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Factors Institutional Masterclass

*Featuring: **Dimitris Melas***, Managing Director and Global Head of Core Equity Research at MSCI

Mark Colegate: Hello and welcome to this Asset TV Masterclass with me Mark Colegate on Factor Investing. With the world's markets under huge pressure, how could factor based investments performed? Have they performed in line with what's expected? And how do they compare to what active managers have achieved? Well, to discuss that I'm joined by Dimitris Melas, Global Head of Core Equity Research at MSCI. Dimitris Melas, at MSCI you focus mainly on the security level when it comes to factors or do you sort of run products around sector level and above?

Dimitris Melas: So Mark, at MSCI I'm responsible for equity research supporting both our index products as well as our analytics products and risk models. And actually partially, I don't draw a distinction between factor investing on one hand and investing in general. I think over time, all investors, fundamental investors, quantitative investors, long only, long-short hedge funds have recognized that factors are important tools that help them understand and manage the risk and the performance of portfolios. So I'm supporting MSCI in terms of bringing those tools to our clients.

Mark Colegate: In terms of the factors that you look at Dimitris, can you run us through what the main factors are in the equity space?

Dimitris Melas: So look, in the equity space, traditionally in factor models we have fundamental factors; value size, momentum, volatility, quality, yield, growth and liquidity. These are the main factor groups that we incorporate in fundamental factor models. And here an important point to make here is that these factors and strategies based on these factors remain appropriate and valid now and in the future. I think it's important to continue to evolve and enhance our data, our analytics, our tools with respect to these factors and the factor models that have served us well over a period of time. But at the same time it's important to talk about, I think, innovation and what's coming in the next few years and how we can continue to provide, you know, cutting edge data and tools to investors to help them manage portfolios.

Mark Colegate: Dimitris, can we pick up on that point about factors picking but passing, if I can call it the John Shells Purity Test. How are they doing?

Dimitris Melas: Absolutely. Mark, in fact I wanted to take issue and disagree slightly with a comment you made earlier, you said that during the crisis correlation went to one. Actually, what we've seen during this crisis, one of the important lessons was that markets were quite-- were not indiscriminate in the crisis. In other words, we actually saw quite a lot of variation and dispersion in performance across markets, across asset classes, sectors, industries, themes, strategies and factors. And in fact this variation in performance that we saw during the crisis has two important consequences. On one hand, it creates diversification opportunities for investors who want to spread risk across different assets and factors and strategies, but it also creates a lot of opportunities for active management. You know, having a lot of dispersion in performance across factors and assets is really the perfect hunting ground for active managers who were in the past complaining that there isn't a lot of dispersion in the market. So I think it's important to bear in mind that sometimes we tend to think of a crisis as a period where there's nowhere to hide, correlations go to one, but in fact if you look at the data there's quite a lot of dispersion in terms of performance.

And this very much also apply to factors in this crisis. In other words, generally, factor strategies as Rich was saying earlier, performed as expected. In a deep economic and financial crisis like the one we are going through now you would expect that economic dissensitive strategies and factors like value and size would underperform and that's indeed what has been happening. And on the other hand you would expect quality and low volatility, the more defensive factors to outperform and we've also observed that.

There was one distinction, one difference in this crisis versus previous crisis and I think Rich mentioned, momentum. And indeed, in previous crisis you would have seen that momentum tends to suffer a drawdown as leadership in the markets then tends to rotate from one type of stock to another. But in fact what's happened here is that momentum has done well in the benign market conditions of 2019 and continued to do well, you know, in Q1 and continues to do well this year during the crisis.

There's a very simple reason for that. As we are all working remotely, playing remotely, it's no surprise that those technology stocks that had done well in 2019 and you know, enabled us all to work and play remotely, the so called funds which are a big part of momentum strategies, you know, have continued to do well in this environment. So I think generally speaking, factors performed as expected in the crisis with the possible exception of momentum. But there are some very simple and easy to understand reasons why that's the case.

Mark Colegate: You know, we've talked a little bit about what the experience of factor investing has been in the last few months during this big period of stressed markets, but I wanted to focus in now on one specific factor which is value. And I guess there's a bit of a question out there on has value completely run its course? At the risk of sounding like a Monty Python sketch, is it dead or merely stunned?

Dimitris Melas: Yes, actually I wanted to add some comments with respect to value, and maybe specifically for equities but I think some of these comments could be applied across asset classes. And I think it is desirable and appropriate to continue to refine and evolve the way we define these factors, these notions and value is certainly part of that. And so we need to be of course guided by academic theory, but also we need to reflect investment practices. And what do I mean by that? If you speak to any fundamental equity manager, a competent active investor and you tell them, "Look, I will only use price to book because that's what Fama and French used in one of their papers 30 years ago," they will laugh. They will simply say, "Actually you need to look at different dimensions of value." Yes, price to book is an important indicator, but in investment practice we don't assess value just based on one indicator simply because, you know, price to book is appropriate for companies with a lot of real assets, but perhaps less appropriate for technology companies where a lot of the value is in intellectual property for example.

So I think when we talk about value it's important to differentiate between absolute value and relative value. You know, if you simply run an absolute value strategy, you'll end up with a portfolio dominated by certain types of stocks, perhaps some utility, some industrial companies. Most investors in practice actually when they talk about value, they talk about relative value and the big question there is relative to what? Should you assess the valuations of the company relative to other companies from the same country? Should you do the assessment relative to valuations from companies in the same industry or sector? Or perhaps you should use more sophisticated methods and techniques to identify the right peer group and then do the valuation assessment relative to the right peer group. So that's I think one area where a lot of sophisticated investors are working on and they're trying to refine value and value strategies.

Another important point is portfolio construction. So if you simply again, use valuation metrics like price to book and put together a portfolio, that portfolio will give you a lot of exposure to value, it will be cheap, but it will also have bad momentum, it will also have high volatility, it may have low quality characteristics. So you're fighting against a number of schedulings that are linked to non-target factor exposures that we call them. So yes, on one hand we're getting a lot of exposure to your target factor which is value but we don't want to have all of those other schedulings working against you. So that the portfolio construction level and this can be done in active (…) strategies but also in industries as well. You can dial down, you can neutralize some of these other unintended factor exposures. You don't want to make your value portfolio necessarily a momentum portfolio, but maybe you want to dial down and get rid of the negative exposure to that factor. So I think these are some important considerations in terms of how values define and how we construct indices and strategies around.

Mark Colegate: On to the start, Dimitris, with a bit of a focus on ESG and sustainability. A quarter of all the active managers that I've been speaking to recently have said, well actually there could be a real positive with oil stocks which is that, these companies, rather than chucking out big dividends today will have to start thinking about what they're really-- their long-term focus is and they and their shareholders will have to focus on that. It's interesting that whether the period over which you judge excess is changing, how do you fit that into your model, so think about that? Specifically around this idea of sustainability and what makes a sustainable business.

Dimitris Melas: Absolutely and look, one of the key points about ESG and sustainability and sustainable investing is that unlike other factors and strategies, we don't really have a lot of historical data or very good quality and long history across markets in order to be able to test various hypothesis. Having said that, in the last 5 to 10 years I think we've seen an increasing body of academic and industry research actually suggesting, putting forward the hypothesis that, you know, investing in companies with good ESG characteristics may help to mitigate both systematic and idiosyncratic risk.

And I think this crisis is really the first real test of this hypothesis. And actually what we've seen in the market is that portfolios or even industries and strategies that have superior ESG characteristics they tend to have higher (…) in good ESG companies have actually that-- those portfolios have weathered the crisis better than the market. So they have outperformed the market. In other words, ESG has helped to mitigate drawdowns during the crisis. And in fact we wanted to go a little bit further than that and we did some analysis to see was ESG just a proxy for quality? In other words, you know, one argument is that ESG is highly correlated with quality, so when quality does well in a crisis, no, it's not a big surprise that ESG portfolios also do well. But in fact what we found is that when we do formal performance attribution, ESG actually contributed to this outperformance of ESG portfolios during the crisis net of all other factor exposures. So once you take out, you know, quality, low volatility or underweight in energy and so on, you still have a big chunk of active performance that is linked directly to ESG and I think, obviously it's a short period, its only one data point. But I think this was a very severe real test of hypothesis that we have postulated in the past about how ESG strategies might perform in a down turn.

Mark Colegate: And I think you've said about the importance about factors and strategies developing over time. So we've got a couple of minutes left, I want to get a bit of a thoughtful about new sources of data that you're exploring at the moment and why you think those might help inform some of the judgements you make around factor investing. Dimitris Melas, what are some of the areas that you're looking at that perhaps 5 or 10 years ago you wouldn't have bothered?

Dimitris Melas: Absolutely, so look, this is a very exciting area of research and actually product development as well. And as I've already mentioned, of course we need to continue to evolve the existing data sets tools and techniques and they still very much remain fit for purpose fundamental factor strategies and cross sectional fundamental factor models. We also need to innovate and a lot of our most sophisticated clients and investors, quantitative hedge funds, active investors and so on are looking to innovate. And they're trying to discover new data sets that they can use as potential signals and inputs into the investment process and also new methods and processing techniques and tools linked to machine learning and data science and so on.

So if we think about the new data sets, there's a lot of work going on and has been going on for a while to exploit new market related data sets. For example for an equity investor, these market data sets come from other markets linked to equities, for instance the auctions market, that there are a lot of signals from auctions trading that may help equity investors for quantitative and fundamental investors. There are a lot of signals potentially from credit markets and CDS spreads that could be huge in selecting equity securities. And there are also for instance the repo market, short selling, the activities of hedge funds in terms of short interest and which securities they are trying to borrow in order to (…). Could those be signals used into long only investing? There's also a lot of signals coming from social media and what I call cyber data sets. For example new sentiments, using machine learning to try and understand what is the sentiment in news stories about particular companies. Consumer sentiments on consumers, you know, write reviews about products and services. Even regulatory filings, the language and the tone in the language of regulatory filings, you know, there are efforts underway to use machine learning to try and detect changes in the regulatory filling and then use that as an input in a stock selection process.

Mark Colegate: We're out of time, way but so much we've spoke about, there's a lot more we could speak about but I'm afraid we do have to end it there. Thank you for watching, from all of us here, goodbye for now.

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