

Factor Views

Themes from the quarterly Quantitative Beta Research Summit

4Q 2020

IN BRIEF

- Factor performance was mixed, on balance, over the quarter with many factors following recent trajectories.
- Equity value continued to plumb new depths; quality was negative for a second consecutive quarter as fundamental factors generally underperformed.
- Merger arbitrage enjoyed a strong quarter; however, other event-driven factors have not bounced back from losses suffered earlier in 2020.
- Macro factors declined as reversals across currency and commodity markets impacted momentum positioning.
- We continue to see the outlook for equity value and equity quality as attractive; we have tempered our view across event-driven factors.

OVERVIEW

Risk assets continued their climb in the third quarter, buoyed by the ongoing global economic recovery, unprecedented policy support and sentiment that remained positive for much of the quarter before fading in September. Equity markets were up across the globe, driven by familiar themes: the U.S. outperformed other regions, technology ranked among the top performing sectors and large cap stocks surpassed small caps. High yield bonds and inflation-linked bonds were the best performing segments of fixed income markets as nominal bonds remained range bound. The U.S. dollar fell, particularly against the euro and the British pound. The majority of commodity markets rallied, many reversing losses from earlier in the year. Against this backdrop, the factors that we favor were mixed, with equity value extending its plunge and the equity momentum and merger arbitrage factors finishing positive again (**EXHIBIT 1**).

We remain optimistic in our outlook across equity factors as valuations are supportive of equity value and equity quality. We acknowledge difficulty, however, in forecasting the turning point for those factors that have underperformed of late, especially if we remain on the current macro trajectory and in the same market regime.

AUTHORS



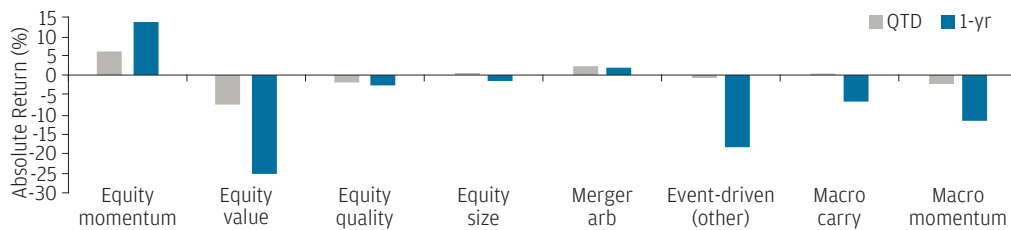
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Factors were mixed in Q3, though they remain down, in aggregate, over the past year

EXHIBIT 1: QUANTITATIVE BETA STRATEGIES LONG/SHORT FACTOR RETURNS

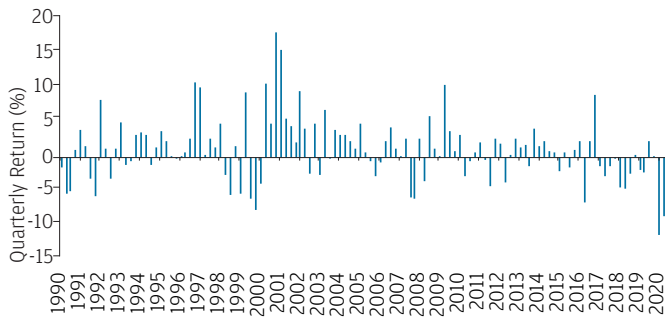


Source: J.P. Morgan Asset Management; data as of September 30, 2020.

Note: Factors presented are long/short in nature. Equity factors represented as 100% long notional exposure, event-driven (other) scaled to 5% vol, and macro factors as aggregation of 5% vol subcomponents.

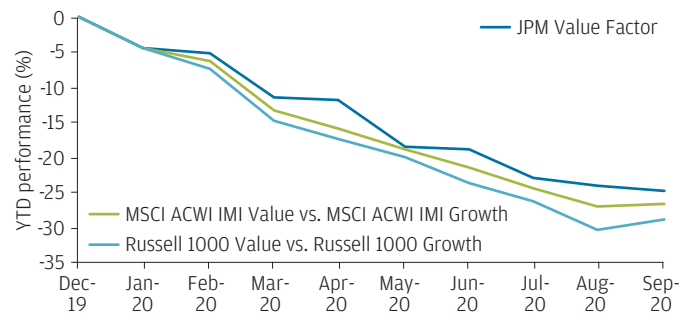
Value underperformance has been significant, regardless of how it is accessed

EXHIBIT 2: VALUE FACTOR QUARTERLY PERFORMANCE



Source: J.P. Morgan Asset Management; data as of September 30, 2020.

EXHIBIT 3: YTD VALUE FACTOR PERFORMANCE



Source: J.P. Morgan Asset Management; data as of September 30, 2020.

FACTORS IN FOCUS

Equity factors: Opportunity for the quality factor continues to improve

Equity factor performance in the third quarter matched patterns from last quarter: momentum led the way while value and quality lagged. The equity value factor continued to plumb new depths, with the current drawdown now extending well past what was experienced in the dot-com bubble of the late 1990s.¹ Equity value declined 7% over Q3, the factor’s fourth-worst quarter since 1990. Two of the next-worst quarters occurred in 2020, as well— in Q1 2020 it declined 11%, and in Q2, 9% (EXHIBIT 2). Losses were comparable across regions (the U.S., Europe, the UK, Asia and emerging markets), sectors (declining in all sectors save for energy) and ways of measuring value (e.g., earnings yield, cash flow yield, dividend yield, book yield).

Particularly noteworthy was how consistent losses were, whether considering the application of value within sectors or across sectors (EXHIBIT 3). As we have discussed in separate publications,² we generally favor a within-sector (or sector-neutral) approach in which stocks are evaluated relative to their sector peers with the objective of avoiding sector biases that may expose investors to ancillary risks. While this difference in construction has had a meaningful impact on long-term performance,³ it has not

¹ The value factor has declined by 37% since December 2016, compared to losses of 28% from May 1998–February 2000.

² For more information on the drawdown of the value factor and our view on the cyclical nature of recent underperformance, see Yazann Romahi, Garrett Norman and Gareth Turner, “Why value investing is poised to make a comeback in the 2020s,” J.P. Morgan Asset Management, updated as of June 15, 2020.

³ Dating back to May 1994, a within-sector approach of accessing value has exhibited annualized returns of 4.26%, whereas an across-sector approach, such as comparing the MSCI ACWI IMI Value Index to the MSCI ACWI IMI Growth Index, has seen value stocks underperform by 0.79% on an annualized basis.

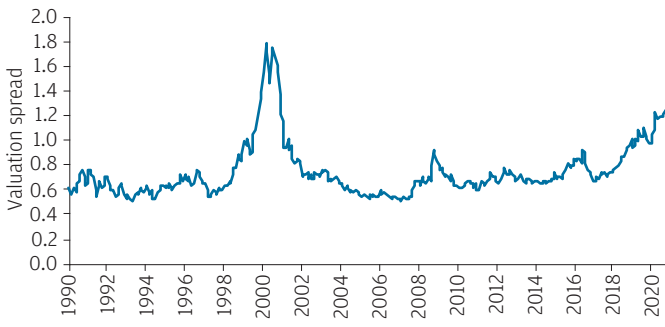
mattered this year. This highlights the pervasiveness of the current value drawdown and that it goes beyond sector dynamics.

In evaluating the prospects for the value factor, we continue to monitor how much of the underperformance may relate to investor preferences (or even exuberance) for growth companies rather than to underlying fundamentals. If investor preference has been the primary driver of value underperformance, we would expect mean reversion and an eventual rebound in value performance. If the fundamentals have dominated, we would ascribe recent underperformance to market participants correctly anticipating value companies’ fundamental weakness and we would expect no such rebound in value stock performance. In prior quarters, we have highlighted how the value factor’s current drawdown was almost fully driven by market sentiment rather than trends in net income growth. As such, we said that we expected market leadership to eventually change. While this generally remains our stance, our outlook is less clear than it was previously, given uncertainties around the path of the coronavirus, in addition to the usual difficulty in predicting changes in market sentiment.

When assessing valuations of the value factor, such as by comparing the forward earnings yield of value companies vs. expensive companies, the factor remains historically cheap – spreads were wider only at the height of the dot-com bubble (EXHIBIT 4). In December 2016, the forward P/E on value stocks stood at 13.2x, while the forward P/E on expensive stocks stood at 25.8x—with both near their long-term P/E averages of 12.2x and 24.9x, respectively. Since then, multiples on value stocks have dropped by 7% (to 12.3x), whereas multiples on expensive stocks have risen by 98%, to 51.2x. From this perspective, the outperformance of expensive stocks appears to be the continued inflating of a bubble.

The value factor has become increasingly attractive

EXHIBIT 4: VALUE FACTOR VALUATION SPREAD (GLOBAL)



Source: J.P. Morgan Asset Management; data as of September 30, 2020.

Note: Valuation spread is a z-score between the median P/E ratio of top-quartile stocks and bottom-quartile stocks as ranked by the value factor.

When assessing net income growth trends, however, we see that value companies have gone through a bout of weakness – which may be linked to the impact of COVID-19 on the economy and on markets.⁴ Over the past year, for example, the median net income growth of value companies declined 22%, vs. a 5% decline for expensive companies (EXHIBIT 5). While value companies typically exhibit slower net income growth than their more expensive growth counterparts, this gap is significantly wider now than in recent years, and wider than earlier in 2020. However, this gap is not unprecedented and reflects a look in the rearview mirror, with value continuing to look cheap from a forward P/E perspective, as described earlier.

Event-driven factors led by merger arbitrage

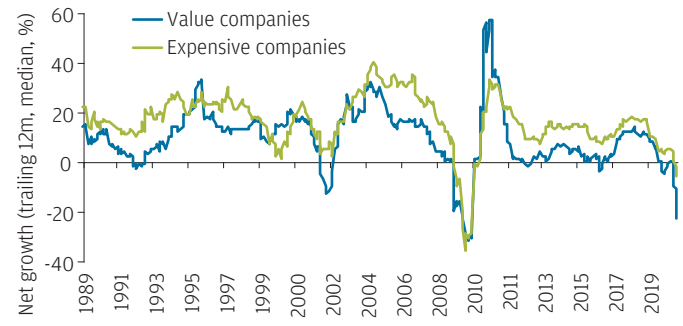
Event-driven factors were positive, in aggregate, over the quarter, led again by the merger arbitrage factor. While M&A activity has been below average in 2020, the merger arbitrage factor has fully recovered from losses in March when liquidity conditions tightened across markets and negatively impacted the arbitrage space. The spinoffs factor was positive while the share buybacks factor continued to underperform, extending a drawdown of a similar in trajectory to that of the equity value factors.

We have a tempered view on the outlook across event-driven factors, as a decline in corporate activity levels has limited investor ability to capture these factors while also remaining diversified. In addition, merger arbitrage spreads have compressed significantly and are now below average (after widening in March to spreads comparable to those during the global financial crisis of 2008-09).

⁴ When analyzing the potential impact of themes associated with COVID-19 on factors, such as by comparing factor scores of stocks that are expected to benefit from structural changes accelerated by the coronavirus relative to companies that may be negatively impacted or left behind, the value factor has been impacted negatively, momentum impacted positively, and the multi-factor approach has been relatively insensitive to these themes.

This year net income growth has been considerably worse for value companies than expensive companies

EXHIBIT 5: NET INCOME GROWTH COMPARISON



Source: J.P. Morgan Asset Management; data as of September 30, 2020.

Macro momentum continues to suffer market reversals

Momentum factors again experienced a challenging quarter, this time disrupted by reversals across currency and commodity markets. Weakness in the U.S. dollar, particularly against the British pound and Norwegian krone, where momentum signals had been positioned bearishly, detracted over the quarter. Within commodity markets, both relative value and time-series momentum models were hurt by strength across a range of soft commodities (coffee, corn and lean-hog markets in particular). Carry factors were again positive in aggregate, however, gains from positioning in fixed income and currency markets were offset by weakness from positioning in commodity markets.

Carry spreads are generally below long-term averages, particularly across G10 government bonds and FX markets. This suggests a diminished potential to capture carry in those markets. Among momentum factors, dispersion in price moves was average across currencies and commodities. The number of significantly trending assets was neutral in aggregate; equity, fixed income and commodity positioning were mixed across markets.

CONCLUDING REMARKS

Factor performance followed familiar themes over the quarter: equity factors were dragged down by value (and quality); event-driven factors were led by momentum; and macro factors were hurt by reversals across markets. The potential across equity factors looks particularly strong. However, as always, we believe in diversifying across a broad range of compensated factors while minimizing exposure to uncompensated risks.

FACTOR OPPORTUNITY SET

The table below summarizes our outlook for each of the factors accessed by the Quantitative Beta Solutions platform. It does not constitute a recommendation but, rather, indicates our estimate of the attractiveness of factors in the current market environment.

FACTOR VIEWS

VS. LAST QUARTER: ▲ Upgrade ▼ Downgrade – No change



		Rationale	
Equity	Momentum	▲	Neutral on valuation, attractive on dispersion (increase from last quarter)
	Valuation	–	Attractive on valuation, attractive on dispersion
	Quality	–	Attractive on valuation, neutral on dispersion
	Size	–	Neutral on valuation
Event-driven	Merger arb	▼	Negative on deal premia (decrease from last quarter), attractive on % of friendly deals, negative on activity level
	Other*	–	Negative on activity level; positive value/size tailwinds
Macro	Carry	–	Negative on FX spreads, neutral on fixed income spread, neutral on commodity spread
	Momentum	–	Neutral on FX price dispersion, neutral on commodity price dispersion, neutral on significant price trends

Source: J.P. Morgan Asset Management; for illustrative purposes only.

*Other: Conglomerate discount arbitrage, share repurchases, equity index arbitrage, post-reorganization equities and activism.

Our framework for evaluating factor outlooks is centered on the concepts of dispersion, valuation and the opportunity for diversification. For equity factors, we measure dispersion and valuation spreads between top-quartile and bottom-quartile stocks on a market, region and sector-neutral basis. For event-driven factors, we measure implied carry and the level of corporate activity as indicative of the ability to minimize idiosyncratic stock risk. For macro factors, we measure the dispersion or spread between top-ranked and bottom-ranked markets as well as the number of significantly trending markets.

GLOSSARY

- **Equity momentum:** Long/short global developed stocks, based on price change and earnings revisions; sector and region neutral
- **Equity value:** Long/short global developed stocks based on book-to-price, earnings yield, dividend yield, cash flow yield; sector and region neutral
- **Equity quality:** Long/short global developed stocks based on financial risk, profitability and earnings quality; sector and region neutral
- **Equity size:** Long/short global developed stocks based on market capitalization; sector and region neutral
- **Merger arb:** Long target company and short acquirer (when offer involves stock component) in announced merger deals across global developed markets
- **Event-driven (other):** Conglomerate discount arbitrage, share repurchases, equity index arbitrage, post-reorganization equities and shareholder activism
- **Macro carry:** FX G10 carry, FX emerging market carry, fixed income term premium, fixed income real yield, commodity carry
- **Macro momentum:** FX cross-sectional momentum, commodity cross-sectional momentum and time-series momentum across equity, fixed income and commodity markets

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