2020 MARKET OUTLOOK

AN INTERVIEW WITH BEN DUNN

Ben Dunn is Chief Investment Officer of Quantitative Strategies at Eastspring Investments, Singapore. He highlights the attractive valuations of Low Volatility stocks in Asia, the potential for quantitative strategies in China as well as the benefits of having exposure to a diversified suite of factors.

1 The MSCI Minimum Volatility indices covering the World, as well as Asia Pacific ex Japan equity markets, failed to beat their broader market equivalents in 2019, implying that the Low Volatility factor has been relatively less effective this year. What drove this divergence?

The underperformance of the Minimum Volatility indices year to date (to October) was driven largely by sector and stock specific effects, the largest of which was the relatively lower representation of large cap technology-related names in the Minimum Volatility benchmarks. While these technology-related stocks delivered strong returns in 2019, they also exhibited higher volatility. In both the global and Asian contexts, the Minimum Volatility indices meaningfully suppressed overall volatility as evidenced below. (See Fig.1).

Over short time periods, the returns from a Low Volatility portfolio can vary from the overall market due to country, industry or even stock specific effects as Low Volatility strategies tend to favour the more defensive pockets of the market.

While we acknowledge that Low Volatility strategies can play a role in tactical decisions (i.e. seeking defensive attributes in preparation for volatility), allocations should be made with a long-term mindset as well as an understanding that returns may deviate from the market (and at times by large amounts) in the short-term. Over the longer term, however, Low Volatility strategies have tended to keep up with and generally outperform the broader market but with significantly less volatility.

2 Given the market volatility in 2019, investors have sought out stocks with more defensive characteristics. Have Low Volatility stocks become expensive as a result?

We have certainly seen growing evidence of a widening valuation gap in defensive/Low Volatility stocks in the US and Europe. For example, the MSCI Minimum Volatility Index in the US has typically traded at a slight price-to-earnings (P/E) premium (less than 10%) relative to the broader parent index (MSCI US). This premium has risen to nearly 30% in recent months. Likewise, in Europe, the MSCI Minimum Volatility Index is trading at a 20% premium to its corresponding parent index (MSCI Europe), versus only a narrow premium historically.

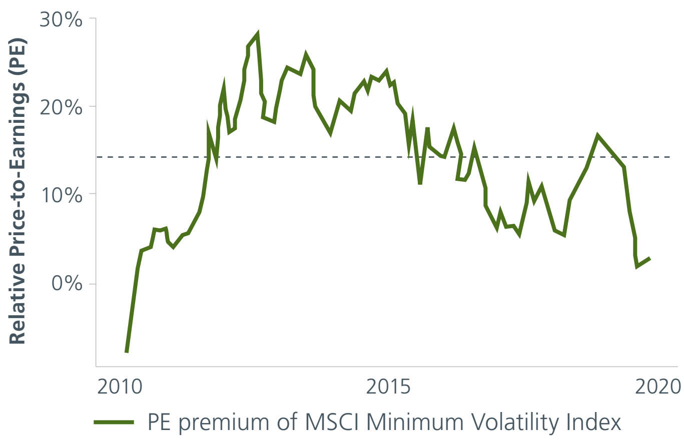
Fig. 1. Minimum Volatility indices suppress overall volatility in 2019[1]

	Global		Asia Pacific ex Japan	
	Minimum Volatility	Market Index	Minimum Volatility	Market Index
Return	19.5%	19.9%	8.9%	12.4%
Volatility (p.a.)	6.6%	10.4%	7.6%	11.4%
% of Market Volatility	63.4%	–	67.0%	–

However, we don't see this in all markets. In fact, in Asia Pacific ex Japan, the Minimum Volatility benchmark's historical premium of about 15% has all but evaporated in recent months. See Fig. 2.

Valuation considerations are a critical part of our Low Volatility approach. In situations where the market is overpaying for defensive stocks, we prefer to find alternative stocks with similar diversification benefits that are more attractively priced.

Fig. 2. Low volatility stocks in Asia look cheap[2]



3 The market expects the Federal Reserve to cut rates in 2020. Historically, how do rate cuts affect the Low Volatility factor?

Defensive stocks tend to be sensitive to changes in bond yields, so the market's anticipation of Fed cuts (or hikes) does have some bearing on the returns to the Low Volatility factor. We observe that falling yields tend to be supportive of the Low Volatility factor. However, our analysis also suggests that Low Volatility strategies are more sensitive to changes in market volatility than to changes in yields.

The VIX index (the market's barometer of investors' expectations for volatility) is currently near 2019's lows despite having several notable spikes in the preceding months. We expect markets to continue to be largely driven by macroeconomic data, political events and news flow in 2020. This dynamic will likely outweigh any impact of Fed's (or other central bank) moves on the Low Volatility factor.

4 We saw a sharp rotation among factors in 2018 and more recently, value made a brief resurgence. How can investors navigate such a dynamic backdrop?

There was a sharp rotation in Momentum and Value factors in September 2019. The move which was most pronounced in the US market, was dominated by sector and stock specific reasons.

MSCI USA Momentum underperformed the parent market index by -3.0% in September mainly due to its overweight in technology stocks and underweight in the banks.

As such, the MSCI USA Enhanced Value Index outperformed the parent market index by +1.8% given its underweight exposure to Growth and Momentum names.

A similar, though less pronounced move in these two factors occurred in October 2019, albeit with different drivers. Then, Momentum's underweights in healthcare and bank stocks drove its underperformance although a rebound in technology stocks helped soften the impact. The Enhanced Value index benefited from its overweight positions in semiconductor and healthcare stocks.

These sharp rotations highlight that trying to time factors, particularly to benefit from short-term relative factor performance, is a challenging pursuit. We believe that investors are better off maintaining exposure to a diversified suite of factors that are persistently rewarded over the long-term. This is the underlying philosophy behind our Multi Factor Equity strategy.

5 China remains a key focus for investors. What are the advantages of accessing the Chinese equity markets via a quantitative approach?

The China A share market has been gaining attention from global investors as market controls and restrictions are being eased and the weight of China A equities increased in regional and global benchmarks.

The China A share market is ideal for quantitative strategies given its ample size, significant breadth (i.e. a large number of stocks across diverse sectors and industries) and depth, as well as its relatively low trading related costs. In addition, given the large proportion of retail participation, the market exhibits many of the inefficiencies that quantitative strategies typically look to exploit.

There are some nuances of the Chinese market that need be acknowledged and accounted for, such as the large influence of local retail investors which results in higher volatility and strong trading reversal patterns. However, many of the typical factors used by quantitative strategies in other markets tend to work very effectively in the China A share market, including the Low Volatility factor.

6 How does your investment process take into account changing market dynamics?

Our quantitative strategies are designed as long-term strategies, and our focus is to gain exposure to those factors that our research has identified as being persistently rewarded over time. In the short-term, the market may be driven temporarily by other factors and events including the US-China trade hostilities, continued falls in already low bond yields and global growth concerns. Our strategies aim to understand the nature of these types of factors and look to reduce their impact by holding diversified portfolios and moderating exposure to unintended sources of risk.

In addition, our strategies incorporate elements of dynamic weighting into the combination of factors we use for each market segment. The factors we employ for generating alpha tend to perform well in most or all markets, but the behaviour and scale of performance within each market and within different sectors does vary. For example, Korea is more of a Value-driven market historically, whereas factors such as Sentiment and Momentum have performed more strongly in Malaysia. We prefer to acknowledge these types of differences across markets and how the factors' relative performances evolve over time.

Sources: [1]Bloomberg. MSCI. As of October 2019. [2]MSCI. Eastspring Investments. November 2019. Please refer to www.eastspring.com/reference-index-list for more details on the indices.

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