Factor food for thought

February 2021

Research Signals

2021 started out as a relatively uneventful month of positive momentum in high risk shares, carried over from the end of last year, on optimistic vaccination and economic outlook. However, pressure built up in the final week of January in a battle between day traders and hedge funds, resulting in frenzied trading in GameStop and other heavily shorted stocks, with major indexes erasing their initial gains for the month. Yet, retail investors' uprise could not derail the bull market and stocks continued to make new highs in the early days of February. As the bull market rages on, we take a few snapshots of factor exposures to highlight current market attributes.

- In mid-January 2021, a handful of the most shorted stocks saw a parabolic increase in performance relative to the market, though valuations of a broader set of highly shorted stocks remained comparatively in check
- As the market rebounded from the pandemic lows, investors bid up the valuations of high risk names in addition to those with negative earnings
- A notable number of stocks are trading at elevated price-to-earnings and price-to-sales multiples, alongside those trading at 52-week highs

The vagaries of healing from the pandemic

Before we dig into factor exposures, we set the stage with a macroeconomic view of various segments of the market, including large and small caps and value and growth stocks. We use the iShares Russell 1000 ETF (IWB), iShares Russell 2000 ETF (IWM), iShares Russell 1000 Growth ETF (IWF) and iShares Russell 1000 Value ETF (IWD), respectively (sourced from the IHS Markit ETF Analytics database) to represent each theme.

In Figure 1, we present the time series of NAV cumulative returns for each fund since the start of 2020 through 8 February this year. Growth was the top performing style over the period, with a 44.9% cumulative return, outpacing large caps by a spread of 18.2% and value by 37.2%. Growth (93.6%) also experienced a larger bounce relative to large caps (83.8%) and value (72.1%) off the 23 March low at the onset of the coronavirus pandemic; however, small caps were the clear winners since the market bottom, with a 130.7% return.

November was an especially strong month for stocks, with positive vaccine developments and reduced uncertainty following the US election supporting solid double-digit monthly gains across each style. Small caps (18.4%) led the

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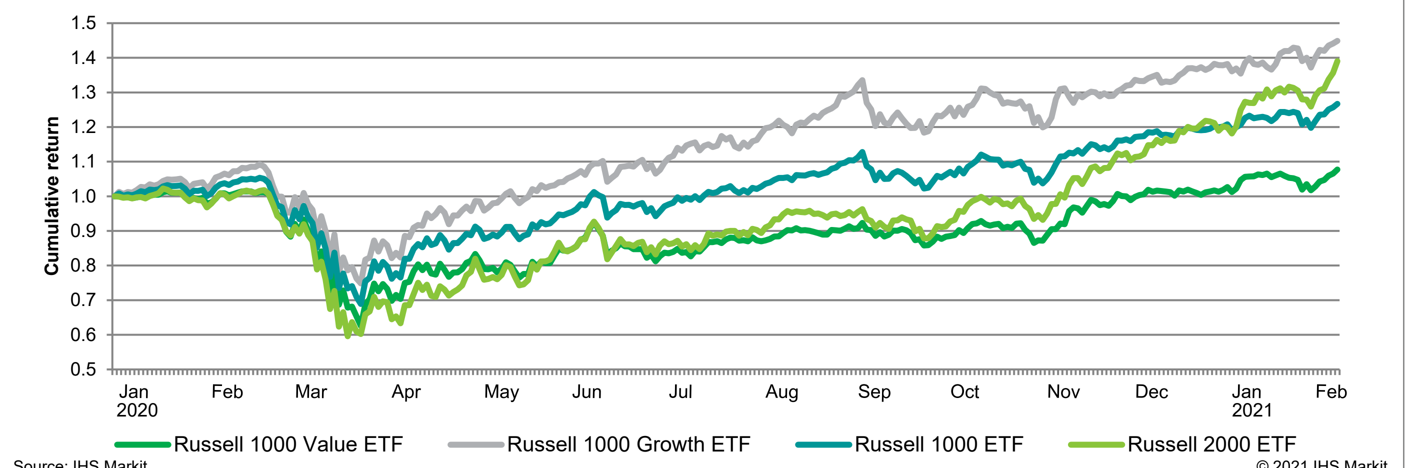
way, followed by a style shift to value (13.4%), with both funds recording their highest monthly performance since inception. While value had a nice run into 2021, growth has once again regained its footing.

Figure 1

ETF NAV performance



Source: IHS Markit

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Yet, the developing trend in investor sentiment toward value stocks since November has been reinforced by flows into the respective ETFs (Figure 2). Growth began to see outflows beginning in May, with the only exception in November, which was a strongly positive month in general for equity ETFs. In fact, investors poured near record amounts into value for the month, the third highest inflow over the fund's history, and have maintained their favor towards this style. Likewise, small caps have also been the beneficiaries of retail investors' dollars compared with large caps over this same period (Figure 3).

Figure 2

ETF flows

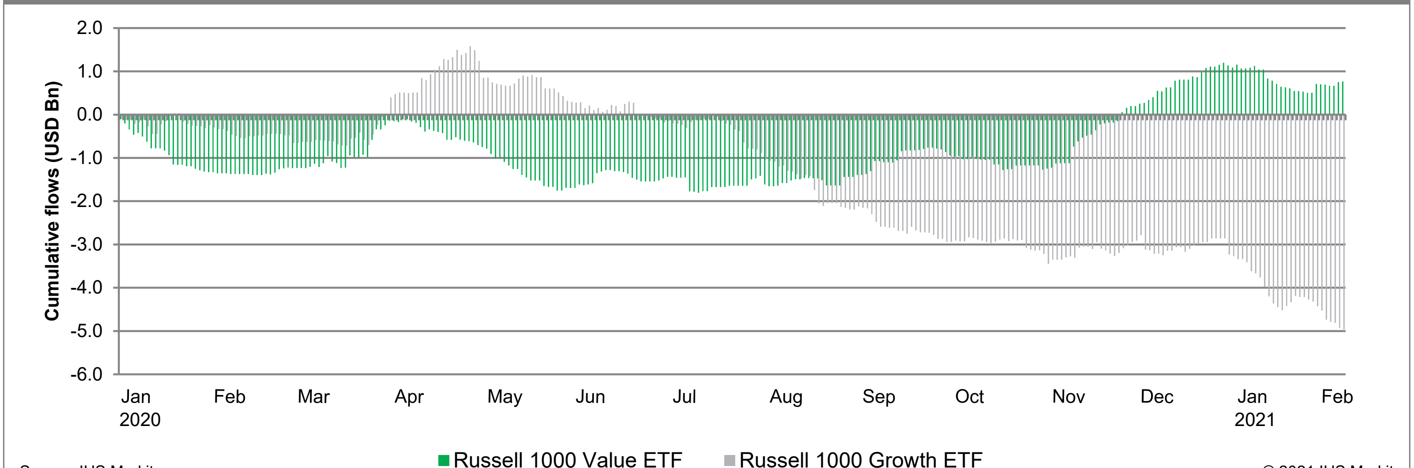

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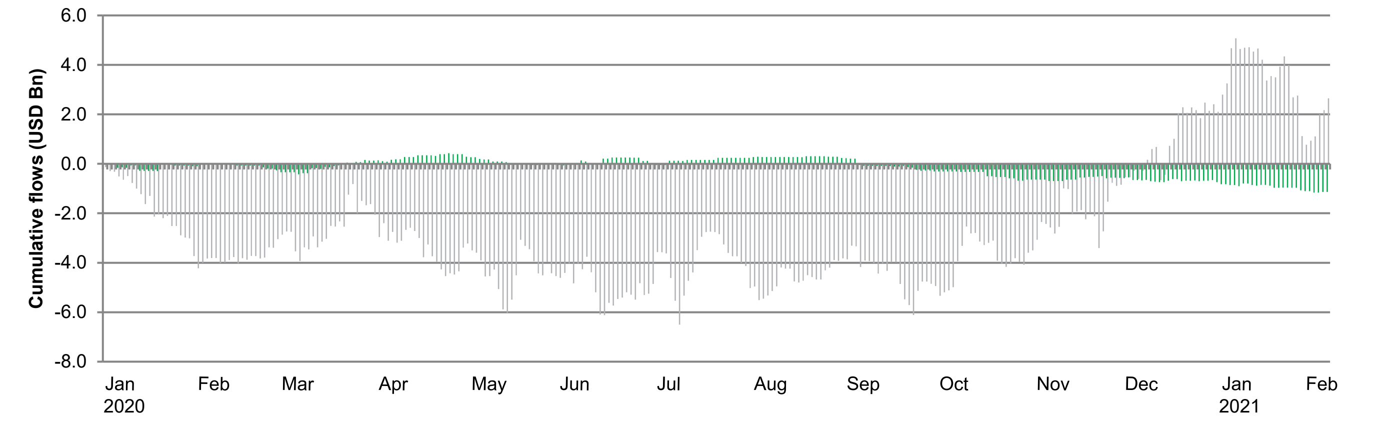
Figure 3

ETF flows



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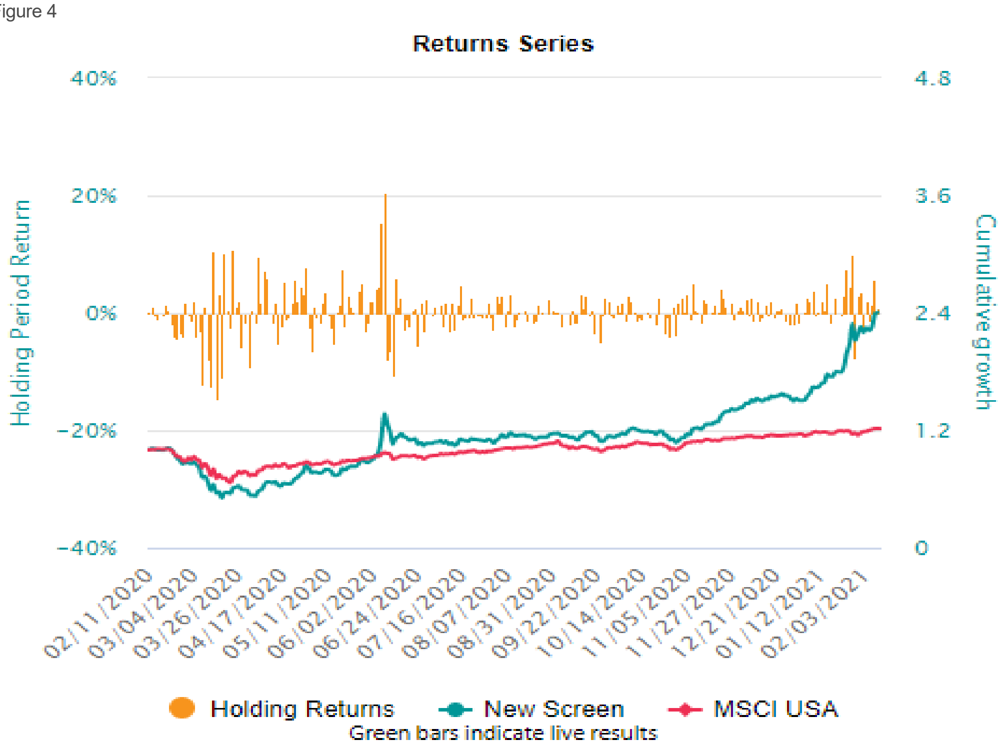
Short interest mania

Moving to factor level insights underpinning recent market developments, the leading market news thus far this year was certainly the wild ride in January in a handful of highly shorted US stocks. With this in mind, we begin by reporting on performance of the 50 stocks with the highest short interest (Figure 4) across the US Total Cap universe (representing approximately the top 3,000 names by market capitalization) through 9 February 2021. Beginning in November 2020, this cohort of stocks began to handsomely outperform the MSCI USA index as the risk trade strengthened. Yet, by mid-January prices soared amid the battle between retail traders and short sellers.

Figure 4



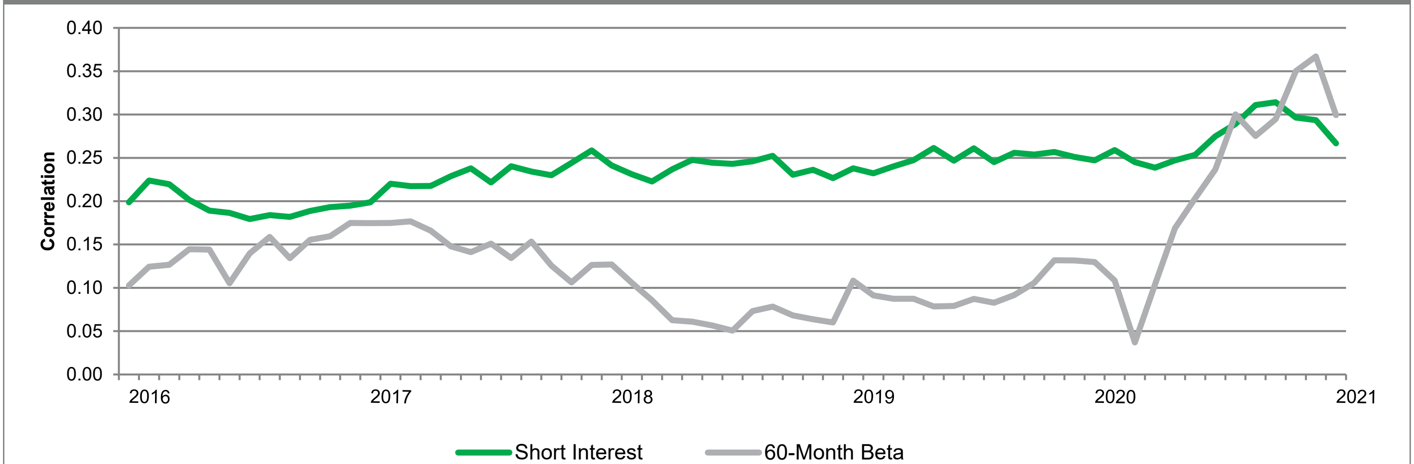
In light of such extreme market movements, we take a look at the impact on valuations of the two most notably affected segments, high short interest and high risk stocks. For this analysis, we examine the correlations in monthly cross-sectional factor ranks between factors representing these themes, Short Interest and 60-Month Beta, respectively, and that of value stocks gauged by TTM EPS before Extra-Items-to-Price (Figure 5).

For Short Interest, we observe an increasing trend in rank correlations with value through most of 2020. The interpretation is that unfavorably ranked high short interest stocks tended to see higher valuations for a good part of the market rebound. Interestingly, though, this relationship has seen some reversal in the last few months, suggesting that the manic trading in a handful of highly shorted stocks has not resulted in an extension in the overall relationship between high short interest and overvalued shares.

On the other hand, the pandemic-plagued markets of 2020 were much more favorable from a valuation perspective towards low risk names, which witnessed an appreciable bounce in correlation with undervalued rankings. In other words, high risk names were afforded much higher valuations as markets demonstrated surprising resilience following the significant disruption in economic activity caused by the coronavirus.

Figure 5

TTM EPS before Extra Items-to-Price rank correlations



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More on valuations

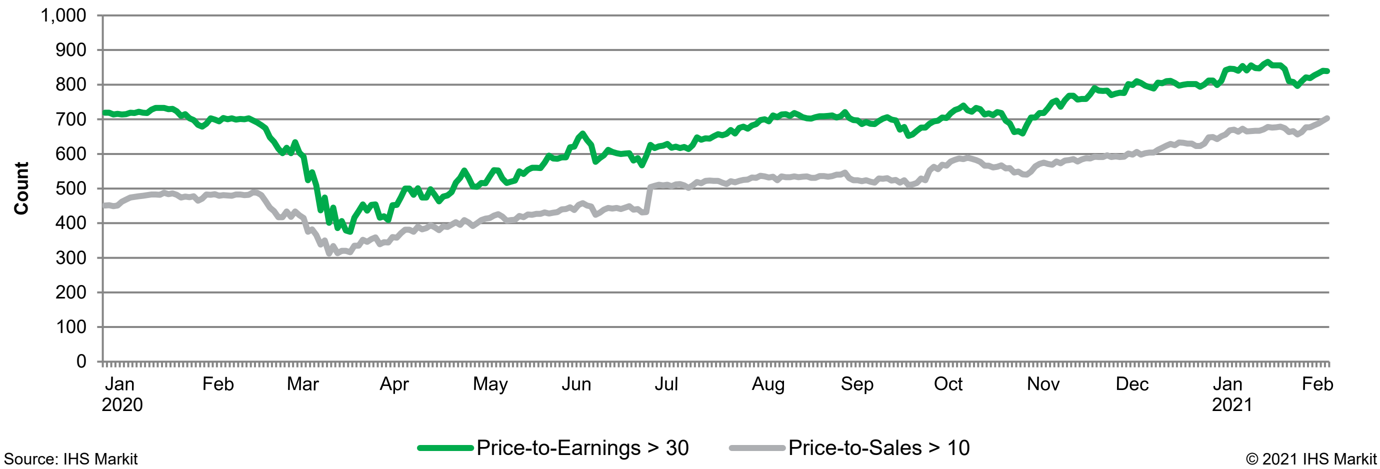
Next, we provide a few alternative factor perspectives on market valuations. First, we report the number of stocks in our US Total Cap universe which are trading at a Price-to-Earnings (PE) ratio in excess of 30 and those with a Price-to-Sales (PS) greater than 10 (Figure 6). Ratios are derived from our TTM EPS before Extra Items-to-Price and TTM Sales-to-Price factors, respectively.

Leading up to the pandemic, we find that a good number of stocks were trading at high valuations, but levels corrected during the ensuing bear market. Nevertheless, as markets recovered, we have seen a steady increase in overvalued stocks. From an earnings viewpoint, prior to the pandemic, the peak number of stocks trading at a PE greater than 30 was reached on 17 January (733). As of 9 February, this level now stands at 839, a 14.5% increase from the prior high.

However, a more interesting story unfolds from a sales standpoint. The pre-pandemic market top on 19 February 2020 coincided with the near-term peak (489) in the number of stocks trading at a PS greater than 10. While tailing off the following month, this value has subsequently shot up to 703, a 43.8% peak-to-peak increase.

Figure 6

US Total Cap universe high valuation stocks



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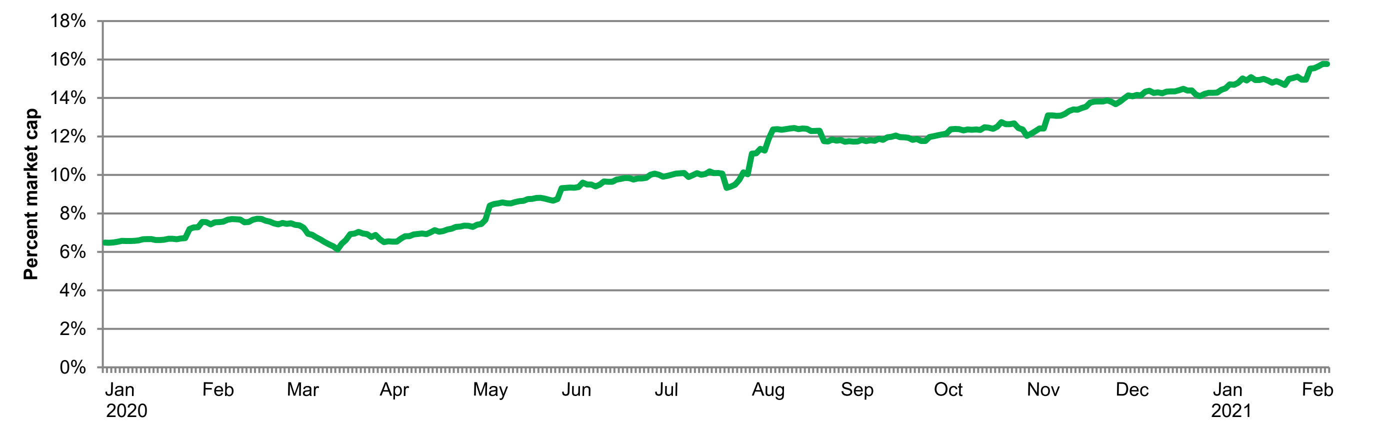
This leads us to the follow up question on the valuation that investors were willing to pay for stocks with negative earnings. To investigate this idea, we compute the sum of market capitalization of stocks with negative TTM earnings (filtered out from our TTM EPS before Extra Items-to-Price ratio) as a percent of the full universe (Figure 7). In this case, we find a two-fold increase in market cap representation from 19 February 2020 through 9 February 2021, indicating that firms with negative earnings saw a doubling in valuation relative to the market from the prior market peak to date, a byproduct of increases in stock prices for negative earning stocks and an increase in companies with negative earnings.

Figure 7

Stocks with negative earnings percent market cap of the US Total Cap universe



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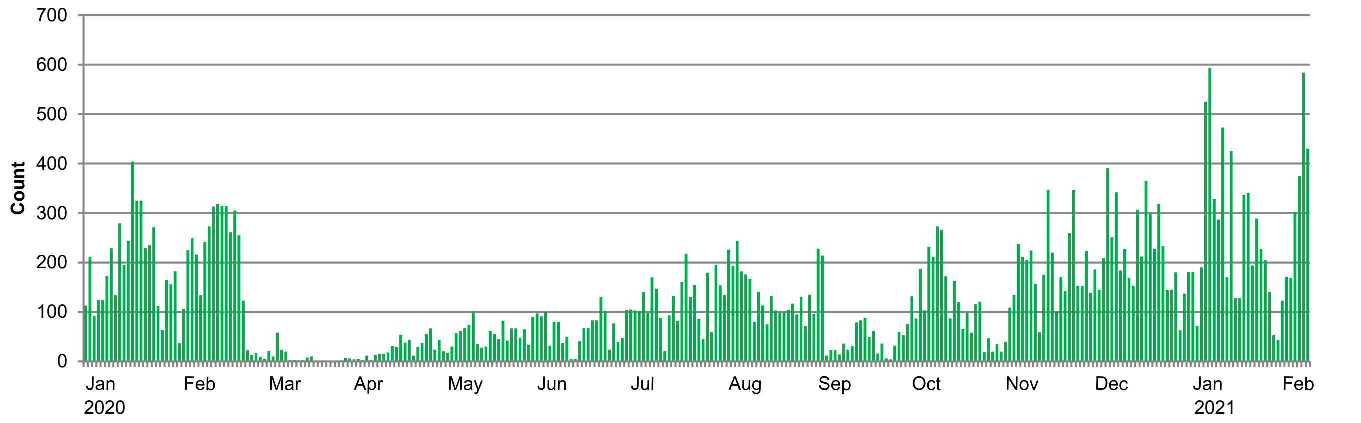
Lastly, we present the number of stocks trading at their annual high, in other words, with our 52-Week High factor at its maximum value of one (Figure 8). In early 2020, the maximum number of stocks trading at their high reached 404 on 16 January. The impact of the rout in stocks at the onset of the pandemic is clearly detected in the single-digit range recorded in this time series around that time period. As the market rebounded, so too did the number of stocks priced at extremes, with two particularly strong days this year occurring on 7 January (594), on bullish sentiment regarding additional fiscal stimulus following the confirmation of election results, and 8 February (584), again on expectations for a large fiscal stimulus package, with markets posting record highs on both days.

Figure 8

US Total Cap universe stocks trading at 52-week high



Source: IHS Markit

In summary, valuations of high risk names, alongside those with negative earnings, escalated as the market rebounded from the pandemic. In addition, a notable number of stocks are trading at excessive earnings and sales ratios, in addition to those trading at 52-week highs.

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