# Factor Trends: What's in? What's out?

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

**Adam Bass:**

This is MSCI Perspectives, your source for weekly research insights as investors respond to the COVID-19 pandemic. I'm your host Adam Bass, and today is July 9th, 2020.

This week, I'll look at the factor trends across equity and fixed income markets. Where did we see outperformance during the second quarter and what did MSCI's models show as we moved in to Q3? We caught up with Hitendra Varsani, executive director on the core research team from his home in suburban London.

Okay, Hitendra. First off, thank you very much for being here.

**Hitendra Varsani:**

Thanks, Adam. Great to be here.

**Adam Bass:**

So the UK where you're located has been on a slightly different track than the US in terms of quarantines and fighting against the virus, but we've all been on lockdown more or less for the last few months. Have you found any new ways to pass the time?

**Hitendra Varsani:**

Sure. So I've actually taken up a hobby in cycling and I found myself drawing parallels with my cycling activities with financial markets. I've taken a measured approach to both my long terms and short-term goals. I plan my journey. I avoid crowded or congested places, [inaudible 00:01:17] expectations, and then I use technology or tools that help me evaluate how well I'm doing in my current practice against previous practices and against general benchmarks.

**Adam Bass:**

I have to say your exercise regimen sounds much more well, let's say regimented, than mine is.

**Hitendra Varsani:**

Thank you.

**Adam Bass:**

But today we're here to talk about the second quarter performance of the markets specifically. It was the first full quarter where the pandemic was everywhere, yet markets recovered sharply. Some like in the US set record levels. So today while we're looking back through the quarter, we're going to do so through the lens of factors. Before we dive into that, can you just give us a brief definition of what we mean by factor investment?

**Hitendra Varsani:**

Sure. So factors by construction are designed to take targeted exposures to specific segments of the market with certain characteristics such as quality stocks with high profitability and low leverage or value stocks where market prices are compared to some fundamental anchor. At MSCI we have a universe of factors, and these are largely based on an economic rationale and there's academic evidence to support their existence. And within MSCI, we have research teams that are dedicated to also validating that empirical evidence and ensuring that these factors meet certain statistical competence levels.

**Adam Bass:**

Let's take a look. What did the second quarter look like from a factors perspective?

**Hitendra Varsani:**

So if we take a step back and just look at the broad market, the ACWI index delivered a headline return of 19.4% over the second quarter. Developed markets outperformed emerging markets, USA outperformed Europe, and in terms of style factors quality and momentum outperformed. However, what we did see is strong dispersion in regional and factor indexes, which indicates that certain countries and regions may be at different points in their cycle and investors are taking a more nuanced view. So let's take an example. In Asia in Q1, low size outperformed. In Q2, that trend transpired to USA and Europe, and low size performance is a typical indication of an early stage recovery. Where we've seen surprises in fact more generally is in equity momentum. That's a factor that follows trends. Things that have worked continue to work, and momentum will benefit. What we've experienced is unprecedented market volatility, significant drawdowns followed by significant recoveries. Momentum has outperformed on the way down and also on the way up.

**Adam Bass:**

And it's interesting that low size, as you say, as a harbinger of recovery would come in in the midst of what for a lot of the world was not so great economic news. How does that square?

**Hitendra Varsani:**

So at this point in time, it's largely based on expectations. Many countries and regions are still in lockdown phases or unwinding their lockdown, and it's not clear how quickly businesses will recover. There has been a significant amount of monetary stimulus. We now have fiscal stimulus and small cap stocks or lower capitalization stocks have underperformed for some time if we look over the last few years, and the valuations had reached much lower levels than they had been in the past. And so when there is a recovery, they have been the most sensitive.

**Adam Bass:**

And what about the other side of the equation? Which factors underperformed in this environment?

**Hitendra Varsani:**

So in the context of a normal 20% market rally in the MSCI ACWI index, low volatility stocks have led the board market. It's those high-beta stocks that perform well, and so low-beta stocks have lagged. In early stage recovery, low volatility stocks typically do underperform. I think what's somewhat surprising is values underperformance have generally continued, but having said that there are pockets of outperformance. So if we look at Europe value, Europe's value has outperformed its [pair 00:05:53] by 290 basis points in the second quarter.

**Adam Bass:**

And does the outperformance in Europe tell us anything specific about what investors are looking for from European firms or expecting?

**Hitendra Varsani:**

So during market recoveries, perhaps investors are looking for value but looking for value in one of the cheapest regions in the globe, and that has been Europe. Having said that, by the end of Q2 markets have repriced. As you mentioned, many markets are close to all-time highs. At the end of 2019, the [inaudible 00:06:33] earnings of the MSCI ACWI index was around 16 and during the peak of the crisis towards the end of March the valuations were around 13, so much more depressed. However, by the end of June, the end of the second quarter, they're at 19. ACWI is still 10% below its high yet its valuation is much higher than it was at the beginning of the year, and that's largely due to earnings being revised downwards. Valuations across many markets, including Europe, are the highest they've been since 2003.

**Adam Bass:**

Did you see anything in the numbers for specific sectors that were outperforming over the quarter?

**Hitendra Varsani:**

So technology has continued its upward trend, and clearly that's a sector that's well positioned. Both quality and momentum factors have been positively biased towards technology, and that's helped the outperformance while being underweight to financials. Financials have continued to underperform. Consumer discretionary stocks that are also exposed to growth and quality have been strong performers as the expectations of discretionary spending may increase. So you could think of it as perhaps market prices are moving more on technicals than fundamentals. And we've seen that in our factors as well where it's the liquidity factor, the volatility factor, the momentum factor that's had outsized returns, whereas the more fundamental factors like value have seen some mixed results depending on the metrics that we look at.

**Adam Bass:**

So you and I for now have been focused mainly on equities and equity markets, equity factors, and I think a lot of people probably associate factors more with equity markets. But what about the fixed income side of things? What did we see there?

**Hitendra Varsani:**

So fixed income factors in the second quarter have behaved as they have during historical episodes. So for example, the pro-cyclical factors like value, carry, low size, outperformed, and so we've very much seen things play by the book.

**Adam Bass:**

Looking backwards is easy and while we can't predict the future, I'm curious, what were the models showing as the quarter ended?

**Hitendra Varsani:**

Sure, Adam. So when we take a look at the adaptive indicators or factor performance, we see contraction in economic indicators and so a mix of factors will be biased towards defensive factors. So overall, there's a pro-cyclical bias towards the low size and value practice. From a valuation point of view, these two factors have been cheap for some time now for the last few years. However, what's changed is momentum has typically had a bias towards the defensive factors, the low-ball momentum quality. What we've seen recently is low volatility taken out, size come in, and hence create pro-cyclical bias as at the end of June. Market sentiment has also turned. We've seen implied volatility come down, credit spreads tighten. Again, that's created a positive market sentiment indicator and overall pointing again towards those pro-cyclical factors, low size, and value. So it will be interesting to see how this actually plays out over the next quarter.

**Adam Bass:**

That's all for this week. Thanks to Hitendra and to all of you for joining us. We hope you'll join us next week when our guest will be Brett Winton, director of research at ARK Invest. We'll ask Brett about the implications of what he's termed "the genomic age of medicine", what it has meant as scientists hunt for a COVID-19 vaccine, and why he identified genomics as a key driver for thematic investing even before the pandemic.

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Until next week, I'm your host, Adam Bass, and this is MSCI Perspectives. Stay safe, everyone.

TRANSCRIPT

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