Investment Insights

Morningstar Manager Selection Services EMEA - Observations of Trends and Themes across markets - Q1 2020

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Manager Selection Services
Morningstar Investment Management
Europe Limited

For further information please contact
gavin.corr@morningstar.com
laura.Stannard@morningstar.com

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The first quarter of 2020 has proven to be an extraordinary and unique period with some of the most volatile movements that have ever been seen, even surpassing those witnessed during the height of the global financial crisis (GFC). Most markets which had already begun to weaken in February became increasingly roiled through March by the rapid escalation and globalisation of Covid-19 which had begun to have a dramatic and tangibly negative impact on the global economy. What was initially thought to be a supply side event that was disrupting global trade emanating from the Chinese manufacturing hub, has now turned out to be an extraordinary demand shock as the consumer and corporates grind to a consumption halt through enforced lock-downs across almost all regions, in both developed economies and developing economies.

To compound this the oil price, which had been weakening as a direct consequence of this demand shock, collapsed on the 8th and 9th of March as a result of a dramatic breakdown in relations between Saudi Arabia (and it's OPEC Block) and Russia over an unwillingness from Russia to cut production to support falling oils prices as demand slowed due to the impact of Covid-19. The oil price fell as much 33% on the 9th of March alone, the largest fall on record. Brent crude's fall continued through the month and touched a 17-year low on the 30th March falling briefly below $23 as the market anticipated an increasingly flooded oil market.

As a result of these two related issues, the equity market collapsed on the 9th March, with the largest falls seen since the financial crisis. Some markets were down over 10% on the day. Volatility spiked dramatically, with the VIX reaching its highest level since December 2008, and safe-haven assets such as Gold, US Treasuries, German Bunds and the Dollar performed very strongly. An example of this rush to perceived safety was when the UK 2year Gilts momentarily offered a negative yield and the US 10 year briefly hit a record low of 0.32%.

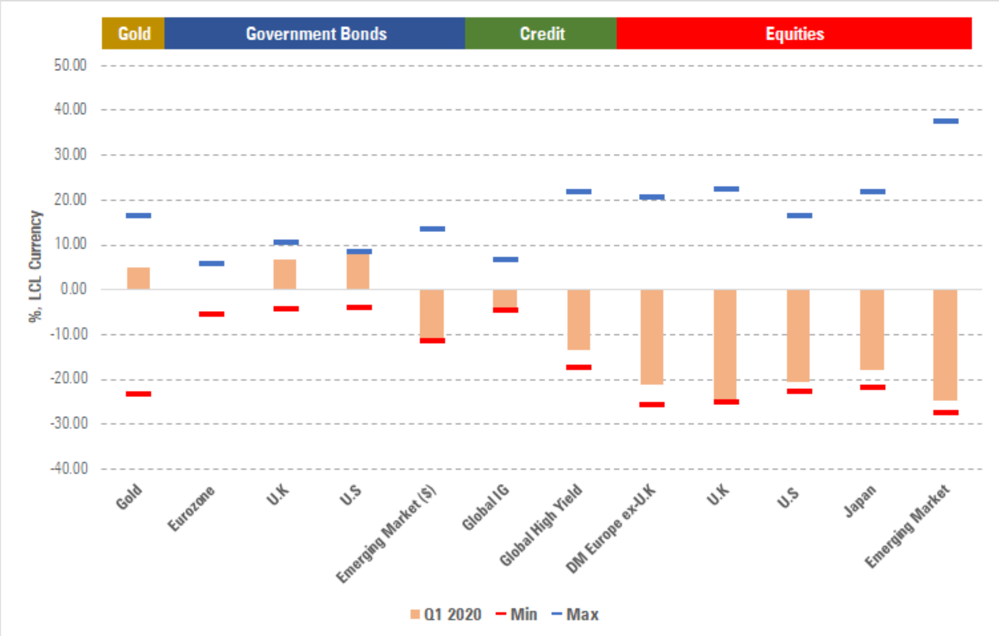
Central banks began somewhat haltingly to inject liquidity through monetary stimulus into the system which was mirrored by the beginning of fiscal support from governments. However, markets were unimpressed by these uncoordinated efforts initially, and as a consequence, riskier assets namely equities and high yield credit continued their dramatic slide pushing equities into a technical bear market faster than has ever been witnessed before.

After this initial rush to safe-haven assets, the market quickly began to appreciate the huge amount of government stimulus that was going to be injected into the global economy to limit the damage being done. Government bonds quickly joined in the sell-off seen elsewhere as investors looked to raise cash wherever they could, but still posted positive returns for the quarter.

One asset class that has behaved well over the quarter, albeit with increased volatility has been gold which initially benefitted from a rush to safe haven assets, then sold off in the middle of March as investors looked to raise cash wherever they could, and then subsequently rallied again to close to a five year high of $1,600 t/oz at the end of the quarter.

Within a week of witnessing the worst correction on record, increasingly coordinated government and central bank emergency stimulus packages in all the major economies finally began to be ramped up to reflect the severity of the environment. This had a stunning effect on investor confidence with equity markets staging their fastest ever move from a market low to a technical "bull" market in the US on the 26th of March 2020.

The graphic below charts the quarterly return of the major asset classes in local currency terms, along with their minimum and maximum quarterly returns going back to Q2 2000. Notably, Q1 2020 was the worst quarterly period for EMD $, Global Investment Grade bonds and U.K equities. Conversely U.S treasuries posted their best quarter with a return of 8.50% during Q1.



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The falls we have seen across many asset classes have thrown up some greater value than we have seen for some years. It is worth pondering however, as to whether there will be some structural changes to the global economy and society that will have a significant impact on markets for a long time. Will there be a rotation in style as markets bottom or will the powerful trends of predictable growth, technology, and sustainability lead any recovery, given we are going to be in an indebted, and arguably low growth environment for many years to come. Will the dominance of growth as a style continue, will multi-asset funds whose performance has been poor relative to expectations continue to lose assets, and will sustainability rise evermore to the forefront of investor's minds as investors and society digest what we have been going through? Will people travel and work the same as before, and what are the implications for large swathes of industry such as oil, property, leisure and travel? Will the reversal in globalisation accelerate? Does everything that's gone down necessarily have to go up again? Only time will tell.

This month will go down in the annals as one where investors, governments and central banks, and perhaps society in general were challenged as never before. We at Morningstar however are driven by the desire to shed light on the trends and themes that we have observed during this period to empower investor success. To this end we have trawled through our data and research to draw out some interesting and hopefully insightful observations to enlighten our clients and investors focused on four key areas;

1) Active versus Passive Fund Performance

Equities

Active equity managers struggled over the quarter, with few managing to make the most of a structural overweight to cash. Growth managers comfortably beat broad market passives whilst value managers capitulated against passive peers. This is most evident in the US (also driving global) and Europe, with the main driver in the US being a continuation of the recent years' trends of cyclicals, industrials and banks massively underperforming whilst mega cap and technology names outperformed. In the UK, Japan and Emerging markets the trends were the same, with active managers on a whole underperforming but growth and quality managers able to find alpha and outperform.

Morningstar Category	Median Excess Return
EAA OE Sector Equity Infrastructure	8.15
EAA OE Europe Large-Cap Growth Equity	7.19
EAA OE Russia Equity	5.03
EAA OE US Small-Cap Equity	4.40
EAA OE Global Large-Cap Growth Equity	4.19
EAA OE US Large-Cap Growth Equity	3.94
EAA OE Hong Kong Equity	3.45
EAA OE Property - Indirect Europe	3.41
EAA OE Property - Indirect Global	3.22
EAA OE Europe ex-UK Small/Mid-Cap Equity	2.45
EAA OE Global Emerging Markets Small/Mid-Cap Equity	2.19
EAA OE UK Small-Cap Equity	2.17
EAA OE Sector Equity Financial Services	2.08
EAA OE Switzerland Small/Mid-Cap Equity	2.00
EAA OE India Equity	1.48
EAA OE Greater China Equity	1.19
EAA OE Europe Small-Cap Equity	1.04
EAA OE China Equity - A Shares	0.68
EAA OE Emerging Europe Equity	0.58
EAA OE Sector Equity Ecology	0.56
EAA OE Eurozone Large-Cap Equity	0.40
EAA OE Asia-Pacific ex-Japan Equity	0.34
EAA OE Europe Equity Income	0.27
EAA OE Europe Large-Cap Blend Equity	-0.07
EAA OE Latin America Equity	-0.30
EAA OE Global Small-Cap Equity	-0.32
EAA OE Asia ex-Japan Equity	-0.33
EAA OE China Equity	-0.34
EAA OE Europe ex-UK Equity	-0.35
EAA OE UK Mid-Cap Equity	-0.44

Morningstar Category	Median Excess Return
EAA OE Asia ex-Japan Small/Mid-Cap Equity	-0.62
EAA OE Global Emerging Markets Equity	-0.71
EAA OE US Mid-Cap Equity	-1.02
EAA OE Eurozone Mid-Cap Equity	-1.08
EAA OE Sector Equity Biotechnology	-1.14
EAA OE US Large-Cap Blend Equity	-1.16
EAA OE Global Large-Cap Blend Equity	-1.16
EAA OE Sector Equity Consumer Goods & Services	-1.32
EAA OE Global Flex-Cap Equity	-1.42
EAA OE Global Equity Income	-1.42
EAA OE UK Large-Cap Equity	-2.06
EAA OE Sector Equity Water	-2.34
EAA OE UK Equity Income	-2.39
EAA OE Japan Large-Cap Equity	-2.58
EAA OE Sector Equity Healthcare	-2.61
EAA OE Asia-Pacific ex-Japan Equity Income	-2.81
EAA OE US Flex-Cap Equity	-3.10
EAA OE Switzerland Equity	-3.29
EAA OE Europe Flex-Cap Equity	-3.32
EAA OE Sector Equity Technology	-3.41
EAA OE UK Flex-Cap Equity	-3.66
EAA OE Germany Equity	-3.90
EAA OE Japan Small/Mid-Cap Equity	-3.98
EAA OE Global Frontier Markets Equity	-4.41
EAA OE Japan Flex-Cap Equity	-4.71
EAA OE Sector Equity Precious Metals	-4.87
EAA OE Sector Equity Energy	-6.05
EAA OE Global Large-Cap Value Equity	-6.57
EAA OE Europe Large-Cap Value Equity	-6.94
EAA OE Nordic Equity	-7.47
EAA OE US Large-Cap Value Equity	-9.68

Data displayed for Q1 2020 as a % in GBP. Past Performance is not a guide to future returns.

This polarity of performance that was witnessed across asset classes, within asset classes and across regions was also replicated in performance at the stock and corporate bond level. For example in the UK in the first quarter, two gold mining companies Fresnilo, and Polymetal International were the best performers posting positive gains of between 10% and 15% as the gold price soared whereas Carnival, the global cruise company in contrast fell circa 75% for the quarter. Similarly, British airways parent group IAG and EasyJet were down circa 67% and 61% respectively, the oil majors BP and Royal Dutch were down 32% and 41% respectively and the UK banks were down over 45% over the quarter. These index heavy weights did most of the damage from an index weighting perspective and partly explains why the UK market was a relatively poor performing market. Food retail companies across Europe held up far better than broad markets as demand surged as consumers stockpiled as the lockdowns were rolled out. In the US companies such as Zoom, a US on-line conference call facilitator, companies such as Teladoc Health which provides on-line medical advice and companies producing PPE equipment have performed very strongly.

Across equities in general we saw downgrades to earnings that were the worst and sharpest since 1974, surpassing the dire downgrades of 2008. The market quickly moved to a pessimistic view of short to medium term economic and earnings growth with unprecedented sharp recessions all but baked in everywhere.

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The underperformance of active managers was indiscriminate of styles for the most part with value funds underperforming the most, but few growth funds keeping pace with indexes that match their style. Whilst they comfortably outstripped the broad market, they underperformed the relevant growth indexes by 100-200bps on average. Value managers got a little closer to their relevant value indexes, underperforming these by around 50bps on average.

Active managers did manage to generate alpha in some niche areas, mainly on the downside, with Russia and Financials being hit hard as well as some small caps. Passive options in these spaces can be limited but active managers comfortably outperformed any ETFs available in these areas. REIT fund managers also defended on the downside with many REITs joining indiscriminate sell offs, especially in the US following a margin call on the Invesco Mortgage Capital REIT which led to some contagion across the asset class.

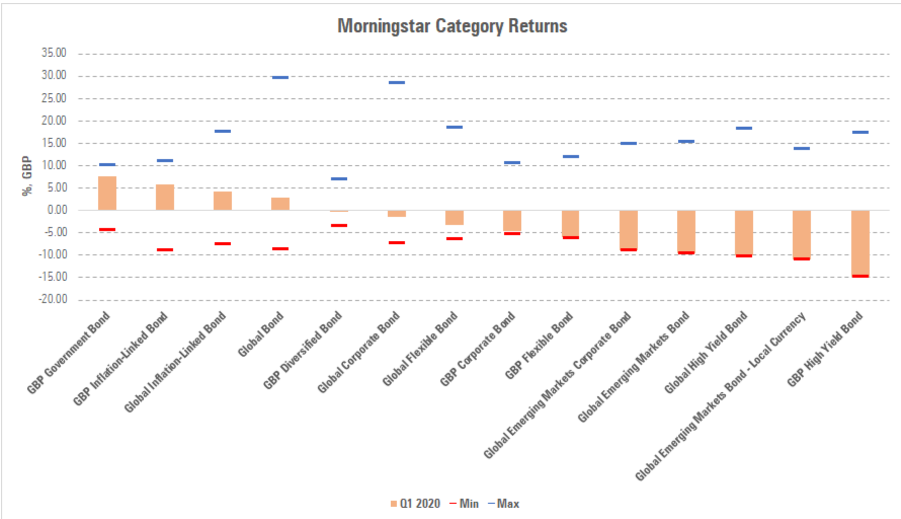
Fixed Income

As shown below, most fixed income funds underperformed, with flexible bond funds fairing the worst owing to a combination of high yield exposure, short rates/duration positions and less dollar exposure relative to their benchmark. Interestingly, with high yield spreads exceeding 900bps, HY index returns at least 1 year out have always been positive – watch this space.
Managers of inflation-linked bond funds did well as did global high yield managers with hedged currency; the latter is quite surprising given that the benchmark is not easily investable and liquidity issues were particularly acute.

Morningstar Category	Median Excess Return (GBP)	Morningstar Category	Median Excess Return (EUR)
EAA Fund Global Corporate Bond - GBP Hedged	1.54	EAA Fund Global High Yield Bond - EUR Hedged	1.09
EAA Fund GBP Inflation-Linked Bond	0.93	EAA Fund Global Inflation-Linked Bond - EUR Hedged	0.60
EAA Fund Global High Yield Bond - GBP Hedged	0.45	EAA Fund EUR High Yield Bond	0.50
EAA Fund GBP Diversified Bond - Short Term	0.19	EAA Fund EUR Inflation-Linked Bond	-0.14
EAA Fund Global Inflation-Linked Bond - GBP Hedged	-0.41	EAA Fund EUR Government Bond	-0.17
EAA Fund Global Corporate Bond	-0.69	EAA Fund EUR Corporate Bond	-1.16
EAA Fund Global Emerging Markets Bond	-1.03	EAA Fund Global High Yield Bond	-1.33
EAA Fund Global Bond - GBP Hedged	-1.07	EAA Fund Global Emerging Markets Bond - Local Currency	-1.51
EAA Fund GBP Government Bond	-1.50	EAA Fund EUR Diversified Bond	-1.55
EAA Fund GBP Corporate Bond	-1.51	EAA Fund EUR Corporate Bond - Short Term	-1.67
EAA Fund Global Bond	-1.79	EAA Fund Global Bond	-2.10
EAA Fund Global Emerging Markets Bond - Local Currency	-1.85	EAA Fund EUR Diversified Bond - Short Term	-2.11
EAA Fund Asia Bond - Local Currency	-1.89	EAA Fund Global Corporate Bond	-2.13
EAA Fund GBP Diversified Bond	-2.66	EAA Fund Global Emerging Markets Bond	-2.20
EAA Fund Global Emerging Markets Corporate Bond	-4.35	EAA Fund Global Emerging Markets Corporate Bond	-3.19
EAA Fund GBP High Yield Bond	-4.85	EAA Fund Global Bond - EUR Hedged	-4.23
EAA Fund Global High Yield Bond	-6.14	EAA Fund Global Flexible Bond - EUR Hedged	-5.17
EAA Fund GBP Flexible Bond	-6.53	EAA Fund EUR Flexible Bond	-6.19
EAA Fund Global Flexible Bond	-7.42	EAA Fund Global Flexible Bond	-7.06
EAA Fund Global Flexible Bond - GBP Hedged	-8.23	EAA Fund EUR Subordinated Bond	-7.30

Data displayed for Q1 2020 as a %. Past Performance is not a guide to future returns.

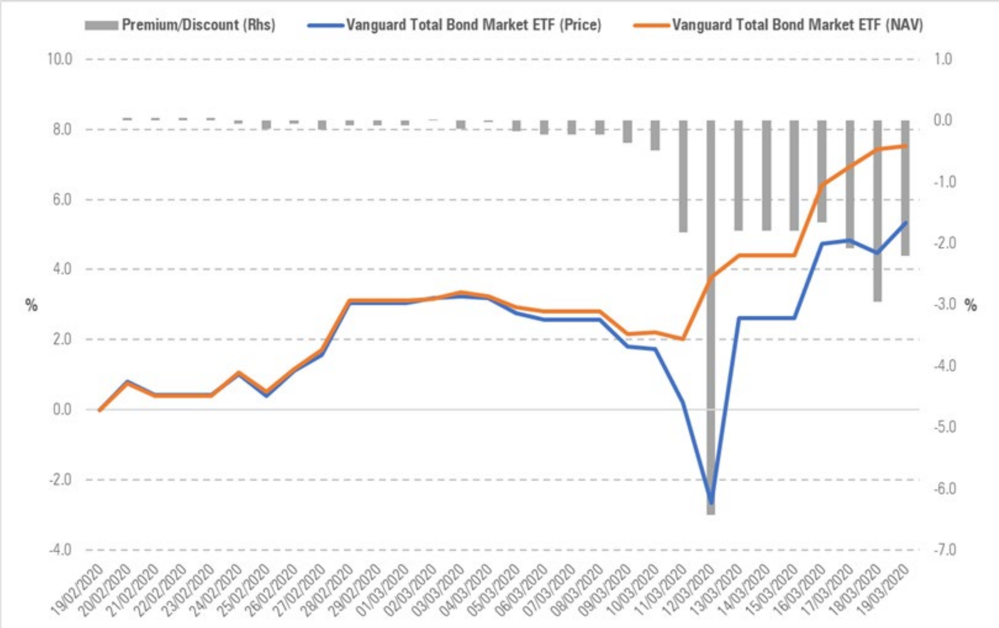
Like before, we have depicted below the Q1 2020 return for Morningstar's Fixed Income categories against their minimum and maximum quarterly returns going back to Q2 2000. In general, it was a horrible period for managers of credit funds, many probably experiencing the worst quarter of their careers.



Past performance is not a guide to future returns

The high yield market took a beating this quarter, with US spreads moving above 1,000 bps on March 20th and into recessionary levels, with expected default rates priced at around 10%. This spread is still below the 2,000 bps peak during the GFC, however it has been the speed and aggressiveness of the sell-off that has taken many by surprise. The Euro High Yield market has fared slightly better than the US, owing to a lower share of single-B and CCC rated credits and lower exposure to the oil and gas sector.

Liquidity also became an issue of concern across global credit markets and was most visible in the pricing of Credit ETF funds which started to become dislocated from their NAVs. This reached an extreme on the 12th March as shown below, with Vanguard's $55bn Total Bond Market ETF, one of the world's largest, reaching a discount of –6.2%.



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2) Styles and Factors

Growth/Value

There had been a short-term reversal over the early part of the year until the end of February of the outperformance of the growth style factor versus value. This was most notable in the UK market where the post- election "Boris Bounce" resulted in flows of money into the UK, one of the cheapest asset classes, which favoured some of the value sectors. However, the dramatic sell-off, which was particularly savage in the carbon complex of oil stocks and metals and mining and across financials, has seen a complete reversal of that mini-trend, with growth stocks, sectors and managers exposed to those areas once again outperforming strongly. Value managers who had been waiting for a reversal in markets and momentum have been disappointed as this sell-off has been harmful to many of their portfolios.

Many managers and market commentators are suggesting that growth stocks, in addition to having weathered this storm better, may also emerge out of it faster, thereby continuing the outperformance of growth vs value. The financial strength of these companies is likely to continue to attract investors as we remain in a period of extreme uncertainty thereby continuing to attract investors to the relative safety offered by Growth companies.

During the quarter, as the sell-off deepened and officially entered a bear market, the complexion of the decline shifted from initially a market where all shares were punished almost equally and indiscriminately (from the February 19th peak through to the end of February) to one where the factor landscape of the previous three years re-asserted itself through to the quarter end.

Prior to the market collapse, the dominant investing trend was the significant outperformance of growth strategies over value strategies. However, in the initial sell-off funds in the Global Large Cap value and growth Morningstar Categories had similar average returns. In addition, size played a barely noticeable role in global fund returns.

Source: Morningstar Direct

However, through March the trend had re-asserted itself with the Global large cap growth category significantly outperforming large cap value during the month and small caps trailing both of these.

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Volatility

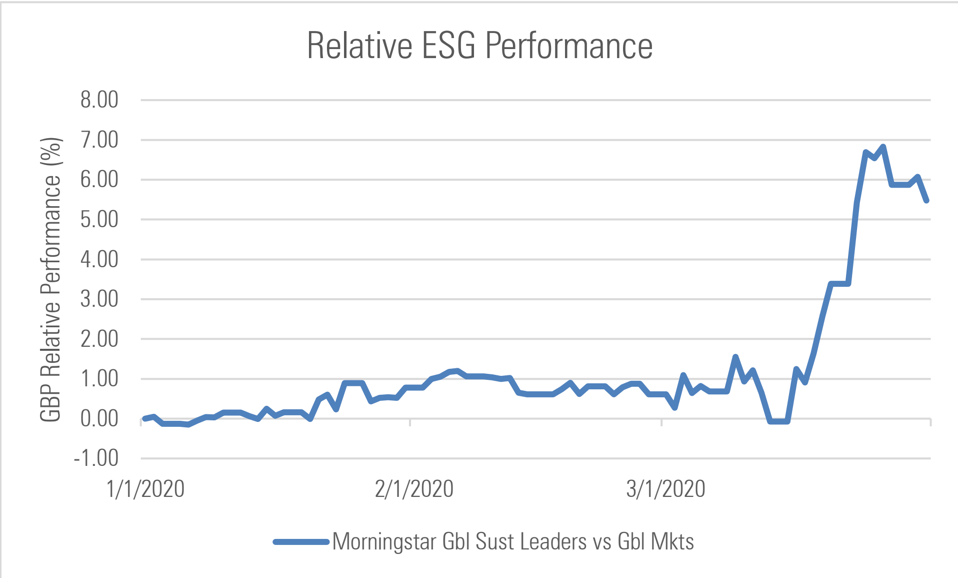
Looking at other factors using Morningstar's Factor Profile data, we can see that another reflection of the sell-everything mentality at the start of the market sell-off was that funds dominated by low-volatility stocks didn't fare that much better than funds that held more-volatile shares. That changed in March, as funds with more low-volatility stocks outperformed their higher-volatility counterparts. High volatility is often seen as a proxy for balance sheet stress; despite this group jumping in the last week of March on hopes of widespread government bailouts they still underperformed low volatility stocks.

Momentum

Another factor that resumed its place as one with a strong connection to returns in March was momentum. Momentum is based on the premise that stocks that have recently outperformed will continue to do so, and those that have underperformed will stay behind. Many of the higher-momentum stocks have been technology companies, which may weather the downturn better. whilst low momentum stocks, which were likely already struggling —hence their shares' poor momentum profile—and where the economic shock likely only magnifies those woes.

3) Sustainability and ESG Performance

Interestingly the dramatic market moves also favoured sustainability and ESG as winning themes. The lack of exposure to the oil and materials sectors was initially very beneficial to the relative outperformance of exclusionary strategies given how badly those cyclical sectors performed at the start of March, then many ESG strategies partook fully in the rally at the end of the month to cap a good quarter for them in relative term. Many areas of the market that are beneficiaries of the sustainability shift are characterised by strong growth factors and have also exhibited strong momentum in terms of medium-term share price performance, however across the globe "Best in class" indexes, which focus on the leading ESG names in each sector to avoid significant deviation from the benchmark, outperformed.



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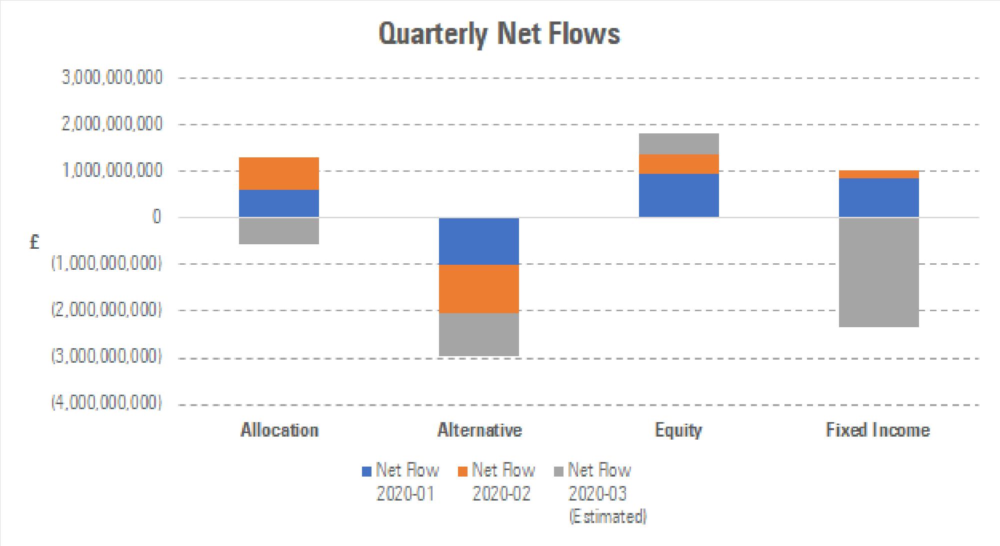
Globally, the Morningstar Global Markets Sustainable Leaders index outperformed its conventional counterpart by over 4 percentage points. The two indexes have similar factor exposures so it can be argued ESG has provided alpha above and beyond the style headwinds outlined previously. In terms of regions the starkest difference came in the UK where the ESG index outperformed the FTSE All Share by around 450 basis points over the quarter, despite the late rally from big oil and defensive nature of big tobacco. This trend does not just appear in the UK either, ESG/Sustainable Leaders indexes from MSCI and Morningstar, which use a best in class methodology across sectors to avoid skewing too far from the conventional benchmark, outpaced or kept up with broad indexes in North America, Japan and Europe. This could even be seen in fixed income where the Bloomberg Barclays MSCI Euro Corporate SRI index marginally outperformed the conventional equivalent over the quarter.

Whilst the levels of outperformance might grab the headlines what is potentially more encouraging for ESG investors is the participation on the upside of a recovery. Whereas traditional wisdom might suggest following a sell off or a downturn the fastest recovering stocks will be old economy or low-quality companies, the ESG index kept pace with the conventional index. Again, the UK was the one of the clearest example of this, with the FTSE 100 being dominated by old economy and cheap companies the MSCI UK ESG Leaders Index lagged this by just 20 basis points in the last full week of March, having outperformed by well over 100 basis points the 2 prior weeks. A different trend prevailed in the US, where investors began to consider the long term impacts of this crisis, which in many cases may actually be ESG positive in the long run, companies at the forefront of automation and remote working made big gains as markets rebounded at the end of march. This suggests that ESG integration into markets is ever increasing as more and more market participants factor ESG somehow into valuations.

4) Asset Flows



Depicted above are the net flows seen across UK domiciled funds over the quarter. Allocation, Equity and Fixed Income funds all saw positive net flow over the first 2 months of the year. Alternative funds continued their trend of net outflow, particularly within the multi-strategy space. In March* sentiment changed, particularly within Fixed Income which experienced a sell-off across most Morningstar categories. The largest outflows were seen in GBP Corporate Bonds, with M&G Corporate and Strategic Corporate Bond funds having the biggest redemptions. GBP Inflation-Linked Bonds and Global Flexible Bond – GBP Hedged funds also suffered.

Casting the net wider to include Luxembourg and Irish domiciled funds, the scale of sell-off in March was even greater. As of the 26th March there was approximately £67 bn of net outflow, £52 bn from active funds and £15 bn from passives (most of which being ETFs). These numbers are staggering, eclipsing the £42 bn of outflow we saw in October 2008, and dwarfing anything we've seen since. The largest outflows in both the active and passive space have been from emerging market debt funds (hard and local), totalling approximately £20 bn. Amongst active funds, the other large outflows have been from USD High Yield (£4.3 bn), EUR High Yield (£4 bn), EUR Corporate (£3.9 bn). USD Government funds have taken inflows of £4.8 bn.

**These are approximations and are likely to underestimate the true figures*

Source of Statistics referenced: Morningstar Direct

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