5 Lessons from the COVID-19 Market Crisis

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

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 June 18, 2020. This week, what lessons have we learned from the current crisis? When we last spoke with Dimitris Melas, MSCI's global head of equity research, there was so much unknown about the disease and its effects on investors and markets. Since then, he's been able to digest it all a bit. Dimitris returns now with five lessons he's learned. Welcome back to the program, Dimitris. Before we get to those lessons, I have a question that everyone involved with Perspectives has wondered about. The last time you were on, you shared with us that your favorite local pub, the oldest in England, I believe, you said it had been closed because of the pandemic. So has the pub reopened, and have you been able to get that pint?

Dimitris Melas:

Unfortunately, no, not yet. The British government has announced plans to reopen hospitality venues later in the summer. There is no clear date yet, but I'm hoping I'll be able to do that quite soon, but not yet.

Adam Bass:

I hope so too. Actually, it'd be great to buy you a beer there one day. Now, as I mentioned, your research has led you to five lessons from the market crisis. Given that it's still ongoing, why was this the right moment to step back and look at what we've learned so far?

Dimitris Melas:

Well, you see, it's quite remarkable how much the world has changed in the last few months. This has been a very short period of time, and during this short period of time, this crisis has completely changed the way we live our lives. But we have also witnessed almost the complete market cycle in the last three months. We had a very sharp drop in equity markets in March, and that was followed by what was an almost equally rapid recovery in April and May. So that's precisely why we felt now is the right moment to take a step back and see what we have learned so far. And in particular, we wanted to try and understand how different markets and strategies have weathered this unprecedented storm.

Adam Bass:

The first lesson you point to is around one of the fundamentals of investing, diversification. What kind of performance did you see for investors with global portfolios, and global companies for that matter?

Dimitris Melas:

I think it's fair to say that global markets have proven to be quite resilient so far during the crisis. And this is obviously good news, because it has allowed both issuers to continue to raise capital and also investors to spread the risk across different markets. For global investors in particular, being able to invest across different markets meant that their portfolios were less exposed to regional variations in performance as the crisis was spreading to different countries with different speed and with different intensity as well. So that was the benefit for investors. They were able to spread risk and weather the storm.

For companies at the corporate level, what we have seen is that the companies with assets and revenues, even supply chains across multiple locations, these types of companies have been relatively more resilient to local disruption in economic and business activity. And I think all of these observations will likely lead both investors, but also corporate managers, to make risk diversification a more important driver of their business and investment decisions in the future.

Adam Bass:

You also found that throughout the crisis, there were definitely opportunities for active managers, who are sometimes known as stock pickers, but those opportunities were not necessarily because of the stocks they picked. Can you explain what you found?

Dimitris Melas:

Very often when a crisis hits, you hear commentators say that in a crisis, there's nowhere to hide, correlations go to one. You may even hear comments about panic-selling in the market and so on, but actually when you examine the data, when you look at the data, you draw a different conclusion. It has been clear that markets have not been indiscriminate in this crisis, and that's the case also for previous crises as well. So what's been happening is that certain economically sensitive factors and assets have very sharp draw-downs, while at the same time, other more defensive, safer assets suffered only small drops, and in some cases even rallied.

And I think this is far from reflecting market panic. Actually, what this is demonstrating is that investors reacted in a rational and discriminating way and tried to price different assets and strategies according to the exposure they had to the deteriorating economic and market environment. And obviously another implication is that dispersion in performance is great for active management. It really provides a lot of opportunity for active portfolio managers to deploy their skills and add value through active management.

Adam Bass:

Yes. I remember being struck by your analysis of the markets as rational. At the time, that was not the general consensus. But please. You were talking about the dispersion of performance.

Dimitris Melas:

Dispersion increased dramatically. But one important question that we wanted to address was what were the sources that contributed most to this dispersion? And when we analyzed cross-sectional returns, we found that dispersion attributed to common factors actually rose a lot more sharply than stock-specific qualities. What does this mean in plain English? Just to give a very simple example, you can imagine that as the crisis struck it quickly became evident that certain sectors would suffer a lot, for example, leisure, hospitality, travel. So clearly in this type of environment, you can imagine it was absolutely critical to manage exposure to the airlines industry. And it was much less important to try and choose between British Airways and American Airlines. In other words, in this type of environment, managing your factor exposures effectively became much more important than trying to pick the right stocks.

Adam Bass:

And by and large, did active managers capitalize on those opportunities?

Dimitris Melas:

Actually I'm afraid to say no, they did not, at least not in aggregate. So what we did is we examined a large sample of actively-managed mutual funds investing in global equities. We had over 1600 actively-managed equity funds in our sample. And what we found was that only 26% of those funds outperformed their benchmark in the first quarter of the year, which was when the crisis hit, compared to 40% of those funds had experienced out-performance over the previous 10 years.

So over the longer term you find that 40% of those managers in our sample have good performance, but in the crisis, actually that percentage dropped to 26%. Also, we wanted to see if more concentrated high-conviction strategies were a better place to weather the storm. We didn't really find any evidence that those high-conviction strategies, high [inaudible 00:07:44] funds did any better. There were a lot of opportunities, but that doesn't necessarily translate into easier performance. Quite the opposite. Outperforming was in fact harder than before.

Adam Bass:

Next up, and not surprising at all, ESG. The resilience of ESG has been a huge story during the crisis, but you were able to dig deeper and explore the effects of ESG exposure at another level. What did you find?

Dimitris Melas:

Well, we've seen that the use of ESG in investment analysis and in portfolio management has really gained a lot of acceptance in the last five to ten years. There are a lot of research that we've done at MSCI, but also research done by academics and other industry organizations, that identify ESG as a potential way to mitigate both systematic and idiosyncratic risk. But actually we haven't had the test of that hypothesis up until this crisis. And this COVID-19 crisis really provided the first real test for ESG and how it might perform in a crisis.

And what we saw was that the company's portfolios industries that had high exposure to good ESG characteristics actually suffered smaller draw-downs in relative terms. But that was only part of the story. The other part of the story, which I think is quite important to highlight, is that when you go beneath the surface and you do attribution analysis to see what was the reason for the out-performance of good ESG portfolios, actually a large part of this relative out-performance did come from ESG and was not just a proxy for other defensive factors like quality or low quality.

Adam Bass:

What about approaches that aim to replicate indexes? Investments like ETFs?

Dimitris Melas:

Indexed-based strategies, in fact, played a very critical role by providing flexible tools that enabled investors to continue to manage their portfolios actively in a rapidly-changing market environment. So index-tracking ETFs generally remained liquid, and they provided an efficient tool for investors to implement the asset allocation changes and active asset allocation decisions during the crisis.

Adam Bass:

You've definitely given us a lot to think about with these five lessons, but have you drawn any other lessons from this experience?

Dimitris Melas:

So actually I have learned two very personal lessons from this crisis as well. And those are that I don't necessarily need the services of a professional barber and I don't really need a gym subscription. That's because during the lockdown I've been playing basketball almost on a daily basis in our backyard with my son, and that's sufficient exercise. And also my 14-year-old son can cut my hair with clippers and the result is no better or worse than when my barber cuts my hair. So those are two very personal lessons from this crisis that I thought I might share with you guys.

Adam Bass:

That's all for this week. Thanks to Dimitris and to all of you for joining us. We hope you'll join us next week when our guest will be [Sebastian Liebling 00:00:11:07], global head of Index Solutions, Sebastian joins us to discuss the results of MSCI's annual market classification review, as well as the pandemic's effect on the process. If you have a moment, we hope you'll subscribe to the podcast so you can stay up to date on our latest episodes and insights. If there's a topic you'd like explored, or if you just want to let us know what you think, don't hesitate to leave a comment. For more from MSCI, check out our sister podcast ESG Now, follow us on the MSCI LinkedIn page, and don't forget to bookmark www.msci.com/coronavirus for all our crisis-related content. Until next week. I'm your host, Adam Bass, and this is MSCI Perspectives. Stay safe, everyone.

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