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TRANSCRIPT

So, Factor Investors, Why So Defensive? Part 1

Featuring:

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Shuo Xu, Vice President, 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 September 30th, 2021. Today we look at global equity markets over the third quarter and put factors in particular into focus. While markets continued to deliver positive performance during the quarter, investors had a lot on their minds between the still prevalent Delta variant, the specter of inflation and concerns over rising levels of corporate leverage. This was especially true in China. Perhaps not surprisingly, we saw a rotation to more defensive factors, such as minimum volatility and quality.

Adam Bass (00:50):

Now our guests provided their insights, of course, to help us pull apart these issues and others in the markets. But I should add that this time around, we asked them to do so with one hand tied behind their back so to speak. Because of production schedules, and I won't bore you with those, the interviews, well, they took place with a couple of days left in the quarter, to be honest. Now that said, the perspectives of our guests are wider and applicable over more than the last few months. We to begin with the star of our quarterly series, Hitendra Varsani. Part of MSCI's global research team based in London and accomplished duathlon participant. Hitendra reflected on the value factors specifically.

Hitendra Varsani (01:37):

So those that have been following our podcasts will have seen that we've reiterated to this point many, many times, and that's that the economic cycle that we've experienced over the last 12 months has been much shorter than previous cycles. And that's because of the nature of this crisis. We've been in a health crisis and there's been unprecedented fiscal and monetary support during this last 12 months. So from the downturn to the upswing, our reopening of economies, we've highlighted that value typically outperforms during that early stage of recovery and that's what we've seen.

Hitendra Varsani (02:17):

Now, following that trend of value out performance earlier on, momentum picked on some value exposure, as we highlighted in June, and this led to momentum having some of the lowest valuations that we've seen for over a decade. And it turns out, that momentum was actually one of the strongest performing factor, if not the strongest performing factor, over the last quarter. Now, will this continue? With value taking somewhat of a setback recently, momentum could potentially rotate away from that exposure and potentially go into more defensive stocks, like low beater and higher quality stocks

Mark Carver (02:59):
Value dimmed.

Adam Bass (03:01):
That's our second guest for this week.

Mark Carver (03:03):
So I'm Mark Carver. I head up our equity factor product business, as well as our equity portfolio management business.

Adam Bass (03:12):
So the value factor.

Mark Carver (03:15):
If we think about it shining in the beginning of the year, it dimmed a little bit in the quarter. In fact, we saw weakness in value and yield or equity income, if you will, while the best performing factor was momentum. And what's really interesting, for someone who sits in my seat, is we saw this both in our factor models, or pure factors, if you will, where momentum has been the best performing factor, as well as in our factor indexes, where momentum has outperformed in virtually every region. And that probably surprises clients, that we've seen that kind of strength. And part of it is that we're moving in some of the developed markets from early cycle to mid cycle from an economic standpoint and that can often be a good period for momentum investors. Despite that, if we look at ETFs, we actually saw money come out of momentum based ETFs, both those linked to MSCI indexes as well as others.

Adam Bass (04:18):
But let's leave momentum behind a moment and keep moving forward. What other factors did well?

Hitendra Varsani (04:25):
Low volatility stocks outperform high volatility stocks and then stocks with high quality fared well as well. But it wasn't the same everywhere. Now within developed markets, we've seen continued corporate earnings recovery, as economies reopen but the indicators for economic growth that we look at have slowed down. And we've seen investors have shifted their attention from the upbeat growth to now reassessing inflation risks, tapering in the US markets, potential rate rises, although this is not yet prevalent in other markets like Europe or in Asia.

Adam Bass (05:03):
For more on that, let's turn to our third guest for the day.

Shuo Xu (05:06):
This is Shuo Xu. I'm working in MSCI covering APAC research and mostly working in the index applied research. I based in Shanghai and in China. China equity market has suffered from big loss this year. The draw down since the highest in February is more than 30% and it continues in Q3. But

interestingly, the local [issue 00:05:33] market is relatively flat. The year to date return is close to 0%, although it's quite volatile in between.

Adam Bass (05:43):

But from a factors perspective?

Shuo Xu (05:47):

So in recent quarters, we are still seeing it's quite pretty similar to the global market. We are seeing the quality, the momentum is still back into play. And also we are seeing some rebounds, from the value side and high yield side, as well. So that's probably due to those expensive stocks, or maybe high volatility stocks, they are severely impacted during this certain period.

Adam Bass (06:20):

We're going to take a slight detour here to dig in a bit about those two sides or parts of the Chinese equity markets, the international and local markets, and how they differ. The momentum factor actually along with quality provides an excellent example of this.

Shuo Xu (06:38):

When we are looking at the China market, both in China international and both in China [A-share 00:06:46] market, the momentum and quality on the top of the list, regarding the index performance, but they tend to perform differently. For example, in China international market, it's dominated by some giant tech names listed in US. But in China A-shares, previously, they is dominated by the retail market and they are trading based on their gut feelings, the story they may be overhear the on the street, something like that. Because the retail investors, the individual investors, they have different appetite during investment. For example, they tend to have a shorter time horizon and sometimes they prefer volatility.

Shuo Xu (07:41):

So maybe let me give another example. So we have a main volatility strategy in China A-shares market, and over almost a 13 years period, the main volatility delivered 2.2% annual active return, but with 4% lower annualized volatility comparing to its parent in a A-share market. But so far, we didn't see any successful products in this area, locally. So that's very, very interesting that investors maybe totally ignore the long term out performance, but they are still more focusing on the volatile, or maybe they even believe in some short term stories. So that's make the market less predictable, or maybe unlike a very long run investment horizon. Right?

Adam Bass (08:39):

Shuo went on to explain that this dynamic is changing as institutional investors have increased their participation in the Chinese A-shares market and local investors actually have started shifting more toward mutual funds as their investment vehicle of choice. Now, this is after they've been burned one too many times, collectively, but there is still a way to go. Even the oldest mutual funds may be younger than this century. But one trend we just heard about around minimum volatility, that's "min vol" to its friends, about that factor not attracting investor interest. Well, that one that is not just a China issue. Let's follow the money and see where it goes.

Hitendra Varsani (09:26):

Minimum volatility is a strategy that's designed to deliver lower volatility than the parent index. That's the main objective of that strategy. In a risk-on environment, investors have [chased high beater 00:09:40] stocks to capture the upswing in equity markets. So in the short term, yes, we have seen some outflows in minimum volatility, ETFs, despite the long term out performance in risk adjusted returns. Now, as we move through the cycle, perhaps potentially, the demand for defensive positioning could be sought after. And so, minimum volatility is designed to deliver lower volatility than the parent index could be a tool to manage risk in portfolios.

Adam Bass (10:19):

When we look at those defensive factors, how do the valuations stack up against those that tend to be more cyclical?

Hitendra Varsani (10:26):

Great question. So we looked at the relative valuations of the two most popular defensive factors, minimum volatility and quality. And what we found is the relative valuation of min vol is at the lowest level relative to quality not seen since over two decades. Quality has seen positive performance this year. It has accrued flows in terms of ETFs. And that's a tool perhaps that investors have used to participate in equities, but also with the defensive stance. But perhaps min vol has been unloved for too long, given the flows that we've seen and the performance that we've seen, and that's led to this very discounted valuation relative to quality.

Mark Carver (11:14):

One of the greatest puzzles of the market is the question of, do flows influence returns or returns influence flows? And a lot of really smart people have opined on this question. And I don't think there's a settled answer on that. What we do know for sure, is that the flows to min vol are negative. They've been negative for an extended period of time, but the performance in the quarter has started to improve. If we take a little bit longer look at minimum volatility, in this case, I'm defining longer as if we go back to 2020 and through where we sit today, there was this perception that it really performed badly in 2020. And in a year of crazy uncertainty, where we are all around the world were suffering through in a pandemic that nobody could see coming and that nobody was prepared for, why wouldn't a defensive strategy do well?

Mark Carver (12:16):

And the answer is very interesting. When we look at the data, now again, I'm thinking about 2020, what we saw was an incredible rally of risk assets. From the bottom of the market through the end of the year, we saw the strongest performance of risk assets. We have a factor in our factor models called residual volatility. 2020 was the best year for performance for that factor in 40 years. And so it wasn't that we saw min vol or low vol disappoint. It was we saw this incredible unprecedented rally of high volatility stocks. And that surprised probably everybody who looked at that data. Because of that, we've seen flows out of more defensive, particularly minimum volatility, strategies and that's just continued.

Adam Bass (13:14):

So far, we've got defensive factors starting to outperform, but retail investors at least, not as fully committed to that direction. The question is, what's behind all this?

Hitendra Varsani (13:27):

I think there's multiple things that play here. Tapering. If we look back at 2014, that was a more volatile year than 2013 when the tapering was made, but then implemented the following year. The second is the seasonality in markets. October tends to be one of the most volatile months alongside March, whether we're looking at developed markets or emerging markets, going back to 2001. But I think also one of the other risks that is emerging, is slower growth going forward. So we've been through a period of unprecedented support and upswing in growth indicators as economies reopened. But the question is, how sustainable this will be as type and gets rolled out.

Mark Carver (14:20):

The things that people are really thinking about are inflation and rates, right? So will we have potentially high inflation? They're thinking about employment and the pace of the recovery. Is it's sustainable? They're thinking about the Delta variant. What does this mean for both of those things, both employment and the strengthening, weakening or the impact on the recovery? And for sure people are worried about all of this because the Fed and government policies can influence, obviously, the pace of markets. And so the reaction of the European Central Banks, clearly the US Fed, Chinese regulation, what is this going to mean for markets? These are the things that clients are thinking about. And they're trying to figure at how they reposition portfolios, given various scenarios that could play out.

Mark Carver (15:16):

I think people accept the fact that rates are going to go higher. The question is the pace of that move and the levels that they settle on. And the average person recognizes, that modest rates can be good for equity investors because at the end of the day, companies may have their top line benefit from modestly higher inflation, for instance. But higher inflation rather than modest inflation, but high inflation, can actually be detrimental to some investors. Our research team put out some really interesting analysis, early in this quarter in fact, looking at the performance of factor indexes, specifically in periods of low, moderate, or high inflation. And what we can very clearly see in that data, is that the factor performance does vary based on the levels of inflation. You might see for instance, in periods of high inflation, things like size or low volatility do relatively well, where growth is a winning factor in periods of low inflation.

Adam Bass (16:30):

One other issue that's keeping some at night might have a familiar ring to it.

Hitendra Varsani (16:36):

Over the last five to six years or so, we have seen leverage increasing in certain pockets of China, particularly in the real estate sector. And the recent events is a stark reminder of the consequences of taking high leverage. It creates more volatility in the market. And so based on the events that we've seen, that's somewhat spooked investors more broadly outside China, also spilling into Asian markets more broadly.

Adam Bass (17:09):

To be precise, corporate leverage was high in many markets, but the China did stand out. And the poster child for leveraging Chinese real estate has been Evergrande and its possibility of default. Now while Evergrande is not the only company in question here, I asked Hitendra about the possible parallels. The word leverage in real estate, you can't help but think back to global financial crises. Could that be on investors' minds, that association?

Hitendra Varsani (17:39):

We have seen parallels with the Lehman event and the collapse of a major institution. That at the time had major repercussions on global markets, given the interconnectedness and globalization of financial markets. Whether the same could be said about the events we've seen in China is questionable, whether it's a contagion event or an isolated event.

Shuo Xu (18:04):

So actually the policy to control, or maybe the regulations to control, the house price is not just happened in this year. So it, already announced five or even six years ago, but recently we are seeing it force onto to the ground, maybe more solid in detail process and maybe some detailed rules applied into those companies. And we are seeing the regulators publish a lot of rules to control the bank side because previously those real estate companies, they borrowed a lot of money from the bank.

Shuo Xu (18:48):

So it could be maybe becoming a systematic issues in a financial system, but we already saw some regulators taking action last year to stop such kind of bank debt into those real estate companies. The reason behind is the top priority of China government is stable. So for example, if comparing to a 50% loss in a single year, so a 5% annual loss across 10 years is more acceptable. So the China government may try to diverse the single loss into [amount 00:19:36] period. So which means it'll be less suffered in a single year. So that could be much, much smaller squeeze on liquidity and avoiding some certain kind of crisis in the market.

Adam Bass (19:55):

As we spoke some more, Shuo compared the potential approach to the difference between basically letting the air seep slowly from a balloon versus simply popping it. And to his point on the day, we're recording this, there was news. Evergrande agreed to sell a 20% stake in one of its banks, with the corporate debt on its books, to the local [Shengjiang 00:25:56] government. And so investors around the world continue to watch. And that brings us to something Mark and I spoke about as he was talking about potential reasons behind the shift toward defensive factors and how part of it may be, like so much else these days, linked with how the world has changed since March 2020.

Mark Carver (20:40):

I think the first thing we should realize is the interconnected of us as a global community. And at MSCI, we often say, and we hear this from our leadership team, including Henry Fernandez, we should be global citizens. And I think what the pandemic showed us, is we should be because we had a global experience, we had a common experience of having to deal with this pandemic. And that was a unique experience, probably for everybody that brought, I think some level of, "we're in this together" attitude. But it did signal just how connected the world economies are, because what we know is that we have global supply chains. And as people tried to get goods and just to buy common consumer products, there were shortages. Why? Because global supply chains were shut down.

Mark Carver (21:45):

Why were they shut down? Because people couldn't go into work, we couldn't produce the goods and services that people typically consume. And this was not unique to someone who lives in Westport, Connecticut like I do. It was common across the world. But that commonality did mean that we had to think about the connectedness of markets, what it meant, and then for investors, when we think about 2020, part of the reason we saw some of the performance of assets that we observed was, that many investors couldn't price the fundamentals of companies with a lot of competence. Because how do you predict the earnings power of a company, when you're not even sure if they're going to have the supplies they need to produce their goods. And that changed the overall dynamics of the way we live, the way we work, the way we price assets from a market standpoint, and in some ways, this may end up being a positive thing. That we realize just how connected, how dependent we are on each other around the world.

Adam Bass (22:58):

So where do we go from here? What are investors thinking about as they begin the last leg of 2021?

Mark Carver (23:05):

I often talk about this notion of asset allocation 3.0. And maybe I'm going to have to come up with a new term because that one doesn't seem to be catching on. But the idea is really simple, where once upon a time we thought about stocks, bonds, cash. And then investors were starting to say, "Look, I'm going to overweight this region, underweight another, I'll overweight equities, I'll underweight fixed income, but with a little bit more precision." Today, we go for even further precision where we'll say, "Not only do I want to overweight one region and underweight another, but I'm going to be more specific in the way I want to take that exposure."

Mark Carver (23:47):

And so more and more of our clients are thinking this way. And what they're saying is, "While the US might have a strong reopening, what types of exposures do well in markets that are reopening in effectively in a more pro cyclical environment while other economies are farther behind?" And we're seeing more of our clients think in these terms where they might take one exposure in the US, another in Europe, still another in the emerging markets, and this is allowing them to do this, as I call it asset allocation 3.0. Bring in additional lens of precision. And it's very clearly different than the things that were on the minds of our clients three, five, six years ago.

Hitendra Varsani (24:36):

So we have a few days until we update our adaptive multifactor allocation model, which gives indicators for factor performance. But having said that, what's on investors' minds at the moment? Concerns around the slowdown in economic growth, the attention on inflation risks rising again, tapering in the US. We've also in a period of seasonality of historically higher volatility. And so that has motivated some to think about defensive positioning. And as we've talked about earlier, we have seen defensive factors outperform over the last quarter, led by minimum volatility, quality, alongside momentum as well.

Adam Bass (25:21):

That's all for this week. Our thanks to Hitendra, Mark, and Shuo and to all of you for listening. For a look at what the model showed once the quarter actually ended, we will follow up with Hitendra with an interview that you'll be able to find on the MSCI LinkedIn feed. You can also check out the latest installment of the Factors in Focus blog and register for this quarter's Markets in Focus webinar all at MSCI.com. Please, if you enjoy the show, share it with colleagues, subscribe and leave a comment. Until then, I'm your host, Adam Bass and this is MSCI perspectives. Stay safe, everyone.

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