Equitorial

Hidden factors: exploring equity market behaviour in 2020

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In just about every respect, 2020 was a year unlike any other. The emergence and spread of Covid-19 was far more than a global health issue, radically disrupting as it did almost every aspect of our day-to-day lives.

The world of equity investment was certainly no exception: 2020 will be remembered not only for one of the steepest market declines in history, but also for perhaps the fastest market recovery ever recorded. From a record high on February 19, it took the S&P 500 only 22 trading days to fall 30% – the fastest drop of this magnitude in its recorded history. Yet by late August, it had recovered and was setting new highs.

What made this seem more remarkable for the uninitiated was that the recovery happened even as the pandemic continued. However, if there’s one thing we all might have learned over the past year, it’s the importance of looking behind the headline numbers and taking a nuanced view.

As we enter a new year, it’s customary to look both back to the past and forward to the future. This year, it would be tempting to focus on a future in which the virus is finally brought under control, gladly turning our backs on 2020 and consigning it to the annals of history. However, looking at the extreme market events of the past 12 months can provide some valuable insights for investors.

In this issue of Equitorial, we explore the behaviour of the markets in 2020 through the lens of investment factors, looking at how the impact of macro events affected the performance of specific factors at different times. In particular, we’ll look at three distinct, record-breaking events: the significant outperformance of companies with strong balance sheets in March, the long summer of growth, and the value rebound prompted by the announcement of a vaccine in November. Having explained 2020 from a factor investing perspective, we’ll offer a brief outlook on potential factor performance in 2021.

The Alpha Model: a firm foundation for consistent returns

On the Federated Hermes Global Equities team, our aim is to generate consistent, positive relative returns regardless of market direction or the wider geopolitical environment. We define our core style as one with no persistent bias, so while our portfolio may show small biases towards particular factors, no single bias will dominate over time. The unprecedented events and extreme volatility of the last 12 months have provided an excellent test of the efficacy of our approach, which focuses on time-tested company fundamentals.

Our proprietary Alpha Model acts as an “automated analyst”, assessing the attractiveness of every investable company in our universe on a daily basis and assigning them an “Alpha Score”. It does this by analysing, weighting and combining six fundamental characteristics or “factors” (see Figure 1). Ideally, we’re looking for companies with a combination of solid financials, competitive strength, quality management and a strong performance on environmental, social and governance (ESG). For the latter, we incorporate proprietary data from our responsible investment and engagement specialists, EOS at Federated Hermes.

The metrics used are justified by both economic reasoning and statistical effectiveness. By weighting and combining these factors appropriately we are able to forecast a company’s long-term prospects, using this knowledge to create an all-weather portfolio designed to consistently outperform the benchmark.

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1 “This was the fastest 30% sell-off ever, exceeding the pace of declines during the Great Depression,” published by CNBC in March 2020.
**Event 1: the flight to quality**

As we entered 2020, the mood among most investors was optimistic: global equity markets had been on the up through the end of 2019 and many expected it to continue that way. As January progressed into February, investor risk aversion became somewhat more cautious, fuelled mainly by rising tensions in the Middle East and the ongoing trade war between the US and China.

Throughout January, reports had surfaced from China of a novel strain of coronavirus and on 30 January the World Health Organisation (WHO) declared the outbreak a “public health emergency of national concern”. However, it wasn’t until 22 February, when Italian authorities reported clusters of cases in several regions, that investor risk aversion spiked and financial markets began to sell off.

**Risk aversion: quantifying investor confidence**

Risk aversion is a measure of investor confidence. We use our Risk Aversion Index to quantify and assess investor confidence over time – when the risk aversion indicator is in the green zone investors tend to be more speculative and seek higher risk assets; when it is in the red zone investors are nervous and tend to seek safety.

**Figure 2. Risk Aversion Index over Q1 2020**

That sell off continued well into March, by which time it represented one of the sharpest market declines in history. With companies facing clear and present danger in terms of reduced business activity and a breakdown in global supply chains, investors understandably focused on companies with strong enough fundamentals to stay afloat.

As a result, those companies with strong balance sheets (measured by our Capital Structure factor, shown by the dark blue line on Figure 3) and those with healthy margins generating strong cashflows (measured by our Profitability factor, shown by the amber line) outperformed across all markets.

**Figure 3. Factor performance from the February 2020 crash**

In fact, avoiding companies at risk of bankruptcy was such a high priority in March 2020 that our Interest Coverage factor, which measures the financial soundness of a company’s balance sheet, provided the largest factor returns ever seen in our model’s history. That is, the degree to which companies with high levels of interest cover (more financially sound) outperformed those with low levels of interest cover (less financially sound) was unprecedented for any metric we have assessed since the early 2000s.

While interest coverage has typically been an important consideration for investors in times of market stress, in March 2020 the magnitude of the return was staggering, as can be appreciated from Figure 4, which shows standardised returns on Interest Coverage ratios since 2004.

**Figure 4. Standardised Interest Coverage Factor returns since 2004**

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2 Factor returns are calculated as the difference in average monthly total return between companies in the highest and lowest ranked quintile, based on companies within the Global Equities Investment Universe. Factor history is calculated from January 2003 – December 2020.
As you can see from Figure 4, the last period of greatly elevated market focus on a company’s interest coverage ratio was during the financial crisis of 2008/2009. In August 2008, our Interest Coverage factor saw a three standard deviation positive return, which was followed by a reversal equal in magnitude eight months later.

In 2020 there was a repeat of this pattern but at a much larger magnitude: nearly six standard deviations of outperformance in March, followed by a similar reversal in November. This spike occurred at the same time as a historic inversion of the VIX volatility index, indicating that investors were worried about the immediate danger of companies going bankrupt rather than them potentially winding down over the following few months.

As would be expected, the Interest Coverage factor performed particularly strongly in the most economically sensitive sectors, such as Energy, Materials and Industrials. However, the Energy sector saw this strength much earlier than other sectors. It had already been roiled by the collapse in oil prices earlier in February, and as the market crashed in late February, investors reacted quickly to avoid the double whammy for the worst hit firms of lower prices and severely reduced demand that would leave them struggling to pay their debts.

**Volatility as an indicator of market panic**

A traditional indicator of the level of “fear” in the market is the CBOE Volatility Index or “VIX”, which reflects market expectations of volatility over the following 30 days. By looking at VIX futures, it is possible to derive a term-structure of the index (see Figure 5). Under normal conditions, longer-dated contracts are usually priced higher than shorter ones, based on the fact that the future tends to be more uncertain the further out you look.

In Q1 of 2020 the VIX spiked massively – unsurprising given the dramatic market sell-off and the resulting increase in investor risk aversion. However, more interesting was the fact that the VIX “inverted” i.e. three-to-six-month futures contracts were priced lower than short-term spot contracts. Investors were clearly most concerned about immediate short-term risks while expecting risk in the medium-term to reduce, a signal of an acute panic rather than a general aversion to risk.

The VIX has inverted several times in the last decade, most noticeably in 2011 during the European sovereign debt crisis, and again in 2015 when China devalued the Yuan. However, the scale of the inversion in Q1 2020 was much higher than anything seen before, reflecting the level of panic investors were feeling. The impact of this fear can be seen in Figure 6, which maps the VIX against our Interest Coverage factor. At times when the VIX inverts (indicated by the grey shaded boxes) the Interest Coverage factor shows extreme volatility as investors seek safety.

The value of investments and income from them may go down as well as up, and you may not get back the original amount invested. Any investments overseas may be affected by currency exchange rates. Past performance is not a reliable indicator of future results and targets are not guaranteed.
Event 2: A summer of growth
Towards the end of March equity markets started to recover from the initial shock and through mid-April into May, Capital Structure and Profitability factors became less important. By the end of May, many European economies had relaxed their “stay-at-home” orders, allowing economic activity to resume. As a result, Sentiment and Growth factors started to pick up as risk aversion trended down.

This trend towards Sentiment and Growth factors saw a slight hiccup in the first week of June, with a burst of risk-on sentiment creating signs of a potential value rotation; our Sentiment factor took a sudden dive while the Valuation factor had a rare rally.

Figure 7. A sudden burst of risk-on sentiment occurred in early June

With much of the global population largely confined to their own homes, many companies in the Consumer Discretionary and Communication Services sectors had seen demand for their products and services soar. Businesses focussed on home improvement, interior decorating, video games and media streaming services all sat in the top quintiles of our Growth and Sentiment factors; many of these businesses showed continued outperformance over the summer months as earnings were released.

Our Growth factor in particular performed exceptionally well compared to its historical average, with returns during July the largest we have observed since 2004 (see Figure 10).

Figure 9. Performance of Growth and Sentiment factors between 1 June 2020 and 30 September 2020

Source: Federated Hermes, FactSet, as at 30 September 2020.

Sector outperformance of Growth and Sentiment factors
Between June and October most of the gains in Growth and Sentiment were concentrated in the Health Care, Consumer Discretionary, IT and Communications Services sectors (see Figure 9).

Figure 10. Standardised Growth factor returns since 2004

Source: Federated Hermes, FactSet, as at 30 November 2020.

The pattern set in that first week of June would be repeated multiple times throughout the summer, with further notable value rebounds in the first weeks of August and September (see Figure 8). Each time value began to outperform, market commentators would draw parallels to the Internet Bubble, the suggestion being that finally growth had become too expensive and mean reversion would follow. Yet each time value’s revival failed to last more than a week.
Regional differences in sector performance

One thing to note is that while most regions saw the Growth factor perform well through the summer, the sources of outperformance varied meaningfully by region. In North America Communication Services companies dominated, while in Europe, high-growth companies in Technology and Healthcare led the way as lockdown measures eased.

In the European Tech sector, Growth factor returns were mainly driven by companies providing solutions to businesses, who were either looking to re-open their doors to consumers in the safest way possible or adapting to remote working. In the European Healthcare sector, meanwhile, the focus on reducing or even eliminating a second wave of the virus boosted typically smaller companies providing manufacturing, distribution or processing of Covid-19 testing.

By contrast, the differing profile of the pandemic in the US saw Communications Services firms emerge as the key drivers of growth. The lack of a national stay-at-home order, compounded by months of civil unrest across several states, meant that cases of Covid-19 never tailed off as they did in Europe; indeed, Dr Anthony Fauci, the most prominent member of the Trump administration’s White House Coronavirus Task Force, declared as late as October 2020 that the US was still in its first wave.

As a result, the US never experienced the effects of locking down an economy and later reopening it. Instead, economic effects were smoothed over the year, and over the summer the high-growth stocks in the US were those in the Communication Services sector, who continued to benefit from stay-at-home orders around the world thanks to their global revenue base.

Back in Europe, the end of the summer saw the emergence of the dreaded “second wave”, with new restrictions put in place by governments. This curtailed the exceptional run of Growth and Sentiment stocks, setting the stage for the third major event of the factor investing year.

Event 3: Vaccines give Value a boost

As October turned to November, most investors were focused on the potential outcome of the US presidential election. However, in the end the news which triggered the third major market event of 2020 had nothing to do with either Biden or Trump.

On 9 November, as the result of the election still hung in the balance, Pfizer announced the results of Phase 3 trials of its Covid-19 vaccine candidate; but more surprising than the timing was its over 90% effectiveness against the virus.

The effect on the financial markets was swift and dramatic, as can be seen in Figure 12. A sudden rotation away from the year’s Growth and Sentiment-driven winners saw beaten-up value stocks suddenly in demand, along with those consumer and travel brands which had previously fallen out of favour. Small cap stocks, which had been similarly unpopular over the summer, also soared.

This time, unlike in early June, the rotation did not reverse after a week but continued throughout November: the long-awaited rebound in Valuation factors was finally realised.

Yet, while positive monthly returns for value stocks dominated the headlines, the real story here was the underperformance of Growth and Sentiment factors: in this new rotation, the winning styles of the summer actually suffered far more than value benefited.
Value, but not just any Value

The rapid rotation in November didn’t involve all value stocks. Suddenly in favour were companies whose outlooks had been written off during the pandemic but whose fortunes investors now hoped would revive. In contrast, investors now gave little heed to the actual results achieved by companies during the pandemic.

In this scenario, favouring companies which looked cheap based on their achieved results actually proved to be a loss-making strategy. Instead, investors tended to buy companies which looked cheap because their expected earnings had been depressed due to the pandemic. So, it was specifically the forward-looking valuation metrics that tended to correlate with shareholder returns.

The rotation from growth to valuation was particularly evident in Developed Europe, where cheap stocks in the Real Estate, Financials and Materials sectors dominated. The (soon to be dashed) hopes of a “return to normal” just before the festive season seem to have made owners of European shopping centres and providers of European banking and credit services particularly attractive to investors. With the vaccine offering the prospect of an imminent “return to normal” it was no great surprise to see the most economically sensitive names in some of the most depressed sectors react most strongly.

What lies ahead in 2021?

As we have seen, behind the headlines of historic crashes and highs, a surprisingly nuanced story of 2020 can be told by analysing the performance of different investment factors over the course of the year. It may have been a year unlike any other, but an examination of the behaviour of the various factors involved demonstrates that market behaviour was ultimately explainable, if not exactly predictable.

So, what can we expect in terms of factor investing in 2021?

While there may be some moments of lost confidence along the way, an economic rebound enabled by the vaccine is likely to continue to be beneficial for the economically sensitive value end of the market. After almost a decade of underperformance, and with the relative valuations of growth and value styles remaining elevated (see Figure 14), it is hard to see a more perfect environment for value in the short-to-medium term.

![Figure 13. Factor performance as at 1 November 2020](source: Federated Hermes, FactSet, as at 30 November 2020)

As we emerge from the pandemic, we will of course want to embrace many of the behaviours and activities of our old lives. However, it would be foolish not to think that the virus has changed our behaviour in ways which are likely to have a lasting impact. From distance learning and remote working to shopping locally and living more sustainably, 2020 has accelerated existing social trends while kickstarting new ones.

From an investment perspective, while we anticipate a reset between growth and value in the short term, it would take a brave investor to dismiss the power of growth stocks over a longer time horizon. As the dust begins to settle, many of the “Covid-winners” – the growth stocks in sectors such as Tech, Healthcare, IT and Communications that dominated over the summer of 2020 – are likely to return to favour.

However these somewhat antagonistic trends play out, the nuances of our Alpha Model will enable us to interpret the signals and adapt our investments, accordingly, giving our clients the best opportunity to generate consistent alpha whatever 2021 has in store.

![Figure 14. The price-earnings ratio of the MSCI World Value Index and the MSCI World Growth Index since 2011](source: Bloomberg, as at December 2020)
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