TRANSCRIPT

2021 Factor Investing Mid-Year Review Part I: Importance of Factors in the Portfolio Construction Process

Featuring:

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Raina Oberoi:

Thanks Jenna, for having me. And Andrew as always, it's a pleasure sharing the stage with you. What a wild year this has been, touching literally every part of our lives. Now, while markets were anticipating a vaccine announcement late last year, the actual announcement November 9th, that we now actually have vaccines that are more than 90% effective in preventing COVID-19, has been a game changer, and a key trigger for some big shifts across markets and factors in particular.

Now, while equity markets demonstrated resilience during a period of really high economic uncertainty, what we saw in Q4 of 2020, given the vaccine announcement and Joe Biden winning the US presidential election, was the fact that rotation really intensified. Momentum, which already has stretched valuations at the end of Q3 pullback, and we saw value stock, which has underperformed for a majority of the year, add gains in literally every region in a quite dramatic rotation. We saw small cap stocks significantly outperform their larger cap counterparts, reversing yet another trend. And investors favored higher beta stocks over lower beta stocks. We've seen some of these same trends persist as we've entered 2021.

Now, I think I won't do justice if I didn't spend some time on discussing the resurgence of value as economies started opening up. In fact, I believe in the last State of the Union in fall of 2020, Andrew had discussed the potential of a comeback in value, as these stocks do tend to outperform during the recovery. And what we saw is actually value did find its trigger in the vaccine announcement and the reopening of the economies.

Now, in the chart here, you actually see a clear out-performance of value starting on November 9th, 2020, reversing a really long trend. And the reason value is such a key topic to discuss is that after 15 years of challenging performance, investors were actually beginning to question whether value is still a valid investment strategy. Many proclaim that value is dead, and that there is no longer a premium associated with investing in such stocks. But what we have seen is that the reopening of the global economy following the rollout of the COVID-19 vaccinations has once again triggered and reignited interest in value strategies.

Now, as we have gone further into 2021, we have seen some trends reverse. Momentum, for example, which had plummeted since the vaccine announcement, showed better performance in the second quarter of this year. Now, one would wonder, well, what changed? And actually, there was no new trigger this time, but just that momentum did what it typically does. Momentum by definition, rotates to the securities with recent outperformance, regardless of other factor, sector, or country exposures.

Now, if you take, for example, the MSCI momentum indexes as a proxy, we saw these indexes rotate into securities with higher value and lower growth characteristics. And that's because value stocks outperformed in the last six months, and growth stock showed weaker performance in the same time period.

So as a result of these changes in relative factor performance over the last six months, securities of higher value exposure started to exhibit higher momentum characteristics. And we now see an increased value in momentum correlation. Simultaneously, we saw poor performing growth, low volatility and quality stocks decrease the momentum characteristics.

So, what is important to note is that momentum has reshuffled between factors in the past as well. So, while it may seem right now, that momentum is on the hunt for securities with higher value characteristics, that's only because value is doing well and it's in favor. Now, if that changes, momentum will target other characteristics.

So, I think it's important to understand not only the nuances of a single factor like momentum, but also how does it interact with other factors. And this has been a really good reminder for investors as well, to really take a holistic view on factors, and understand their dynamic between each other.

Finally, I would say, another interesting theme that we saw in the US in particular was the rise of market concentration. That is, a handful of mega cap companies increased their market share in US equity markets, exposing some investors to concentration risk. We also saw US equity markets experiencing increased volatility over the last few years.

So once again, a natural question investors had on their mind is, well, does this hamper investors' ability to capture style-related investment characteristics, or what we call factors, in an effective fashion? You also had some investors wonder that have stock-specific risks now, dominated factor portfolios instead, because now the market seems more concentrated, and it's dominated by just a few stocks. And what be found in our analysis is that actually MSCI's factor indexes and related factor portfolios remain quite robust, and factors still played a key role in explaining risks.

Finally, I would say to conclude, what we saw in these unprecedented months was that understanding and managing portfolio investment characteristics, or what we call factors, remained absolutely critical to the investment process. Thank you. And back to you, Jenna.

Andrew Ang:

Thank you very much. And Raina, it's always a pleasure to talk with you. And I think really, I'm looking forward to the second half of 2021, going back to some semblance of normalcy. And we can see that. We can see increased traffic on the streets, people going back to work, people now being able to meet their friends and help their family. And this is all great. And it's also seen us with what Raina called this dramatic reversal from growth into value. And that's the topic that I want to talk about.

This has been tremendous, this dramatic reversal. We will look at from November 9th, and Raina mentioned that date. This is Pfizer day. It's when we got the first news that there was an effective vaccine against the coronavirus. The difference between value and growth, say in Russell Industries, is about 20%. We've seen year-to-date, our performance that's been terrific as well. If we look at the flows coming into value strategies, we can look at the flow into VLUE, or US value, and that's been around $5 billion. So, this trend has been recognized by investors too.

I want to make three comments about this value resurgence. First, we have a lot further to run. Second, there is a way to actually hop on at the very beginning of a new value trend, and that's international value. And I'll elaborate on that. And the third one is that if we're looking for a compliment to this dramatic reversal of value, then I advocate that quality can be considered by investors.

So, let's turn to each of these three. There is still a long way to run with value. If we look at this slide, our value underperformance since 2017 to the end of 2020, with the comeback really from that Pfizer day of the beginning of November 2017 to 2020 is the worst value drawdown in approximately a hundred years of data, using this data from Fama and French. It is the longest duration of the drawdown as well. So, we hit from 2017 to the low of 2020, a drawdown of about minus 60%. Now, we've clawed our way back for some of that, but we still have a long way to go.

From 2017 to 2020, we've had a really late, prolonged slowdown at the late stage of an economic cycle. And then in 2020, we got hit with the coronavirus, exacerbating this. And the coronavirus all sent us into lockdown, where we had growth technology companies doing very well. And that penalizes the value companies who are usually long physical capital. But since that reopening, we've seen that dramatic reversal into value. The fact that it's been just so bad over so many years, means that we have a long way to go.

Okay, the second one is, if we look at international value, 2020 was the second worst year for international value in approximately a century of data. Now, international value is interesting because we've seen this reopening of the economy in the United States. There are some countries like the US, that have very high vaccination rates, countries like Israel and Canada. But most of the rest of the world, including most of Europe and Asia, lag behind the vaccination rates of the US. Asia is interesting because they were really good at handling, by and large, the lockdown in 2020, and containing the coronavirus. But they've been slower to adopt vaccinations for their populations.

So, as we go back to that reopening, there will be further reopening for these other international markets, which the US has really led. So, we can still look at going on this resurgence for value, and we can play that at the beginning with international value strategies.

Last, I want to leave a compliment. Value and quality are negatively correlated at around minus 20%. And that minus correlation is really absolutely terrific for diversification in our portfolios. Why? Well, if we look at value, value is all about buying cheap. Those cheap companies are typically long physical assets, and that's been rewarded as the economy reopens.

If we look at quality, quality is really a statement about the numerator in a dividend discount model. We want things like high productivity or ROE. We'd like to look at how to service that debt or low leverage, and we want lower volatility of earnings. Value buys cheap, so it's mostly a discount rate, what enters the denominator of that pricing formula. So quality is all about the numerator, and value is all about the denominator. Not surprisingly, value and quality are really good compliments. Quality gives us that resistance, that robustness just in case we see further variants coming out. Or we might enter again, hopefully a very transitory period of lockdowns.

But we are on track. The economy is here, it's reopening. And me, myself, I think, like you, were looking really forward to going back to some sense of normalcy. Thank you, Jenna.

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