

Equity investing: applying discipline and resilience in current times

October 2020

In the first quarter global equity markets fell by 20%. Since then we have experienced a 27% rise up to the end of the third quarter, leaving global markets just into positive territory. In total, this represents a +48% increase from the lowest point on the 23rd March, giving 2020 its place in the economic history books as one of the sharpest drawdowns (ending the longest bull-market) and quickest recoveries on record. Chart 1 shows that global equities took just 141 trading days to return to the previous heights reached in mid-February, compared to an average of around 1,000 trading days for other bear markets to reach their pre-crisis level.

The key point to note here is that no market cycle is the same and certainly the COVID-19 pandemic has been incomparable in terms of its impact on global equity markets. This article investigates the recovery and its implication for investors.

Chart 1: MSCI World (price) bear markets greater than 20% drawdown since 1970 in local currency



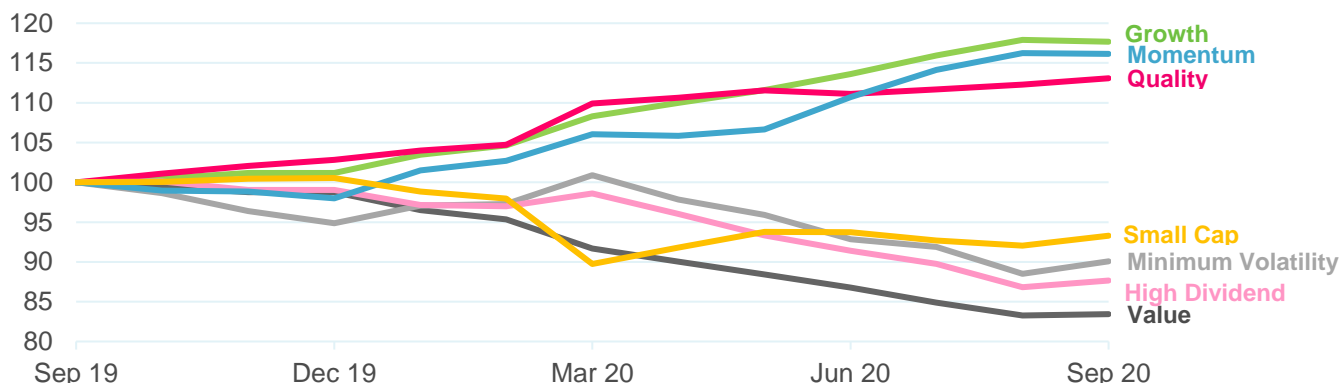
terms

Source: DataStream

The speed of the recovery can largely be attributed to swift central bank and government action that helped to stabilise markets that were, at times, in free-fall in mid-March. One could argue that these were policy actions tested and remembered from the financial crash just over a decade ago.

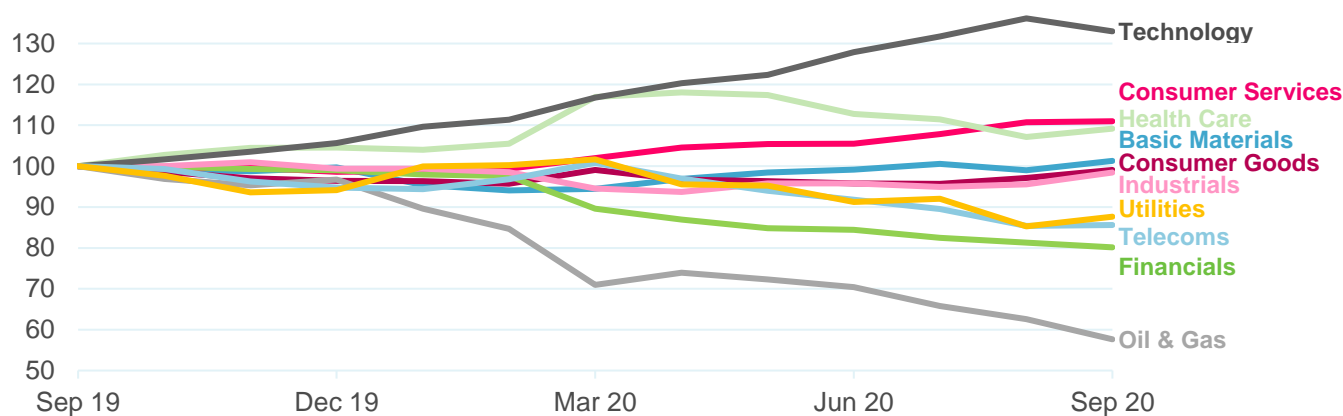
However, this rebound has been far from a uniform picture and the variation in returns across markets has been huge. Within regional equities, we see how well the US market has performed (+11% year to end of September) and how dismally UK equities have fared (-19% year to end of September) in local currency terms. Drivers of regional returns have reflected the often-interlinked sector and factor composition of each market.

Chart 2: Global factor performance relative to the MSCI All Country World Index



Source: DataStream

Chart 3: Global sector performance relative to the FTSE All-World World Index



Source DataStream

How have global equities performed in the recovery?

Charts 2 & 3 show the returns measured monthly for different factors and sectors relative to their broader global equity market index from September 2019 to 2020.

Chart 2 shows so called value, small cap, high dividend and minimum volatility stocks have all suffered over the year, with the divergence from growth, quality and momentum accelerating after the crisis. This is not surprising - value stocks tend to underperform in an economic downturn (let alone a complete closedown) as these stocks are often concentrated in cyclical areas of the market such as financials, oil & gas and materials, which have all underperformed this year (Chart 3). These areas are over-represented in the UK market which partly explains the UK market's underperformance over the year.

While the underperformance of value stocks may be representative of a more traditional end to the market cycle, the performance of minimum volatility and high dividend yield stocks relative to MSCI ACWI is less traditional. These stocks tend to be concentrated in more defensive sectors such as utilities, telecoms and generally more mature, traditional markets and therefore we might have expected them to outperform the market at least during the initial volatility.

Utilities provided some protection as markets tumbled in March, but not a lot – regulated utilities have the resilience of domestic consumer use, but lockdown measures meant that commercial consumption was effectively turned off overnight. They were already at stretched valuations so could only provide limited protection, and then they were always going to lag in a market rally.

Similarly, telecoms would be seen as defensive and might have been expected to perform better given customers on fixed contracts and companies have static revenues - but lockdown has meant increased switch to digital and so their costs have increased during the pandemic to maintain and invest to meet the additional

demand for services. Essentially, they have not benefitted from the huge rise in domestic internet use, unlike some other areas of the market.

On the flip side, if we look at growth, quality and momentum stocks, they have all outperformed significantly over the year, parallel to the outperformance of the technology sector where a number of these stocks reside (but not exclusively). The pandemic was a catalyst for technological adoption, and to adapt a saying, forcing 10 years of advancement in 10 days on a large percentage of the global population. In previous market cycles, we might have expected technology to sell-off further than the broader market, due to the higher levels of speculation involved in valuation, which have on occasion been the cause of bear markets. However, the pandemic's influence on consumption and working patterns caused the sector and more broadly, digital companies, to provide the greatest resilience; record low government bond yields have acted as a tailwind for some of the higher growth stocks as the present value of future expected earnings increased.

In particular, the 5 largest capitalisation stocks in the index (Facebook, Apple, Amazon, Alibaba, Microsoft) have all benefited from the complete shift in consumer behaviour resulting from COVID-19 which catapulted them and the US (excluding Alibaba) market forward. While their leadership of the recovery has led to higher stock concentration in global equity markets than pre-crisis, we would caution against drawing comparisons with previous 'tech bubbles' as these stocks all make money and they are no longer pure tech companies – instead they are all beneficiaries of increased internet use, a trend that is likely to remain sticky even after the pandemic under the new global economy.

What does this mean for global equities?

Public equity markets are highly efficient at pricing the short-term based on the information available today, as demonstrated by the outperformance of technology at the expense of sectors where business models were fundamentally compromised by the lockdown measures. However, predicting the future beyond the short-term is more difficult.

While they have provided greater resilience, will the rise in price multiples of growth or 'new economy' stocks run out of steam? Will there be a catalyst, such as a vaccine, for a return to pre-COVID society lifestyle, without which many of the value or 'old economy' stocks could remain cheap for a long time, or worse fail?

The reality of the environment we are in today means that we do not know where the virus, the economy or markets will be in 6 months let alone 2 years' time. That means we are facing the greatest range of potential outcomes most of us have seen. With all this uncertainty, we believe it is asset allocation should remain balanced and disciplined – to use the old goldilocks porridge analogy: not too hot, not too cold.

Perhaps the only certainty is uncertainty. The pandemic's unique influence on global equity markets and the dispersion of the recovery highlights the difficulty predicting equity market outcomes in any economic environment. This is exactly why we like diversified multi-factor equity strategies that avoid trying to 'time' factor swings and instead try to capture and maintain exposure to all parts of the market and rebalance to them in a disciplined way.



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