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Val-come Back! Shifting Factors as the Cycle Turns

Featuring: ***Hitendra Varsani****, Executive Director, MSCI Research*

Host:

Joining us to mark the 2-year anniversary of Factor In Focus, is Hitendra Varsani, he's the Executive Director, Core Research at MSCI. We'll reflect on the historical relationships between factor returns and macro cycles and discuss the factor outlook for the year ahead. Hitendra, equities rallied in the last quarter of 2020 with the initial release of COVID-19 vaccines, a change in the US administration, Post-Brexit deal between the UK and the EU. How did these significant macro events impact factor performance?

Hitendra:

So, we've seen strong performance across equity markets. The MSCI All Country World Index was up 14.8% over the fourth quarter, reaching an all-time high at the end of the year, and finalizing 2020 up 16.8%. Now, one of the most striking features in 2020 that we've observed is the acceleration of the speed of the cycle, from the downturn to the recovery. We've also seen a reassessment of what constitutes short-term risk versus long-term risk. And this has had significant implications in terms of differentiating winners from losers, and also, this applies across sectors, countries, and star factors. Now, in fact, one of the key lessons that we at MSCI have highlighted over 2020 was that managing factor exposure has been more critical than stock selection. And the last quarter was no exception. Value factor indexes across global, regional, international markets, they were given a boost alongside sectors that appeared to have also some value exposure. For example, energy, financial, materials. And this may indicate a renewed sense of optimism, increasing expectations for higher growth, recovery in businesses that were the hardest hit during the pandemic. Now, the magnitude of this value outperformance was exceptional. Active return of 7.3% over the quarter. Very much comparable to what we observed during the global financial crisis recovery in the second quarter of 2009. Now, within developed markets, large-cap stocks that have dominated for majority of 2020 also took a step back, and those lower, smaller capitalization stocks took the lead in Q4. In fact, MSCI ACWI small-cap index outperformed its parent by a staggering 9%. Now, both value and smaller, lower-sized factor exposures were overweight in our adaptive multi-factor framework, that we highlighted last quarter. And this was largely due to their lower valuations and also the recovery in the economic indicators.

Host:

Earlier you mentioned the shortened cycles that we saw in 2020 in the behavior factors throughout the year, 2021 could look very different than 2020 if the pandemic subsides, bringing lower anticipated volatility. With potential market stabilization, investors a bracing for a rebound in the value factor, can you dive deeper into your factor analysis and describe the relationship between factor performance and economic cycles?

Hitendra:

So, over several market cycles there are certain factors, style factors, that have delivered outperformance. For example, value, momentum, quality, low sides, low volatility. But we do recognize that factors do go through periods of variation through the market cycle. And given the speed at which the cycle has changed in the recent history, we've taken a step back and reassessed how do factors perform in different economic environments? How do they perform as we transition through cycles? And so, in our study what we did is, we constructed portfolios of factors based on different states of the world, as given by our indicators. And the key takeaways are as follows: During Recovery state, it's those price-sensitive factors like value and low size that have typically led. And that's also consistent with what we've seen most recently. During Expansion, it's momentum that's a clear winner. During Slowdown, it's low volatility, and, to some extent, also quality and momentum. And during Contraction phases, defensive factors such as low volatility and quality have led. And this is all relative to an equally weighted factor mix. So, our study may help investors who are active in making factor allocations useful, it can provide a historical context, and backdrop when constructing and building factor-based portfolios.

Host:

So that's the long-term picture, what did the adaptive multi-factor model indicate going into 2021?

Hitendra:

So, as at the end of last year, 2020, our adaptive multi-factor model has continued to show an overweight in value, and low size, and a negative or underweight exposure to quality and low volatility, and neutral stance and momentum. And this is all relative to an equally weighted factor mix. And this is largely based on an improvement in economic indicators, the lower valuations of value and size, despite the recent rally, and also the positive market sentiment and continued optimism that we've seen. Now, clearly we are still in a pandemic and we face significant challenges, and so these indicators should be put into context.

Host:

Excellent. And, when looking at factors, how does this translate from equities to corporate bond performance?

Hitendra:

Sure. So, in the same way style factors in equities give investors more transparency, they offer differentiated risk-return characteristics. Credit factors serve very similar purposes. They are also designed to offer this differentiated risk-return characteristic. And they also vary and deliver performance at different stages of the economic cycle, as we've seen for equities. Now, for fixed income investors, the current challenge is the low-interest-rate environment. Particularly for those yield-seeking investors. However, withing credit, it's factors such as credit carry that are constructed to give exposure to those securities with higher income, could potentially offer that additional source of return. For example, if you look at the most recent environment, over Q4, the MSCI dollar-denominated investment-grade carry index has outperformed its parent index by almost 600 basis points. So, put in context, the current interest rate environment, an outperformance of 590 basis points to be precise on a nexus return basis.

Host:

That's quite a bit of outperformance there. And finally, Hitendra, what role will factors play in 2021?

Hitendra:

So, the recent experience has demonstrated why factors matter now more than ever. And, certainly, factors in not a new concept, but we are seeing increasing use cases for factor investing. Factors provide greater insight when constructing and maintaining portfolios, we've seen that they can help exploit relationships between factor performance and the macro environment in both equities, and we've also studied fixed income as well, and this has been a real motivation for using products linked to factor indexes in asset allocation. And then, finally, factors provide a platform to accommodate an expanding toolkit, from alternative factors to thematic factors, as well as sustainable factors.

Host:

Well, Hitendra, really great to have you, thank you so much for joining us.

Hitendra:

thanks very much for hosting us.

Host:

Absolutely. And thank you for watching. That was Hitendra Varsani, Executive Director, Core Research at MSCI. Really great to hear from him on some of the roles that factors will play in 2021 looking at those economic cycles.

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