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BLOG POST

Covid and Factor Returns

11/23/2020

We've written extensively in recent reports about the dispersion of returns across equity factors amid the COVID pandemic. As we approach the end of the year, we offer some perspectives on how various factors might perform in 2021, given a set of assumptions about the future economic developments due to the COVID pandemic.

Today it appears that the COVID pandemic is worsening if measured by the number of positive cases. While the death rate is not rising materially, governments around the world are locking down business activity, which has recently put downward pressure on equity return expectations.

Momentum Stocks

So far this year, momentum stocks have done relatively well versus the broader market, as measured by the S&P 500 Momentum Index. This outperformance is no surprise given the sharp rally off the March lows. This group of stocks is dominated by mega-cap technology, discretionary and healthcare names (e.g. Apple, Amazon, Microsoft, J&J, United Health), which have either benefited directly from the pandemic or have been largely immune to its effects.

If the pandemic worsens, momentum stocks could continue to run and outperform other factors as investors would see few compelling reasons to rotate out of these names. However, valuation levels are now stretched by many historical measures, so potential mean reversion is an issue worth considering. The average price-to-earnings ratio on stocks in this group is north of 35 times.

High Quality Stocks

High quality stocks – those characterized by strong balance sheets and manageable debt loads – have performed relatively well versus the broader market so far this year, as measured by the S&P 500 High Quality Index. Similar to the momentum factor, the high-quality factor has a concentration to technology stocks, but with a value tilt. Likewise, this group of stocks has a meaningful weight to consumer discretionary and financials. Some of the bigger names in this equity group are Home Depot, Nvidia, Visa, and Mastercard, which in general have benefited from the pandemic.

Valuations on high quality stocks are a bit above longer-term averages, with a price-to-earnings ratio just above 20 times. Similar to momentum, high quality stocks might be a bit stretched in terms of valuations.

Small Cap Stocks

To no surprise, smaller capitalization companies have faced significant headwinds during the pandemic. Investors in general have shunned smaller cap companies with the expectation that many might not survive government-imposed shutdowns. For the year, the S&P 600 Index, which measures the performance of companies with a market capitalization of less than roughly $2.5 billion, has underperformed the broader large cap S&P 500.

If federal and state governments continue to impose lockdowns due to the COVID pandemic, smaller cap stocks will likely continue to underperform the broader market. Access to credit is critical for companies in this group to sustain operations and grow. While smaller cap companies have struggled so far amid the pandemic, a Congressional stimulus package should improve their return prospects. A potential stimulus plan won't likely be uniform (some will benefit more than others) but would nonetheless be a welcome sight for stocks in this group.

From a valuation standpoint, small cap stocks are trading at a price-to-earnings multiple of roughly 15 times, which is about half the valuation of momentum stocks and more in line with longer-term averages.

Value Stocks

As with small cap stocks, value stocks have underperformed the broader market as measured by the S&P 500 Value Index. Within the group, financial and industrial stocks maintain a relatively larger weight to other factors. Some of the larger holdings in this group are IBM, Intel, GM and AT&T. In general, these stocks have underperformed the broader market as investors have favored momentum (growth).

Not surprisingly, the valuations on this group are considerably lower than the other factors, with an average price-to-earnings ratio of roughly 12 times (versus roughly 35 times for momentum and 20 times for high quality). While value stocks have faced stiff headwinds this year, this group could be poised for a breakout if the trend in the pandemic improves. For example, investors could begin to rotate out of pricier momentum stocks (take profits) and reallocate into value names.

Low Volatility Stocks

Typically, low volatility stocks are considered more defensive than the broader market. The group has underperformed the overall market for the year, as measured by the S&P 500 Low Volatility Index. This group overall has a value bias and trades at a price-to-earnings multiple of roughly 20 times. Some of the larger names in this group are Verizon, Costco, Walmart, and Dollar General.

Interestingly, low volatility did not hold up relatively well in the initial market drawdown. However, the constituents in this group have been rebalanced multiple times since March, which might better position the low volatility factor to outperform on a relative basis.