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TRANSCRIPT

Did Pfizer Give the Value Factor a Much-Needed Shot in the Arm?

Featuring:

Robert Hum, US Head of Factor ETFs, BlackRock

Patrick M. Moraniec, CFA, Senior Investment Manager International Equity Division, State of Michigan Retirement System

Hitendra Varsani, Executive Director, Core Research, MSCI

Adam Bass (00:03):

This is MSCI Perspectives, your source for insights for global investors and access to research and expertise from across the investment industry. I'm your host, Adam Bass. And today is July 8th, 2021. Today you can't talk about factor performance in 2021 without talking about the value factor. More specifically, it's the story of its resurgence as parts of the world economy wake up from the medically induced coma that governments placed them in, in response to the pandemic. But as we approach the end of the second quarter, we sat down with a researcher.

Hitendra Varsani (00:43):

So I'm Hitendra Varsani. I'm part of MSCI's global research team based in London. With a specialization in factor investing and derivatives research.

Adam Bass (00:53):

A representative from a large institutional investor.

Patrick Moraniec (00:57):

My name is Patrick Moraniec. I'm the head of the international equity division for the state of Michigan retirement system.

Adam Bass (01:05):

And one from the world's largest asset management firm.

Bob Hum (01:08):

My name is Bob Hum. I head up US factor ETFs here at BlackRock.

Adam Bass (01:14):

Our aim was to pull apart the value story a bit and place it in the context of the larger factor investment story. How it plays out for different folks at different places in the investment ecosystem.

Bob Hum (01:28):

What's interesting is that, you know, factory ETFs is one of the fastest growing areas of ETF market, right? It was about $25 billion a decade ago. It's eclipsed about $600 billion today, but what I find interesting is that most clients actually don't realize that they are a factor investors. They don't understand what factor investing is. And I think it, sometimes people over-complicate it, but the way that I think about it, it's rules-based transparent active. All we're doing is taking strategies that active management using their entire careers, like value, quality, momentum, and we're putting those strategies in the ETF vehicle, for lower costs and more tax efficiency. That's it.

Bob Hum (02:05):

I might be, maybe I'll be dating myself a little bit now with this analogy, but if you think about the way that we used to consume music, right, there was really kind of two options. So we would either one, kind of buy a CD and then get every song that that artist played. So if I wanted to listen to, I don't know, Biz Markie back then and wanted only that one song, I would get all of his other kind of duds that came along with it. Or you could go to, if you remember these infomercials, the jock jam CDs, right? You'd have someone that would actually just pick and choose the songs across a bunch of different artists. You didn't get to choose that, but you outsourced that decision-making to the jock jams brand.

Adam Bass (02:51):

Okay, Biz Markie, jock jams, I'm with you so far. How does this relate back to investing?

Bob Hum (02:58):

So 20, 30 years ago, there were really two options for you. You can either buy the index and buy everything, or you can outsource it for a fee to an active manager. I think what's different about today and what technology has allowed us to do for factor investing, is really pick and choose exactly what factors you want in your portfolio, right? So if I want value, or quality, or momentum, I can individually buy those factors. The same thing with Spotify, right? So Spotify allows me to pick and choose the songs that I want to listen to as opposed to either listening to an entire CD, or outsourcing it to that jock jam CD that you can buy off the shelf. And so again, I think what Spotify and what factory ETFs have done, is given investors or music listeners choice and the ability to customize your playlist or customize your portfolio.

Adam Bass (03:50):

What's interesting there, well one of the things that's interesting with what you're talking about, is the use of the term active management. Especially because when we're talking about factors and we're talking about ETFs, it's not usually thought of in that light.

Bob Hum (04:04):

Yeah absolutely. So, the way that we think about it is that anytime you're moving away from market cap, you were making an active decision, right? So, if you were buying high-quality companies, that is an active decision within your portfolio. And so, what we think about from a factor lens is that we can now do this systematically, just in a much more efficient way, right. You know, I used to do mutual fund due diligence. So I've met with pretty much every active manager in the space. And the key phrase that I've always heard was, I'm a bottom up stock picker looking for consistent earnings, strong balance sheets, and low debt. Well, guess what, now, today, because of technology, we can do that in our quality factory ETF, by screening for your profitability, your ROA, your earnings consistency, the standard deviation of your earnings or your debt levels. Your debt to equity ratio.

Adam Bass (04:54):

Bob and I continue down this path talking about the different ways that financial advisors work with their clients to put single factor strategies, in this case, single factor ETFs, putting them to work as a way to express a view or fill a role within a diversified portfolio. What about someone sitting on the other side of the table, though? How does say someone managing the international equities portion of pension assets for employees in the state of Michigan here in the US put factors to work?

Patrick Moraniec (05:28):

We think about it as really just a systematic way of looking at the world. And really, that's another way of saying a consistent process, really for determining stock selection. And that stock selection influences the drivers of your returns, right? And so a factor by definition has to effectively have a logical story, a why. So it helps bring a level of communication and transparency, we think, to what we're doing ultimately, which is to consistently beat that benchmark. We're more focused on that long-term small wins concept. You know, the hot dot or trying to figure out what's going to work in the next 12 months, we think it's difficult for a whole host of reasons. And then we look at this other concept, multi-factor portfolios, in our case, persistent exposure to certain multifactors. And we just see all these wonderful benefits that why would we go the other route? For us this makes a lot more sense.

Adam Bass (06:24):

Words like consistent and process and the story of why, these are key concepts for Patrick and his team. They came up time and again, throughout our conversation. But what's important to note here is how they lead directly to Patrick's view on the role of factors.

Patrick Moraniec (06:43):

We're International equity, where basically all publicly traded, emerging in developed markets around the world. So it's, we want what we're doing to work broadly in the world and factors just fit really well. At the core, they're really the building blocks of what we do. And so we think about a return series, it's pretty simple. Get exposure to international equity markets, that's the beta. Then select, in our opinion, the factors that make sense in combinations. We have implemented since really the late fall of '18, a factor strategy, a multi-factor strategy, that is focused on quality value and momentum. And we went through a series of analysis where we looked at a tremendous amount of data back over at least 22 years of data for the actual benchmark that we have. ACWI ex US, the MSCI ACWI ex US, but we also looked at some world data, the MSCI world index that goes back a lot further, 40 years. And tried to find some combinations, some factors that made sense to us.

Patrick Moraniec (07:49):

The other thing it does is it really provides known risks, right? So we can clearly communicate either upwards, or like I said, downwards we can communicate our strategy as well, to anyone that's either reviewing the team's work or actually creating the teams work. We think multi-factor approaches are perfect for that. Understanding the relationships between these factors and we view them sometimes as like family or extended family. They have profiles, they have personalities, if you will. They have a story, which is again, back to what really is part of a core definition of what creates a factor. You got to have a why.

Adam Bass (08:28):

Patrick's embrace of factors, however, extends beyond those mathematical relationships.

Patrick Moraniec (08:34):

It's helped us really develop as a team. And that's something that you don't see really written about in academia, but we think it's really important for any institution, is to know who they are as an investment shop, right? So it gives a clear kind of set of marching orders for all of us, including myself. And in factors bring together the team in a way that I guess I underappreciated in the beginning, but we're here now. And it serves a purpose.

Adam Bass (09:01):

As I mentioned at the top of the program, we're here to not only discuss different approaches to factor investing, but also look at factor performance during 2021. And the story of values upswing. For that, we turn to friend of the pod, Hitendra Varsani.

Hitendra Varsani (09:20):

So overall global equity markets have had a fifth consecutive quarter of positive returns. So we're living in exceptional times at the moment. With the reopening of economies and the rollout of vaccines, the value factor has demonstrated very strong performance and leadership in the first half of this year. And this really started out what some people call Pfizer

day, 9th of November 2020, when the efficacy of the Pfizer COVID jab was first announced to the world.

Adam Bass (09:50):

November 9th, Pfizer day. You heard it here first, but what's driving this performance?

Hitendra Varsani (09:58):

So there could be many reasons. One factor that we're tracking is the vaccination rates, based on first dose, around the world. So Canada and USA stand around 67% and 53% respectively. But in contrast, Europe is only at 39% and it's really a mixed bag when you look at individual countries. Now, if you look at Asia, that's in a whole different ball game in itself. Asia has only vaccinated at a rate of 23%. Japan at 20%. So we're seeing strong dispersion in vaccination rates across the globe. Now markets are clearly forward looking [inaudible 00:10:36] from pricing events based on expectations, as opposed to events being realized. And that's being reflected in the factor performance that we've seen.

Bob Hum (10:44):

I think the idea of this reopening and again, buying the most beaten up securities over the past year has been beneficial, whether you're looking in the US, international, emerging markets. But the one thing that I would say is that different parts of the globe are at different stages of that reopening. And so if you look at the US we think that that is probably one of the areas that have the most advanced. It's actually, I think like the fourth highest vaccination rate across the globe and you've seen that reflected in pricing. So the value factor since the post vaccination is up 14% above the market. And if then you look in international markets, it's only about 9% above the market, right? And I think the reason being, X the UK, which have really high vaccination rates, across international markets, it's really skewed across the board, right? So for example, Japan, less than 16% of the population has one dose. Parts of Europe or closer to that 40% range. So they're a little bit further behind.

Adam Bass (11:50):

Japan continues to surprise me whenever I hear those low rates, but what about emerging market countries, which are even further behind? What is it looking like there?

Bob Hum (12:03):

It's the same story, right, as international. I think if you look, I mean we've all seen the tragic news out of India. They're at about a 15% rate, but you look at Russia is at 13%. Malaysia at 11, Thailand at 7%. There's really a long ways to go before we get back to normal, especially in a lot of these EM countries. And so for that, a lot of these undervalued securities and value stocks, still pose a pretty attractive upside, just given how far behind they are from a vaccination perspective.

Patrick Moraniec (12:40):

Value has been, it's been that relative or that family member that took an extended vacation and disappeared for almost more than a decade. So it, you know, they've come home. They're clearly in pretty good shape this year. If you look at the performance, values are doing very well, relative to any industry you look at really. That resurgence we think comes with, I don't know, some caveats. The first is that the irony of this statement is I just think hilarious, it's the valuation of value. So, you know, the idea that value has worked and that it looks cheap, relative at certain points in the last year to quality, or even to momentum, I think is an interesting statement. Because the data we look at says that, yes, that is indeed true, but we also think that comparing it to itself, and you can do this with anything in the world, right?

Patrick Moraniec (13:40):

We can look at the ACWI ex US relative to itself and think about long-term compounded forward-looking returns. We can look at multiples. We can look at the median of stocks that make up that index through history. We can do the same exercise on factors, right? We can look at a z-score spreads, all these sorts of things. And what we find is that the starting point for value, prior to this great run that it's on, really, relative to itself, was not that great. Meaning that at some point, the companies that typically make up a value index suffer from some things that may get called into question. Like, what is the right multiple to pay for, in some instances, heavy cyclical businesses? Which tend to show up in the value index. Energies and material stocks, and things, even financials have a cyclical nature to it.

Adam Bass (14:33):

We heard similar points from Hitendra and Bob. Bob pointed out that while the number one question from clients right now is whether they've missed the boat on value.

Bob Hum (14:43):

Well, people forget that we were actually in the midst of the worst drawdown in a hundred years for value, right? There's still a 40% differential between value and growth, since the start of the drawdown in 2017.

Adam Bass (14:56):

The overall direction of value since Pfizer day, though, has been up. And to continue Patrick's prodigal son idea, not only has value come back home, he's brought along a surprising partner, momentum.

Hitendra Varsani (15:11):

So no, in simple terms, value indicates of low price relative to fundamentals. Momentum based on recent out-performance, typically coinciding with higher prices. And these two strategies are negatively correlated most of the time, but both have delivered out-performance over extended periods and the combination of these two adds to diversification. Now, what have we seen recently? The strong performance in value that we've seen over the

last six months or so has meant that our MSCI momentum indexes, now has exposure to value more than it has in the past. In fact, when we're looking at our momentum indexes and they're rebalancing in the May quarter, we've seen turnover in the range of high 50 to almost 70%. And that's in comparison to a typical average of around 40%.

Hitendra Varsani (16:11):

So investors may think why is my momentum and value factor more correlated than it has in the past. And that's simply due to the fact that momentum has latched on to value exposure through its strong performance. Now, these two factors remain complimentary, but also there are other factors that can add to diversification as well. We've mentioned quality, low volatility. These are factors that have added long-term diversification to factor portfolios.

Patrick Moraniec (16:46):

The momentum factor looks more value today than it ever has looked in the last, let's just say, decade. And so there's an element of, I think that disconnect will be a brief period of time where we would suffer if the value thesis plays out. Like it is truly going to be a shorter run in value. And then it will kind of kick back on. Momentum will probably shift back to like stuff that's working. That's by definition really what it is. And we think that pairs very nicely with quality and the entire ship kind of continues on through the waters. So we would acknowledge that the risk for us at least, but even other practitioners that are looking at these factors, there could be a period of time where if you like value, quality, momentum, where you experienced kind of some lower returns, lower premia, if not negative in some instances, but that the longterm relationships begin to resume. So if we're thinking about the next decade, and we're talking about maybe in the next two or three years this kind of plays out, then really that we've got eight years of normality.

Adam Bass (17:50):

This isn't the first time we've seen momentum hookup with value. Value has historically outperformed during economic upswings and momentum is what Bob called a chameleon factor. By that he meant it reflects whatever's in favor.

Bob Hum (18:06):

So as you can imagine, during the early 2000s, or after the tech bubble, growth oriented securities for it were quite out of favor. And so the momentum indexes would have been buying value oriented securities. And so that was another time where we saw a pretty high correlation between the factors. Now we're not there yet with what momentum ETF looks like relative to value, but you're starting to see kind of some of the value securities enter that portfolio. So, this time is slightly different from then, but there's no reason why if value continued to be in favor, that momentum wouldn't continue to buy those securities. So, there's nothing structurally in place for momentum not to do that. Again, it is a rewarded factor onto itself, and you wanted to buy value seekers if they're in favor. So, not there yet to what it looked like post tech bubble, but we're starting to see some value securities enter that strategy.

Adam Bass (19:08):

Let's put a pin in the value momentum story for just a minute. We'll get back there, but we need to take a bit of a detour and talk about another historical consequence of strong growth, namely inflation. Which we've covered on the program before, but now we look at in terms of factors.

Hitendra Varsani (19:26):

So we live in a global economy and in the current environment this inflation risks are truly global. And there's two factors at play here. One is, expectations of pent up demand. And then secondly, supply chain bottlenecks due to various lockdowns across geographic regions. Now we have seen inflation in the US jump to the highest rate in 2008, as the world's largest economy has rebounded from the Coronavirus. Within Europe we have gone above the European central banks target. It's the highest level in almost three years. If you look at emerging markets and China in particular, that's an importer of inflation. It's exposed to commodity prices rising, but it's also an exporter of goods and production to the rest of the world. And so this integrated economy and inflation risks is very much on everyone's mind.

Patrick Moraniec (20:28):

Inflation, for sure, is very top of mind. The other one would be that relationship that we were describing. Value and momentum, the unusual nature about that relationship, at least in today's terms, specifically in international we'll look at our core strategy back through time, to make sure that we're comfortable addressing maybe both of those relationships or those, I guess, potential issues. And so we looked. We looked at the inflation data. I mean, we have enough kind of returns based analysis and we kind of have a philosophy around how we structure the quality value and momentum concept.

Patrick Moraniec (21:07):

We're able to go back through time and just say, look, we've had some pretty good inflationary periods, at least over the last 40 years, what has been the story and how would your positioning and strategy kind of play out? So, for us, we feel comfortable that we, that won't be what really gets the core strategy or kind of broadsides it. We think, especially in general, public equities at the beginning of an inflation cycle, if indeed this is inflation. So again, we're going to make an assumption there, even if it is, that they actually benefit for awhile. That multiples tend to not have their severe correction contraction, if you will, until we get to much higher levels from where we're at today. And we're not even at a threshold, we think.

Adam Bass (21:53):

Let's get a bit more specific about those 40 years of data and how inflation has affected factor investing.

Hitendra Varsani (22:01):

So we've taken a look at how factors have performed in various inflation and also real yield environments, using our deep history as a guidebook. The reason why we look at real yield as well is inflation is often accompanied with rising interest rates as well. And it's the spread between inflation and rates that can matter for investors. Now using data that extends back over 40 years, covering multiple market cycles, we see three scenarios. So one, where there's an inverse relationship between factors and inflation. One where there's a positive relationship. And the third is, factors that work irrespective of that environment. So when we're looking at factors such as value, we found a positive relationship with inflation. Whereas in contrast growth has had a negative relationship with inflation. But what we found most striking in our research is that quality and momentum outperformed, delivered active returns, irrespective of whether inflation or real yields were high or low.

Adam Bass (23:09):

Okay, I'm starting to see how this all comes together with the growing economy, high-performing stock markets, some inflation warning lights. Eyes on central banks in terms of interest rates. Value on the upswing and marching in step with momentum. Coming into focus. So from here, for what maybe we'll call act three of the program, we're going to look more specifically at whether history affords any lessons. And as I promised, we're going to fold in that inflation question with the positive correlation of value and momentum as we do so. We heard Bob explain that the post tech bubble period comes close to what we're experiencing right now, but it doesn't hit all the marks. Nope, for that we need to go back quite a bit further in time. About 60 years to the 1960s.

Patrick Moraniec (24:04):

You could look at the late 70s and say, yeah, that was different, in Japan and the earliest. I mean, you can kind of go around the world and it isn't always uniform and consistent. 96 forward, just the levels of inflation in the US market. So just periodically, depending on when you're looking at inflation, what's interesting about the 1960s is that it kind of had its own environment that looked like that. And so, you know, I'm not, I'm not a macro expert, but there's elements of, yeah, I would argue that the type of inflation and maybe the environment we're in feels a little bit more like that. And it's kind of interesting to think about this relationship between value, momentum, exhibiting similar kind of profiles today. It almost lines up a little bit better. The good news is, is that it doesn't last for forever, as far as that relationship.

Patrick Moraniec (24:53):

And so we think this is the trouble with factor timing, in its essence. So we think we're giving up, effectively, risk premium in momentum today. You know, you could forgo kind of this period of time where it eventually disconnects. We don't know when, and that's the issue, but yes, there are some parallels with inflation, with momentum. Here's also interesting, general valuation of equity markets. That's very, very similar where there's periods of time in the 1960s. I won't say there necessarily as extreme as we're experiencing, but this idea of like, was it a great go-forward return on the S&P 500? And the answer is no, not at that point. I

mean some value investors would say, no, there were much better entry points coming, effectively. So, yeah I think it's interesting. History is rhyming a bit here, for sure.

Adam Bass (25:49):

While the parallels to the 1960s provide insights and information that can help as investors plan their way forward, Patrick rightly points out that factor timing is a fraught strategy. As we spoke about earlier, his three watch words as a large institutional investor are consistency, consistency, and consistency. But are there other more recent data that investors can also figure into their strategies? Given our focus on value today, it likely comes as no surprise to hear this news about factor ETF flows.

Bob Hum (26:28):

If you look in Q1, just in the large cap value space alone, there was over $20 billion in inflows into that category for large value ETFs. And I think it's not surprising it's because the most investors are actually quite underweight that factor, right? So if you think about just based on your portfolio, let's say you started in 2017 with a 50/50 portfolio of growth and value. If you hadn't rebalanced in that four year period, you'd actually be looking at a 60% growth portfolio, 40% value. And so when we've actually analyzed thousands of advisor portfolios, over 60% were underweight value. And so I think what we're seeing today is truly just inflows, is trying to get people back to neutral. The other thing that I would say that we're starting to see is actually international flows. So I think people are realizing that you can express those same views within the US as well as international. We've seen almost a billion dollars in international value factor ETF so far this year.

Adam Bass (27:37):

The question is, historically speaking, would it have paid for investors to follow the money, to go with the flow? Hitendra and team asked themselves that very question.

Hitendra Varsani (27:49):

So our recent analysis has looked into the flows into global factor ETFs. You'll see, in our research, should you go with the flow, we've highlighted that yield value and low size ETFs have seen enormous [inaudible 00:28:05] year to date. Now, what does that mean? It means that investors have placed conviction into these single factor ETFs that have typically done well during early stages of economic recovery. Now, the question is, should you go with the flow? When there have been outsize moves, in terms of inflows and outflows, in these factor ETFs relative to the history, the question is, is there a relationship between that and future returns going forward? In our recent research we found the simple answer is yes. When single factor ETFs have gathered strong inflows, above and beyond what they would typically accrue, say a two standard deviation event, that's resulted in a out-performance of about 80 basis points. Whereas underperformance of 60 basis points on the flip side. Now the caveat is, our history is short. It's only around six years, but we thought it's something to continue to monitor as the market develops further.

Adam Bass (29:08):

Whether looking back six years or sixty, every investor is always looking for an edge. And while Hitendra, Bob, and Patrick come at these questions from different angles, in the end, we heard a similar message from each of them.

Bob Hum (29:23):

When thinking about factor investing, I want to think about how can I be the most diversified as possible, right? If all of the factors have been rewarded over the longterm and all of them have low to negative correlation amongst each other, there's a huge benefit for pairing factors together.

Patrick Moraniec (29:40):

You got to have a why. You got to have a story here. And we think that that story plays out in mathematical relationships. And those relationships allow you to build those blocks in a certain way, that creates diversification, that creates consistency of returns. What are your expectations going in versus, going back to the idea of short-term performance, and maybe we're more focused on that long-term small wins concept.

Hitendra Varsani (30:06):

Whether it be 2008 crisis, or even the recent COVID-19 crisis, one thing to recognize is market cycles can change quite rapidly. And in this early stage of recovery that we've seen, and also in 2008, value was one of the first factors to come out winning in the early stage. Now as time passes, factor rotation typically happens, market goes into another state and we see strong rotation. So rather than time the market, investors have typically weathered these changes by being diversified across factors and of course different strategies.

Adam Bass (30:51):

That's all for this week. Our thanks to Hitendra, Bob, and Patrick, and to all of you for listening. For a deeper look into factor performance, register for the July 15th markets and focus webinar, at MSCI.com. Next up on Perspectives, the Index Industry Association's, Rick Redding returns to the program to explore the findings of the new ESG focused survey from the association. We'll also have some special guests to discuss how these insights are playing out on the ground. Until then I'm your host, Adam Bass, and this is MSCI Perspectives. Stay safe.

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