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TRANSCRIPT

Episode MMXXI: A New Hope?

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

Adam Bass (00:03):

This is MSCI Perspectives, your source for global investing insights and access to research and expertise from across the investment industry. I'm your host Adam Bass and today is January 7th, 2021. First, a very happy new year to you all and welcome back to the program. A new year means a fresh start. It's a time to try new things. In that spirit, we are broadening the scope of our program, both expanding the range of issues we cover, as well as the depth at which we explore them.

Adam Bass (00:38):

We're also changing the frequency of the program. So going forward, we'll release a new episode every two weeks and have some special features along the way. Of course, some things won't change like our quarterly check-in with Director of Core Equity Research, Hitendra Varsani. We'll take a look at the markets through the lens of equity and fixed income factors. Hitendra, welcome back and of course, happy new year. We made it, buddy. We made it. It's 2021. How does it feel?

Hitendra Varsani (01:09):

Happy new year, Adam, and to all the listeners. So clearly the challenges that we face in 2021 are enormous, but I'm feeling optimistic about the world. We're all coming together and I think we'll come out much stronger as we rebuild. But on a smaller scale, more personally, I have renewed appreciation for all those little things that we may have taken for granted.

Adam Bass (01:29):

Awesome. Well, then let's get right to it. When last we spoke back in October, one area that you spoke of in your quarterly factors in focus report, you spoke with the optimism actually that you mentioned just now, on the area particularly of small cap stocks. Now at the time, that was not exactly a consensus view. So did that play out during the last part of 2020?

Hitendra Varsani (01:55):

That's right. small caps were lagging large caps for majority of 2020. But at the beginning of the last quarter, we did highlight that many indicators that we look at were very much aligned for small cap out performance. Economic indicators had turned more positive, valuations for small caps were low, sentiment was turning more positive and mega caps, which are the most resilient in the first three quarters, really questioned investors' mind in terms of, "When are those smaller capitalization stocks likely to catch up?" Now, looking back, it turns out the MSCI ACWI All-Country World Index Small Cap outperformed its parent, the MSU ACWI, by 9% over the last quarter.

Adam Bass (02:41):

What about other equity facts? I mean, that's a startling number, but there have been some pretty significant market moving events since we last spoke. Joe Biden, winning the U.S. Presidential election, COVID vaccines have started to be distributed around the world, and the long awaited Brexit deal between the U.K. and the E.U. was signed. So how did these events, or how have these events shown up in the market so far?

Hitendra Varsani (03:06):

Clearly the three biggest events over the last few months. I think one of the most striking features about 2020 was how quickly the economic cycle turned and the implications that had on factor performance. The last quarter was no exception. Value factor indexes across global, regional and international markets were given a boost alongside cyclical sectors on the progressive news of a vaccine. This happened as investors increased expectations, perhaps for higher growth and a recovery in businesses that were hardest hit during the worst of the pandemic. This magnitude in terms of value of performance was not small. In fact, it was a staggering 7.3% at the ACWI level, which is comparable to what we observed in the second quarter of 2009 recovery from the global financial crisis.

Adam Bass (03:57):

Does that mean value is back? What drove this performance?

Hitendra Varsani (04:01):

So value stocks certainly fought back after a prolonged period of under performance. However, one might argue that a large part of this recent performance was actually due to the negative momentum exposure and high beat exposure. While this might be the case, it only explains a fraction of the recent returns. So I'll be interested to see how sustainable this value rally actually is, over the coming months.

Adam Bass (04:27):

Now you mentioned earlier economic cycles and how quickly in 2020, for example, we moved through them. Specifically, we're talking about moves through expansion, economic slowdown, contraction, and then ultimately recovery. So as 2021 begins, where do we find ourselves? What has your research told you about the relationship between factor performance and each of these different stages? You started to talk about it, but a little more detail, if you could.

Hitendra Varsani (04:58):

Sure. So let's take a step back. Over several market cycles at certain style factors like value, momentum, quality level, the size, have delivered out performance in that long run. But we do recognize that through market cycles factors have experienced a high degree of variation and performance. We take a look at certain economic indicators, and based on where they are at the beginning of the month, we decide which regime that we're in, which state of the world, you mentioned expansion, slow down, contraction, recovery, based on those states.

Hitendra Varsani (05:35):

What we did is look at a selection of factors and see how they performed on average over a one-month holding period. Now to summarize, in a recovery state, low size and value typically lead, and that's what we've seen over the last few months. During expansion phases, momentum has been a clear winner. During a slowdown, it's low volatility and to some extent, quality and momentum that have the best. In a contraction during times of market stress, defensive factors namely; low volume, quality of outperform, and this is all relative to an equally weighted basket of seven-factor indexes.

Adam Bass (06:17):

So as you mentioned, small caps and value have been the markers of recovery. So are they saying that's where we are right now? What can this possibly tell us about the markets that we're looking at as 2021 begins?

Hitendra Varsani (06:35):

So based on the historical patterns, that is a consistent story. During recovery state, which follows periods of contraction, it's those price sensitive factors, low size and value, that typically bounce back first. Then as we transition into a more sustainable recovery where trends get established and momentum typically takes over. But that's all from a historical context.

Adam Bass (07:01):

Are there any factors that seem to react more to the cyclicality or less than some others?

Hitendra Varsani (07:10):

Absolutely. So we looked at seven factors, and one of the factors included the growth target factor index, the MSCI growth target indexes. This is an index that's been constructed to have a high exposure to the growth factor while mitigating risks or exposures to non target factors like a negative value exposure or a high volatility exposure. In effect, what we found is, once we control for these unintended biases, the growth target index and a steady premium across market cycles and has displayed significantly less cyclicality compared to the other factor indexes that we've walked through. For example, momentum or value or low size. But it's that control of those unintended factor biases that's really given it a more steady performance over time.

Adam Bass (08:06):

So by focusing solely or more purely, to put it another way, on the growth factor, isolates it or has isolated it more so from the cyclicality. Is that accurate?

Hitendra Varsani (08:20):

That's a fair way of putting it. It's the purity of the exposure to growth that has reduced the cyclicality. If we were to put back in those unintended biases, that target index characteristics would be significantly different. And it would be facing very high degrees of cyclicality being exposed to typically high volatility and negatively to value.

Adam Bass (08:46):

Now, we did have an opportunity with some other guests toward the end of last year to talk about two of the three events that you mentioned, or that we both mentioned about the presidential election in the U.S., COVID vaccines. But Brexit, that was a late entry. Happened later in the year, a lot of people were away. Now that we're back online and conversations are starting, I'd be very curious to hear... Given the fact that you are in London, not necessarily looking at the markets per se, but what's the mood on the ground?

Hitendra Varsani (09:24):

Well, this is a situation that's been fairly prolonged, put simply dragged along, for the last three years. So this removal of this uncertainty has brought clarity onto people's minds and within the U.K., it's a renewed source of optimism that we've now done the deal. We've exited the E.U., and now we can move forward with trade deals with not only the E.U., but also global counterparts as well. So I'd say overall, it's been fairly positive.

Adam Bass (09:54):

So speaking of moving ahead Hitendra, and we learned very early on in 2020, the dangers of doing so, but it is the start of the new year. We had a recent MSCI survey of financial advisors in November of last year trying to look ahead. That found that advisors were expecting value, momentum, and quality to outperform other factors, at least in the U.S. How does those findings compare to what the models are showing heading into 2021?

Hitendra Varsani (10:32):

Right. So as at the end of 2020, our adaptive multi-factor model continued to show an overweight to value and low size, and negative exposure on quality and low volatility and neutral on momentum, relative to an equally weighted factor mix. This is largely based on the improvement in economic indicators we've seen. The low valuations of value and low size, despite the recent rally and also the positive market sentiment. Now within the U.K., there is a variation of COVID-19 which is spreading much faster, which poses some risks. But on the other hand, there are a number of vaccines coming to market with positive outcomes. So you may want to tread with cautious optimism based on what the model is saying.

Adam Bass (11:23):

So we've talked a lot about optimism today, Hitendra, and new year, new possibilities. I understand that you're taking on something new this year. You're training for the London Duathlon. What's that all about?

Hitendra Varsani (11:39):

Sure. So this is an event that myself and my colleagues at MSCI have decided to take on for charity. It involves a 5K run, followed by a 22K cycle, finishing off with a 5K run. It's been a great way to engage with colleagues outside of work, while keeping us active under social distancing rules.

Adam Bass (12:03):

Any predictions on how you'll do? Just between the two of us.

Hitendra Varsani (12:07):

So I did my first run just a couple of days ago. When I was planning to do 15 kilometers. But Hey, it's 2021. So I added an extra six and I ended up doing 21 kilometers. 21 for 2021. So I think I'll be just fine.

Adam Bass (12:24):

Of course. Well, I'm getting tired just thinking about that. So seems like a good time to say, Hitendra, thank you so much for joining us on this first episode of perspectives for 2021. Your optimism is contagious.

Hitendra Varsani (12:42):

Thanks Adam. All the best.

Adam Bass (12:45):

That's all for today. Our thanks to Hitendra, and all of you for listening. For more details, check out the full factors in focus report on msci.com. Next up on perspectives, we'll talk China tech, with Nina Xiang. She's founder and Managing Editor of the China Money Network. Until then, I'm your host, Adam Bass, and this is MSCI Perspectives. Stay safe, everyone.

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