Insights
Equities

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COVID-19 and the Impact on Equities — Factor Perspectives from Smart Beta and AQE

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The impact of the COVID-19 pandemic continues to be felt across the world, although there are welcome signs that the pace of increase in the numbers of infection cases and fatalities may be slowing. The scale of the effect of such a health crisis on economies and financial markets has been unprecedented and well-documented.

In terms of equities, the headline returns have been stark but there are nuances worth teasing out and, to this end, we take a look at what has happened through the lens of factors, utilising two different approaches:

1. Smart Beta
2. Active Quantitative Equity

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Factor Indices
An Analysis of Q1 performance

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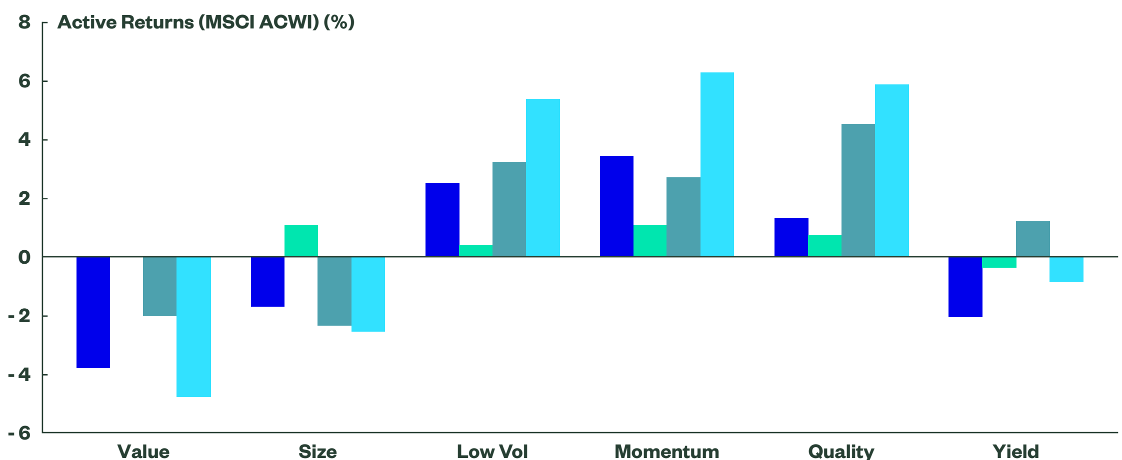
The opening quarter of the year was dominated by COVID-19, but the impact wasn't evenly felt across all parts of the equity market. As we outline below, there was considerable dispersion between the performance of the equity risk premia factors, with defensive factors typically outperforming as the quarter unfolded.

Factor Performance

The reality of the impact of the spreading coronavirus took an increasingly firm hold as the quarter progressed. There was a notable shift to a more conservative stance amongst investors amid mounting concerns of an economic slowdown as global supply-chain disruptions and pandemic fears gripped the market.

Within equities, that was reflected in the outperformance of the quality and low-volatility factors across all regions, supported by defensive sector exposures (Figure 1). By way of contrast, more cyclical factors, such as value and size, registered significant underperformance during this period. There were parallels of this factor performance pattern evident in credit markets where defensive factors also outperformed cyclicals.

Figure 1
Defensive Sectors Outperform in Q1



Source: MSCI as at 31 March 2020. This shows active return (%) performance of the MSCI ACWI Minimum Volatility Index (USD), MSCI ACWI High Dividend Yield Index, MSCI ACWI Quality Index, MSCI ACWI Momentum Index, MSCI ACWI Enhanced Value Index and MSCI ACWI Equal Weighted Index for Q1, January February and March 2020.

This trend in Q1 was in part a continuation of what we saw through much of last year, particularly with regard to the lagging performance of value. In 2019, markets were led higher by stocks with strong balance sheets and low leverage, which contributed to value's relative weakness, and this was exacerbated as the nature of the setback in 2020 became clear.

Factor Valuations

In terms of factor valuations, value is looking extremely cheap after a poor first quarter, but then it was already cheap before the latest crisis came along. Quality, on the other hand, has gotten more expensive than ever as companies with high return on equity and lower debt levels attracted support, providing a measure of defensive protection for portfolios in the quarter. Relative factor valuations tended to be similar across all regions.

Across Regions

The nature of factor performance has been broadly similar across both developed and emerging markets. One aspect of the comparative performance that did stand out in the opening quarter was the behaviour of small caps in emerging markets, where they enjoyed a better performance outcome. One possible explanation for this is that fact that a lot of small companies in these countries are more domestically focused; they were thus less exposed to the global market, which has been more affected by trade and supply chain concerns.

Factors and Sectors

Factor indices have very different sector exposures and this helps us understand their performance. For example, and from a relative weight perspective, Figure 2 illustrates that, within the MSCI All Country World Index universe, quality has a high exposure to the technology sector, which significantly helped the factor's performance in 2019 and 2020. The outperformance of the healthcare sector in 2020 and its high allocation has also bolstered quality's gains. The fact that quality is relatively underweight financials was also a relative positive, given the difficulties experienced by the sector this year. On the other hand, low volatility factor — which is also a defensive factor — actually has a very different sector footprint and its positive outperformance was underpinned by its exposure to utilities and consumer staples sectors.

Figure 2
Factor and Sectors

Sectors	Absolute Weight	Active Weight					
	ACWI	Low Volatility	Yield	Quality	Momentum	Value	Low Size
Communication Services	9.3	2.5	-0.1	1.3	-4.5	-0.4	-3.0
Consumer Discretionary	10.8	-4.1	-5.0	-2.1	-1.6	-1.6	-0.5
Consumer Staples	8.8	5.4	5.2	1.3	4.5	0.3	0.6
Energy	3.7	-3.2	2.3	-3.6	-2.7	0.7	-0.2
Financials	14.4	3.2	-0.6	-11.3	-7.3	0.7	0.6
Health Care	13.3	-5.3	6.1	6.3	-0.3	-0.3	-3.8
Industrials	9.6	-2.0	-0.8	0.3	-1.6	0.7	5.4
Information Technology	18.8	-6.8	-9.6	16.6	2.5	-0.3	-8.2
Materials	4.4	0.5	0.7	-2.5	1.6	-0.3	4.9
Real Estate	3.1	4.3	-1.2	-2.8	3.9	0.6	2.5
Utilities	3.6	5.4	3.0	-3.6	5.4	-0.2	1.4

Source: MSCI, as of 03/04/2020, in USD.
Absolute sector weights of MSCI ACWI and active sector weights of MSCI ACWI Factor Indexes, as of 31 March 2020.

Ultimately, one key takeaway from recent events is that different factors behave differently at different times. And because of the varying behaviour of factors over time, a popular approach among some investors is to combine factors into a multi-factor strategy in order to benefit from the differing behaviour and exposure that each single factor can contribute.

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Factors and Return Opportunities Taking an Active Approach

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While global equity markets have experienced significant reversals of fortune in the past, the nature of the drawdown driven by COVID-19 is different to what has gone before in a couple key respects. Taking the most recent crises — Global Financial Crisis and the deflating TMT Bubble — as a comparison, the stand-out difference has been the speed with which the equity market collapsed. At the end of March, the MSCI World Index was down -23.6% from its peak just 34 days earlier (and the loss had been even greater a few days earlier). In the Tech crash of the early 2000s, it had taken 161 days to shed 25.6% and it was 226 days into the GFC before the index had lost 23.5%.

Another differentiating factor of the latest drawdown has been the relative lack of dispersion among sector returns. Unlike past crises the spread between best and worst performing sectors was narrower than might reasonably be expected — there were very few places to hide in this drawdown.

Existing Trends Reinforced

One particularly interesting aspect of this drawdown is that existing market trends were reinforced rather than reversed. While the health, epidemiological, economic and day-to-day impacts of this crisis are becoming clearer and creating change to our lives and work practices, market dynamics have trundled on without change.

Part of the reason this trend remains intact is the big picture political and policy themes have not reverted in this crisis. We still have, for example, a growing reliance on central banks and governments to support asset markets, we have a continuation of the ultra-low interest rate environment, there's ongoing technological disintermediation of working and leisure practices, and therefore a continuation of the prevailing factor trends that have become established over recent years.

The companies widely considered as likeliest to be most negatively impacted by the virus, or the economic effects of the lockdown and social distancing measures, were in industries that were cheap to start with — cyclical industries, materials, energy and financials. Such companies' share prices were already under pressure ahead of this crisis largely a result of the US-China trade war and deepening concerns around potentially weaker global growth.

Amongst the expensive sectors at the start of this crisis are the winners of recent years — IT software, healthcare, consumer staples. These had benefitted from investor preference for large, expensive, growth stocks and more defensive sectors. Investors perceived this area of the market to be able to sail through the trade war and economic slowdown relatively unscathed, and so bid up share prices considerably. A longer duration profile in some growth segments, also increased the attractiveness of some of these names as interest rates relentless followed a downward path.

When we look at the returns from the peak of the market on 19 February to the trough on 23 March, the relative losers, on the whole, were those already-cheaper segments of the market, while expensive areas of the market outperformed.

From Rational Panic to Exuberance?

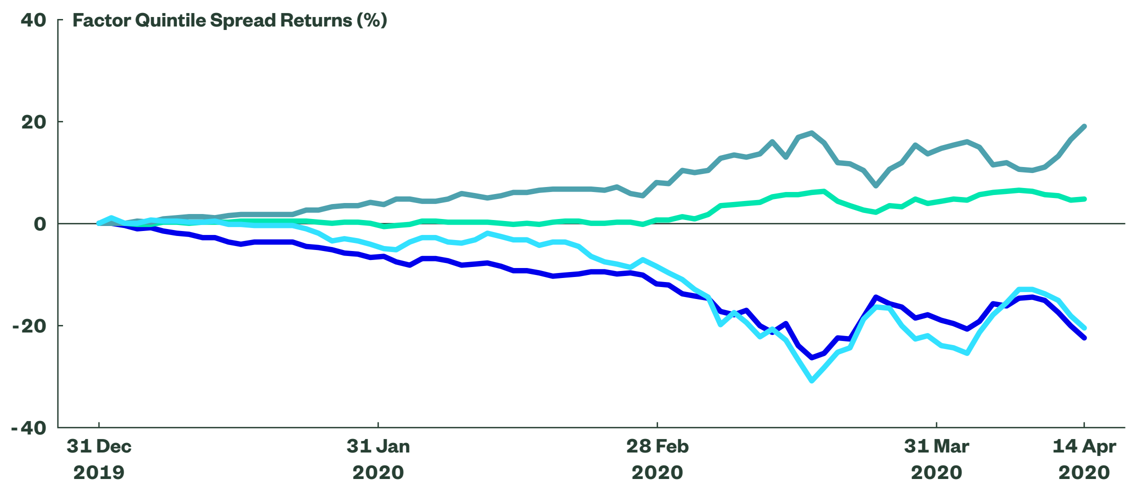
As hopes that a pathway through the health crisis had been identified, and with massive stimulus promising to soften the economic impact of the solution, the equity market rebound from the trough on 23 March has been particularly robust. The extent of the bounce is such that the Nasdaq index had recovered its year-to-date losses, and China's market is now down less than 10% in 2020. Given that we're still in the throes of a global pandemic and heading for a deep recession the shape of which, and the route out of which, is not yet really known, it's been a remarkable turnabout.

At the same time, it's worth noting that markets didn't actually get particularly cheap despite the scale of the sell-off. On a price-to-forward earnings multiple of 15.6x, this really only takes it back to long-term average levels. By comparison, at the bottom of the GFC, the multiple was around 8.6x.

From a Factor Perspective

There's been a remarkable degree of divergence in terms of factor performance, with higher risk, cheap (value) stocks performing poorly and higher quality, high sentiment doing very well. Figure 3 illustrates just how much the differential has grown.

Figure 3
Factor Leadership Remains



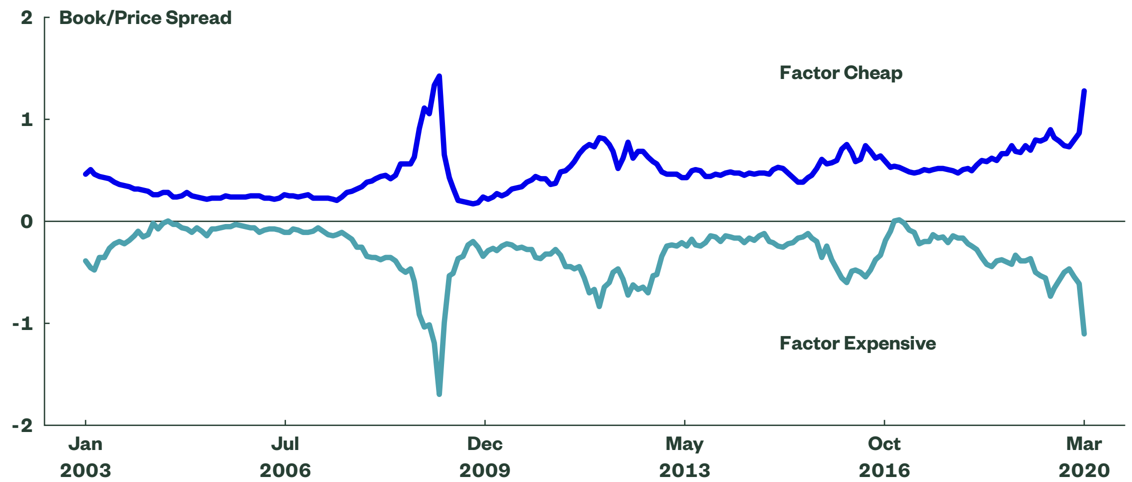
Source: State Street Global Advisors as of 19 April 2020.
Average valuation ranking by region, within GICS Industry group for MSCI World Index with 100 = cheapest and 0 being most expensive stock.

In terms of factors that we consider when building our active portfolios, sentiment as a theme captures investor preferences and fundamental improvements in business. It shows what types of company are being rewarded by the market; this theme has become very aligned with growth and defensive companies.

Even after the market troughed and then rebounded, we haven't seen a meaningful reversal in factor leadership or, indeed, any meaningful factor rotation. Cheaper stocks did rebound somewhat, but the rally fizzled out, whilst sentiment has continued to perform very well. Moreover, if we look back over the last couple of years we can see similar trends emerging and this crisis period has just seen an acceleration of those now-established trends within equity markets.

The continuation of such trends can create distortions and imbalances in markets and deviations from long-term norms. In Figure 4, we show the spread in average book to price values between the top and bottom quintiles of stocks for value and sentiment. Anything above 0 shows the factor is cheap, while anything below is more expensive.

Figure 4
Deviations From Long-term Norms



Source: State Street Global Advisors as of 19 April 2020.
Calculated as the average Book to Price spread between the top 20% of the factor by rank vs bottom 20% of factor.

The chart reflects the acceleration of the trend of recent years, with the value portfolio becoming cheaper than it's been since the GFC. So while value is looking increasingly stressed, sentiment is also beginning to look very expensive relative to its own long term history.

What Now?

Market distortions can present opportunities for active managers. Although markets overall may not be cheap, we are able to find stocks trading at what we believe to be very compelling valuations, with implied commensurate long-term return potential.

But we believe it's important to build a balanced portfolio, and take account of risk as well as return opportunity. Equity markets have rebounded so strongly, that it's likely volatility will re-emerge if there are any speedbumps in the road back to fully functioning economies.

Quality is important in such uncertain environment. Earnings are going to be devastated in the short term, but a nuanced assessment of company quality can differentiate between value and value traps and can guide investors towards companies better-placed to survive the economic downturn.

Defensive equity strategies that balance risk, in terms of total volatility, along with return potential could help soften the drawdown in the case of volatility spikes, and are an important component of an overall balanced portfolio.

In terms of our active strategies, we see attractive opportunities in some financial stocks where valuations are very cheap; we favour higher quality names in this sector, particularly in insurance. We like telecommunications with defensive qualities trading at cheap valuations, and some healthcare equipment names which may not be as cheap as other segments of the market but offer otherwise attractive characteristics.

But more generally we see the best opportunities in stocks at the intersection of cheap, high quality and positive sentiment. And even in times of stressed markets, or especially in time of distressed markets, we think it's important to maintain exposure to all three of these themes.

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