returns. So when Factor ETFs have seen significant inflows say, beyond a two standard deviation event, those factors have outperformed their parent indexes. Just to give you a sense of numbers, on the positive side it's around 80 basis points, and on the negative side, when they've seen outflows it's around 60 basis points. But one thing to realize is that our historical period was around six years, so it's fairly short and it's to be seen whether this continues as the market develops further.

Jenna Dagenhart:

And finally, we discussed the performance of pro-cyclical factors and the flows in the ETFs. Can you share some insights into the indicators for factor performance going into Q3 of 2021?

Hitendra Varsani:

Sure. So over various market cycles having exposure across style factors has delivered diversification. But through market cycles, we recognize that factors are cyclical and experience a strong rotation that we've seen evident in the recent history. Now taking a holistic view on factors is key to understanding what's driving the factor rotation. In an adaptive multi-factor model, we look at the macro indicators, fundamental indicators, what's trending, as well as sentiment driven indicators. Now since the last quarter of 2020, last year, indicators have been positive on value and on smaller capitalization stocks. But however, going into Q3 this year, momentum has actually overtaken value and is now overweight alongside smaller cap stocks. Now why is this the case? Why is momentum overweight? Well, it outperforms the other style factors on a relative basis in the last quarter, and it's got much higher value exposure than what it typically does. So the valuation of momentum is much lower than it is, and that's led to an overweight in momentum in our adaptive model.

Jenna Dagenhart: Well, Hitendra, thank you so much for joining us today and we look forward to more insightful sessions on factors with MSCI.

Hitendra Varsani:

Great. Thank you all for listening.

Jenna Dagenhart:

Yes, thank you so much for watching, and once again, that was Hitendra Varsani, Executive Director Global Solutions Research at MSCI. And I'm Jenna Dagenhart with Asset TV.

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