J. SAFRA SARASIN
SUSTAINABLE ASSET MANAGEMENT

Investment Spotlight

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30 YEARS of SUSTAINABLE INVESTMENTS

Factor investing to navigate the economic cycle

Dear Reader,

The world began to change with the arrival of the Covid pandemic in March 2020. Just eight months later we had the first working vaccine. That kicked off a historic market recovery as demand for the travel, live entertainment and restaurant sectors all re-bounded, changing the outlook for earnings across entire industries. Together with the shortages and price rises that followed, compounded by the war in Ukraine, a new investment landscape has emerged. Three decades of low rates and low growth have shifted to a new paradigm of high inflation and slowing growth. This environment may be with us for years.

In this edition, we turn our attention towards factors - proven tools for analysing financial performance and building robust portfolios. At a time of change in the investment environment, it is worth remembering that factors, including ESG (environmental, social and governance), still behave predictably. We look at how these metrics can explain market movements and inform allocation decisions with the potential to add performance.

Kind Regards,

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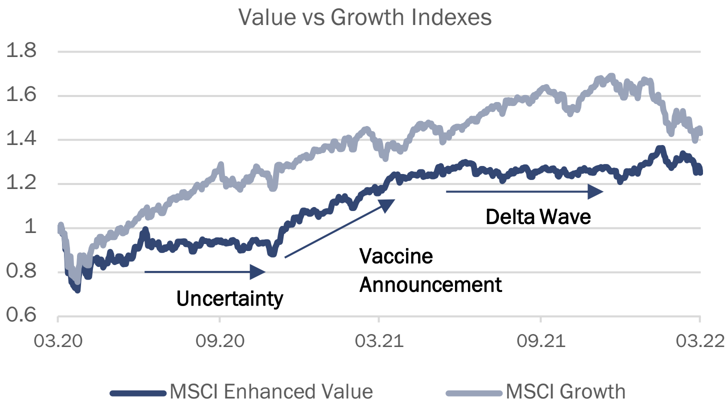
Clearly, this evolution in the investment environment has profoundly impacted asset returns. The good news is that can still prove useful because factors' returns are tightly linked to the economic cycle and a dynamic allocation among factors can provide the answer to navigate successfully through changing market regimes.

While we mostly focus on factors relating to equity markets, our suggestions work just as well for corporate credit, government bonds, currencies, and even commodities.

Exhibit 1: Value vs Growth Indexes



How factors behave

Factors are just a characteristic shared by a collection of assets that we can use to make sense of the complexities of changing asset prices and measure their performance. This is where factors can prove powerful. They let us slice, group and aggregate the movements of financial assets in markets to create a picture of how markets behave in response to evolving fiscal or monetary policies, and the real economy. That translates into better asset allocation decisions.

Value - In a broad enough sample, value stocks typically look 'cheap' because a poor macroeconomic outlook undermines the prospects for earnings growth. When the prospects for revenue growth improve, perhaps because the economy looks healthier, investors no longer need to pay a premium for companies that are generating profits. This means that value investing is all about timing. It makes no sense to buy value stocks as an economy begins to deflate or sell them on the cusp of a recovery.

Momentum - A diversified momentum strategy favours the prevailing market regime because it selects assets which have performed well over the preceding year. This means that when the market's main driver has faded, the factor becomes stale, and risks running into a sharp reversal with momentum profits turning quickly to losses, as investors all try to sell simultaneously. Rapid shifts in sentiment always threaten momentum as the factor is exposed to the most 'crowded trades.'

Quality - Quality has three dimensions: profitability, low leverage and earnings stability. A high and stable return on capital, in combination with low leverage, tends to favour businesses with high barriers to entry and a lasting, competitive position within an industry. These characteristics make quality stocks attractive to generalist investors and therefore typically trade at higher valuations. Demand for quality names depends on the macroeconomic environment. Since the dot-com bubble in the early 2000's for example, economic growth in both Europe and the US was disappointing, and so quality stocks did well.

Quality stocks tend to have a lower proportion of fixed costs and predetermined obligations, meaning they need little working capital. This positions them to better weather recessions than companies with higher capital commitments. On the other hand, the market may overestimate the 'star quality' of high-quality stocks while underestimating the resilience of low-quality stocks when the economy improves. That can lead quality to underperform in the first stages of an economic recovery.

Quality businesses can prove relatively more stable over an economic cycle but are more vulnerable to disruption over longer periods. This is because high quality and asset-light profit margins often attract intense competition from start-ups and the attention of anti-trust regulators.

Low volatility - Stock return drivers can be divided into either cash flows or market returns. Cash is delivered to investors either as dividends or owed in the form of retained earnings. Market returns from stock volatility are typically more meaningful, and visible on a day-to-day basis.

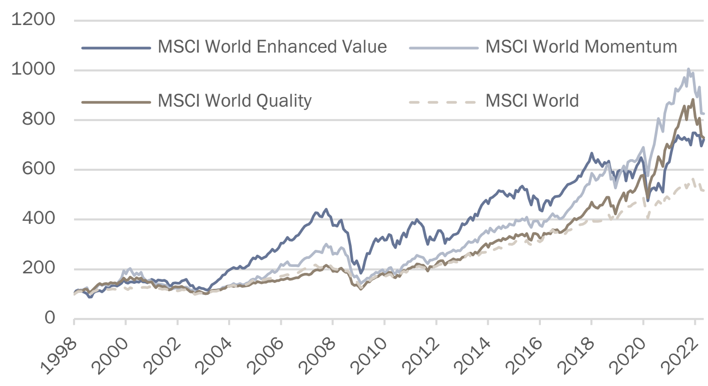
By selecting low volatility stocks, we are selecting liquid businesses with a low probability of bankruptcy, some certainty about earnings growth. We also tilt towards businesses that return a higher proportion of their cash flow to investors, rather than redeploying it into growth opportunities.

In terms of their macroeconomic sensitivity, low volatility relative returns may be more in line with government bonds or high-quality corporate bonds. Structurally, they may not be able to offer compelling returns to investors over long periods, as growth opportunities are limited. Furthermore, when inflation is high, low volatility stocks may be unable to pass-on rising costs to customers, as their pricing power may be limited by either competition or regulation.

Exploiting structural and cyclical factors' potential to outperform

Historically over longer time frames, investors in these four factors have earned returns in excess of passive investments in broad indexes, as shown above.

Exhibit 2: Historical performance of MSCI Factor Indexes and the MSCI World, Net Return



Source: MSCI

Long-term factor performance studies or theoretical behavioural explanations may miss the cyclical nature of returns. As a result, investors can wait years, or even decades, for this alpha outperformance materialise.

This cyclicality of returns is driven by the interaction between macroeconomics and markets. In the visualisation below, we rank the best-to-worst performing factors for each year, using MSCI indexes.

Exhibit 3: Factor performance ranking by year

Value (V), Momentum (M), Quality (Q) and Low Volatility (L).

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Best	V	M	L	M	V	L	L	V	M	L	Q	M
	Q	L	Q	V	M	Q	M	L	Q	M	M	Q
	L	Q	M	Q	Q	M	Q	Q	V	Q	L	L
Worst	M	V	V	L	L	V	V	M	L	V	V	V

Sources: MSCI Enhanced Value, MSCI Quality, MSCI Min Volatility and MSCI Momentum, Bank J. Safra Sarasin (own calculations)

Given this range of performance, it makes sense to manage factors by dynamically tilting and shifting portfolio exposures, depending on the macroeconomic and market cycle.

Factors and their macroeconomic link

Exhibit 3 shows that periods of poor value performance have coincided with decelerating economic growth and disinflation. Conversely, low volatility and quality strategies have thrived in such environments, as investors move towards assets which either perform relatively better during slowdowns or have less exposure to the broader macro economy.

Such performance cycles are the result of equity investors focusing on future growth earnings. In other words, investors pay a premium for certainty and get a discount for uncertainty as market prices anticipate and respond to macroeconomic changes. Other forces amplify the range of performance between factors, beyond the effect from fundamentals alone. The most significant forces are central banks' liquidity supply and investor sentiment.

Monetary and fiscal stimulus can often remain stuck within financial markets, increasing the valuation of assets that investors already favour. During the Covid pandemic, higher valuations for some more speculative parts of the market, including growth stocks, tended to be correlated with monetary and fiscal stimulus. However, such a process can quickly reverse once liquidity drains from the financial system, as we saw in the first half of 2022. At this point, the most commonly owned assets with the most distant cashflows see the worst of the selling.

Investor and consumer sentiment also drive both asset class and factor returns. Over long periods, investors' equity allocations also coincide with economic sentiment. This link is intuitive but generates even greater volatility and factor dispersion in equity markets. A holistic investment process should not overlook the importance of these two return drivers alongside a clear assessment of the prevailing state of the macro economy.

Is ESG a factor?

For decades, ESG criteria have been a cornerstone of our approach to allocating capital for clients. But should we work with ESG as a factor, in the same way as value, momentum or size? Is there an empirical link between the performance characteristics of high, compared with low ESG stocks? It turns out that there is.

Let's look at an example. An analysis of 158 sub-industries shows the impact of ESG on firms' operations, costs and revenues, and assesses the impact of business risks and opportunities. Each business category has its own ESG exposures. Below you can see the results for the apparel, accessories, and luxury goods industry.

ESG Materiality Matrix - Apparel, Accessories & Luxury Goods

	Operations	Costs	Revenues
ENVIRONMENT			
Product Carbon Footprint	-	Opex	-
Raw Material Sourcing	-	-	Business Preservation
SOCIAL			
Labor Management	Continuity, Quality	Opex	Business Preservation
Chemical Safety	-	Opex	Business Preservation
GOVERNANCE			
Board Structure	Quality	Cost of Capital	-
Management Remuneration	Quality	Cost of Capital	-
Ownership & Control	Quality	Cost of Capital	-

For comparison, the same matric for the Oil & Gas industry looks as follows.

ESG Materiality Matrix - Integrated Oil & Gas

	Operations	Costs	Revenues
ENVIRONMENT			
Carbon Emissions	Continuity	OpexCapex	Business Preservation
Biodiversity & Land Use	Continuity	OpexExtraordinary	-
Toxic Emissions & Waste	Continuity	CapexExtraordinary	-
SOCIAL			
Health & Safety	Continuity	Capex, Extraordinary	-
GOVERNANCE			
Board Structure	Quality	Cost of Capital	-
Management Remuneration	Quality	Cost of Capital	-
Ownership & Control	Quality	Cost of Capital	-
Corporate Behaviour	-	Extraordinary	Business Preservation

On top of laying the theoretical groundwork for ESG as a factor, we have linked ESG performance to corporate financial performance, as well as risk and return metrics for diversified portfolios. In a 2019 study, we demonstrated a link between ESG, key issue metrics and portfolio tail-risk, and we recently published a study linking specific sustainability issues to corporate financial performance[1].

ESG metrics operate as factors, clearly distinguishing separate groups of assets, and offering empirical links to financial performance. That does not necessarily mean that ESG factors are linked to the broader macroeconomic environment. Instead, we believe that it makes more sense to use ESG metrics as integral components for building portfolios.

Factor-driven investment – a coherent approach

Factor investing has become a useful and transparent framework for understanding financial performance for many investors because it provides a solid, forward-looking foundation for taking portfolio decisions.

In the Multi-Asset and Systematic team at Bank J. Safra Sarasin we employ all these considerations in our factor-based investment processes. Incorporating the real macro economy and ESG criteria into an understanding of liquidity, investor sentiment and monetary policy is the most prudent, and coherent approach for managing clients' assets. It has our clients well in recent decades.

As we all face a rapidly evolving investment environment, we believe that understanding the use of factors continues to help us to help our clients in making the most robust, and informed decisions about how and where to allocate capital.

[1] Simon and Legnazzi, 2019. ESG Risk Factors and Tail-Risk Mitigation, The Journal of Environmental Investing.

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