MSCI

TRANSCRIPT

Focusing Factors on Inflation

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

Adam Bass (00:02):

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 October 8th, 2020. This week, one of the lessons investors have learned during the pandemic is the importance of factors when it comes to managing portfolios. Some might even say that every investor is a factor investor. As we do each quarter, we welcome back Executive Director for MSCI Core Research, Hitendra Varsani, to help us sort through the latest factor performance. Hitendra, welcome back to the program.

Hitendra Varsani (00:40):

Hi, Adam. Good to be here.

Adam Bass (00:43):

So the last time you were on, you talked a bit about the idea of style factor momentum. How did this play out over the third quarter? Can you just walk us through high level some of the other equity factor performance trends you saw?

Hitendra Varsani (00:59):

Sure. So when we look back at 2020, momentum has been a dominant driver of returns across global markets, along with quality and growth. We presented the concept of style factor momentum, and that's a term that we use to describe simply that factors that work continue to work well going forward. And we've seen strong evidence of that in recent times. The ACWI, All Country World Index, returned a healthy return of about 8.3% in Q3. And momentum and quality have continued to outperform, delivering out performance in the range of 5.1% for momentum and 1.8% for quality. Now, at the end of the first half, we've also highlighted the recovery macro indicators was negative for yield and low vol. And again, we've seen that play out over Q3. These trends, they're fairly consistent across global and regional markets. So whether we're looking at world or emerging markets or Europe or Asian markets, factors that have worked have pushed their valuations higher. Notably a bank's momentum stocks for ACWI, the price to earnings is in excess of 30. For value stocks, it's close to 10.

Adam Bass (02:14):

And what about on the fixed income side? I'm specifically thinking here about US dollar and the Euro markets. Given the continued low rate environment, did you see any effect on issuance or the growth of corporate bond market overall?

Hitendra Varsani (02:30):

Absolutely. So corporate debt issuance and the dollar denominated, and investment grade market in particular, up until the end of August was around $1.7 trillion. And that compares to $1.1 trillion at the same point last year. So clearly, we're in an environment where corporates have taken advantage of the investor appetite for high quality bonds in this low rate environment. We've also seen debt issuance increase in the Euro market as well.

Hitendra Varsani (03:04):

Now, in terms of general market performance, we have indexes that track segments of the IG market in both USD and Euros in terms of style factors, just like we do in equities. Now, if we look back at the last two quarters, we found investors have favorite pro-cyclical factors, such as value or bottom fishing. Those cheap credits carry those that have had a higher spread. And lower size, those that have less debt issuance. Whereas the defensive factors like low risk and high quality have lagged in the recent market.

Adam Bass (03:40):

Have you seen style factor momentum on the fixed income side as well?

Hitendra Varsani (03:44):

The evidence for style factor momentum hasn't been investigated to the extent it has in equities. We had 40 years of data to test that thesis, where the credit factors history goes back only about 15 years. But certainly if we look at 2020, at least over the last two quarters, we've seen those pro-cyclical factors gaining momentum as well.

Adam Bass (04:08):

Going back to the idea of monetary policy, interest rates, the Fed recently shifted their inflation approach from a 2% target to aiming for an average of 2% over time. Of course, the implication being that they won't necessarily raise rates were inflation to pick up. How have you approached this from a factors perspective?

Hitendra Varsani (04:31):

Sure. So we've looked at how equity factors have performed in various inflation and real yield environments using our deep history as a guidebook. So this is a dataset within MSEI that extends back over 40 years. And we see generally, there's three camps. We see factors have had inverse relationship to inflation or real yield. We've seen some factors have had a positive relationship. And then interestingly, we've seen some factors that work irrespective of the environment, quality and momentum. These two factors have outperformed, irrespective of whether inflation or real yields were high or low. And we also observed that these are the two factors that have been dominating the market not only in 2020, but also over the last few years as well.

Adam Bass (05:26):

Very interesting to note, given the recent attention on inflation.

Hitendra Varsani (05:30):

Absolutely.

Adam Bass (05:31):

Now, turning to some conversations that you've had with clients. It's always so valuable to get your experience from this. What is on their mind these days?

Hitendra Varsani (05:41):

Clients are recognizing that the market is increasingly differentiating between winners and losers. So if we take Acquia as an example, the performance year to date is fairly flat, but underneath the surface, we find that 30% of the constituents are 20% lower than where they started at the end of Q3. So the high degree of dispersion that we've seen has really created opportunities for the [inaudible 00:06:11] investor. Now we're in Q4, clients are thinking about what's on the horizon. Let's think about stress testing. And in those different scenarios, how would factors respond? With increased likelihood of lower rates for longer and the potential for high inflation that we spoke about. You see clients think about high dividend yield strategies that have certain quality characteristics, stable dividends, potential for dividend growth. Companies that can continue to pay out during difficult times. And in an environment where income is going to be hard to source, high dividend yield strategies are quite unique in that respect.

Adam Bass (06:50):

Throughout the pandemic, your research, as well as that of your colleagues, you stress the importance of factor selection as being even more important than stock selection. Can you tell a little bit more about that?

Hitendra Varsani (07:04):

Sure. So when we look back at the crisis, clearly there were significant bouts of market volatility that were experienced over time. We refer to that as time series volatility. But it's also important to think about cross-sectional volatility too. That gives a measure of the variation of the returns in stocks over a certain window. During the pandemic, we observed cross-sectional dispersion attributed to common factors rose significantly more sharply than stock specific volatility. Now, that's using fairly scientific jargon. If we think about this more simply, in other words, what we're saying is it was more important to manage your exposure to, say, for example, airlines as a whole, than to, say, distinguish between British Airways and American Airlines. But generally speaking, managing factors effectively at various levels of aggregation via industry, sector, factor levels, these are useful tools to have at hand when managing risk and performance.

Adam Bass (08:14):

And last, but of course not least, everybody wants to know what's coming. At the end of the quarter, what do the models show as we head into the last part of the year?

Hitendra Varsani (08:24):

Sure. So we have an adaptive multifactor model, and this takes a holistic approach to factor assessment based on a number of indicators, expanding macro indicators, the valuations of the factors, recent performance trends, and the risk sentiment in the market. Overall, when we look at the indicators as at the end of Q3, we do see a pro-cyclical bias towards low size. So these are these small capitalization stocks. And we see this bias across all four pillars.

Hitendra Varsani (09:03):

Now, as you and me know, mega caps have outsize gains. They've had strong momentum exposure. They now have premium valuations. And perhaps these smaller names have received less attention and somewhat lagged over the full year. Low size small cap stocks is a factor that has low valuations, has recently turned in terms of performance, and is also overweight due to economic indicators pointing to expansion. However, we do have to keep in mind that we are progressing through an unusual environment during uncertain times. It's unclear whether a vaccine will come for COVID. And so it's interesting to see how this final quarter actually finishes and where we go from here.

Adam Bass (09:56):

That's all for this week. Thanks to Hitendra and to all of you for joining us. Remember, it takes just a moment to subscribe to the podcast, to leave a comment, or share with a friend. Until next week, I'm your host, Adam Bass, and this is MSEI Perspectives. Stay safe, everyone.

TRANSCRIPT

About MSCI

MSCI is a leading provider of critical decision support tools and services for the global investment community. With over 45 years of expertise in research, data and technology, we power better investment decisions by enabling clients to understand and analyze key drivers of risk and return and confidently build more effective portfolios. We create industry-leading research-enhanced solutions that clients use to gain insight into and improve transparency across the investment process. To learn more, please visit **www.msci.com**.
