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WHERE IN THE WORLD?

iShares by BlackRock

Building resilience in DM and EM

October 2021

- **Equity UCITS ETFs have experienced record inflows and risk-on positioning throughout 2021. Asset allocation narratives and recent flow trends suggest investors are looking to remain risk-on while mitigating downside risk, where possible.**
- **In this paper, we analyse two ways investors have been implementing this rotation in broad equity portfolios: moving from small and mid cap exposures into large caps, and boosting exposure to quality and minimum volatility factors in DM and EM.**

Size rotation

Small, mid, and equal-weight ETFs recorded large inflows at the start of 2021, as investors looked to gain exposure to the global activity restart. More recently, this rotation has started to reverse, with UCITS ETF flows highlighting a shift from mid and small cap exposures into large caps. As Figure 1 shows, large caps tend to offer higher exposure to the quality and minimum volatility factors compared to their small cap peers, and could therefore help to bolster portfolio resilience.

Boosting exposure to quality and minimum volatility

Regional equity indices that exhibit a high quality factor score could be well-positioned to profit from structural growth trends, and have historically tended to benefit in a mid-cycle environment when economic growth and activity begins to flatline or decline. These indices have a higher allocation to companies with strong balance sheets, higher profitability and low debt, which can help them to outperform during market turbulence.

Past performance is not a reliable indicator of current or future results.

DM | **Building resilience**

Higher tilts towards US, UK, or Australian equities can increase a portfolio's weighting to quality and low volatility factors. This is largely a result of higher allocations to the technology, healthcare, and consumer staples sectors.

EM | **Selectivity is key**

A recent MSCI report highlights that historically 60% of the factor contribution of performance in emerging market (EM) equities comes from country allocations, highlighting the importance of selectivity in EM .[1]

Figure 1: Size rotation – quality and min vol

Factor exposure

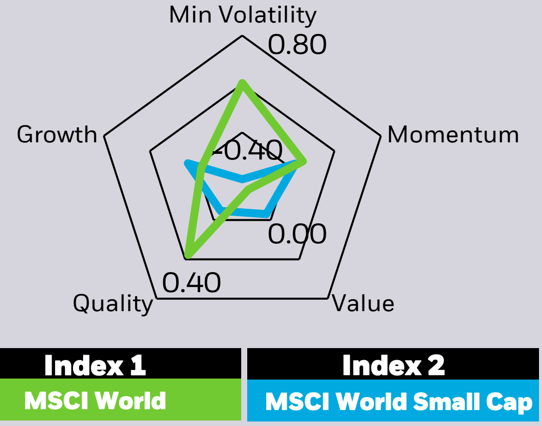
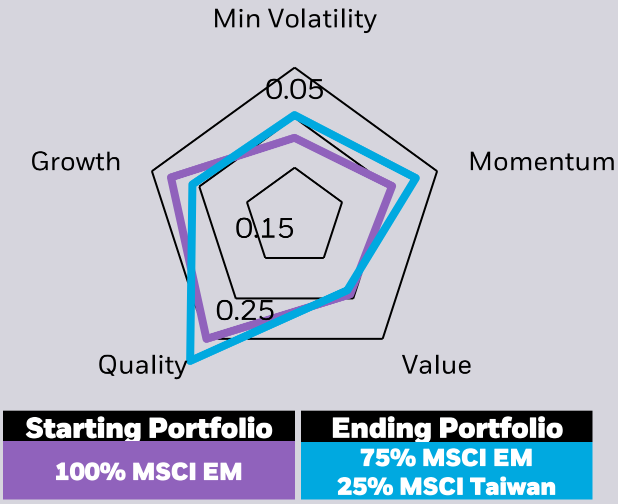


Figure 2: EM case study – tilting with EM ETFs

Factor exposure



Source: BlackRock, as of 30/09/2021. For illustrative purposes only. Factor exposures measured in standard deviation; BlackRock World Risk Model is used. Characteristics are subject to change.

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[1]. Source: MSCI Research, based on MSCI Barra EMM1 Model (Emerging Markets). Period: May 2001 to September 2021

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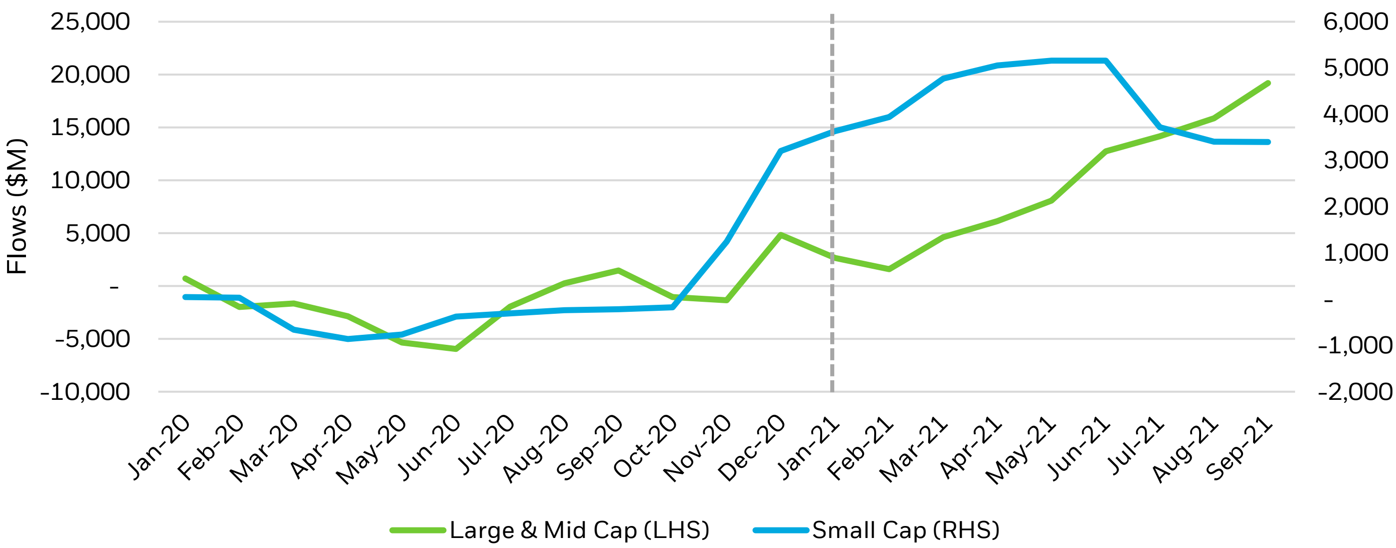
Size Rotation

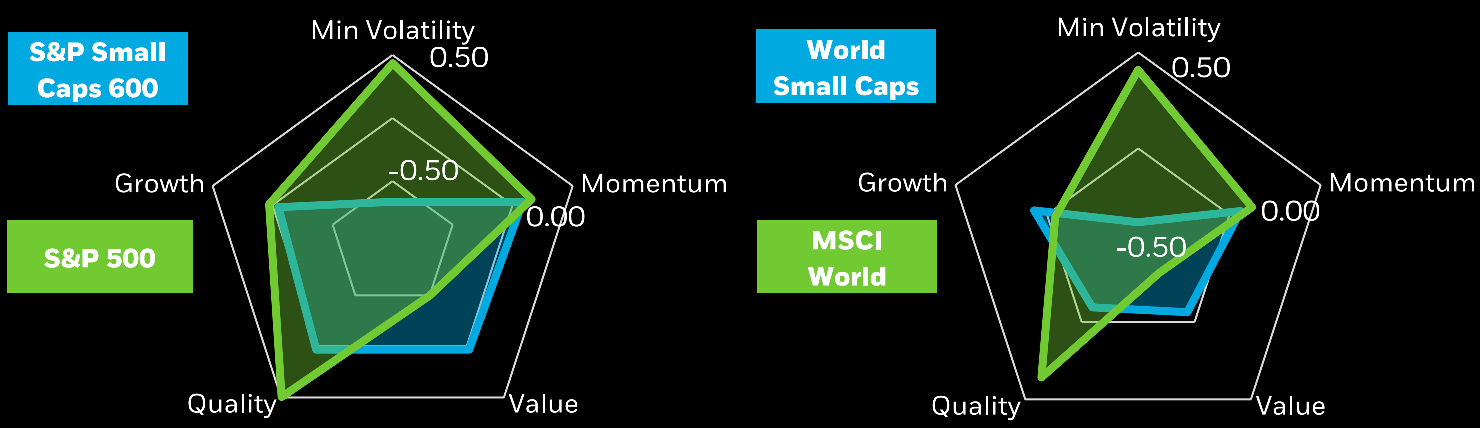
- **Small caps – which tend to have higher exposure to the value factor than their large cap peers (see Figure 4) – were in focus in late-2020 and early-2021,** as investors looked to access the global economic restart and tap into the 'value trade'. Flows surged with the tailwind of the cyclical-driven reopening, and in line with rising inflation expectations.
- **However, analysis of ETF flows shows that investors have recently been rotating out of mid and small cap exposures into large caps.** Broad benchmarks like the S&P 500 and MSCI World offer greater exposure to the quality and minimum volatility factors than small caps.

Figure 3: Flows into Small, Mid, & Large Cap UCITS ETPs



Source: Bloomberg, BlackRock, and Markit, 31 August 2021.

Figure 4: Absolute factor exposures of large vs. small caps



Source: BlackRock, Factset and MSCI as of 30/09/2021. For illustrative purposes only. Factor exposures measured in standard deviation; BlackRock World Risk Model is used. Characteristics are subject to change. References to specific investments are for illustrative purposes only and are not intended and should not be interpreted as recommendations to purchase or sell such investments.

DM Building resilience in portfolios

Investing in specific countries has long been seen as an attractive way to express market views. High-quality country indices can profit from structural growth trends and tend to benefit in a mid-cycle environment – when economic growth and activity begins to flatline or decline. Country indices with a tilt to the low volatility factor could prove more resilient than others in the case of a market downturn or spike in volatility.

Quality

The **NASDAQ 100** index has a relative strong defensive tilt, given its quality characteristics, such as high return on equity, profit margins, and free cash flow yield. The index's high allocation to the IT sector (49%) contributes towards this defensive profile. The **FTSE UK Dividend** index offers exposure to companies paying relatively high dividends, which tend to be large and well-established companies with relatively predictable and consistent profits.

Low Volatility

The **Dow Jones Industrial Average** index exhibits a low volatility profile due to its high allocation to the IT and healthcare sectors. Healthcare companies tend to have high levels of cash and the sector has a low beta to global growth historically. **MSCI Australia** is a defensive candidate in portfolios that could help to bolster resilience, thanks to a strong tilt towards the low volatility factor.

Figure 5: DM indices with tilts towards the quality factor

Source: BlackRock, Factset and MSCI as of 30/09/2021. For illustrative purposes only. Factor exposures measured in standard deviation; BlackRock World Risk Model is used. Characteristics are subject to change. References to specific investments are for illustrative purposes only and are not intended and should not be interpreted as recommendations to purchase or sell such investments.

Figure 6: DM indices with tilts towards the minimum volatility factor

Source: BlackRock, Factset and MSCI as of 30/09/2021. For illustrative purposes only. Factor exposures measured in standard deviation; BlackRock World Risk Model is used. Characteristics are subject to change. References to specific investments are for illustrative purposes only and are not intended and should not be interpreted as recommendations to purchase or sell such investments.

EM Building resilience in portfolios

A recent MSCI report highlights that historically, 60% of the factor contribution of performance in EM equities has come from regional allocations, highlighting the importance of selectivity in EM.[1] Indices with a strong tilt to the quality and low volatility factors could prove more resilient than others in the case of a market downturn or spike in volatility.

Quality	Investors may wish to keep a defensive stance in EM and consider participating in equity markets with a resilient bias, including quality and lower volatility regions such as **Taiwan**, which has maintained a robust price trend YTD.
Low Volatility	**Taiwan** presents a low volatility profile and shows favourable relative strength compared to other EM regions. Minimum volatility indices, such **as MSCI EM Min Vol**, can provide similar exposure to the parent benchmark but with a greater tilt towards companies with resilient characteristics, which could prove beneficial during periods of market turbulence.

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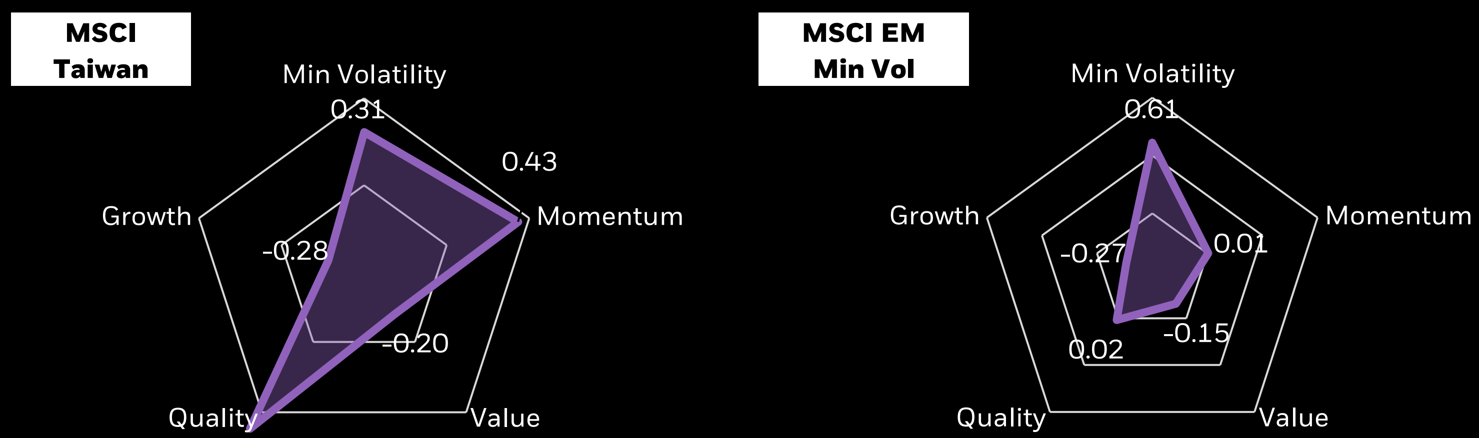
The importance of cyclicality

Other emerging markets such as Brazil and India can offer a strong tilt towards the quality and min vol factors compared to the broad EM benchmark, yet their cyclical tilts may mean they are less well suited for building portfolio resilience.

Figure 7: EM indices with tilts towards the quality and low volatility factors



Source: BlackRock, Factset and MSCI as of 30/09/2021. For illustrative purposes only. Factor exposures measured in standard deviation; BlackRock World Risk Model is used. Characteristics are subject to change. References to specific investments are for illustrative purposes only and are not intended and should not be interpreted as recommendations to purchase or sell such investments.

DM Factor lens

The global activity restart has largely played out, and economic conditions are now more akin to a mid-cycle period, when the business cycle is maturing and many of the early-cycle investment opportunities have been recognised and exploited. Higher quality and less volatile areas may be well-positioned to benefit and provide resilience during such periods.

We see countries such as Switzerland and Australia as defensive DM candidates that can provide resilience in portfolios, alongside selectivity within the US and UK to uncover higher-quality areas.

Indicator / Country	Canada	USA	Austria	France	Germany	Italy	Netherlands	Spain	Switzerland	UK	Australia	Japan
Valuation	+		+		+	–	–	+	+	+	+	
Momentum	–		+	–	–	–	+	–		–		
Quality			–	–	–	–		–		–		–
Low volatility			–			–	–	–	+		+	

+/– *means better / worse than peers or historically*

Sources: BlackRock, MSCI and Factset as of 30/09/2021. Analysis is run on a rolling 10-year period using the BlackRock World Risk Model. For Valuation, the +/- is determined by whether the latest value of the respective risk factor in the risk model is above or below the 10-year average. For Momentum, Quality, and Low Volatility the +/- is determined by how the latest value of the respective risk factor in the risk model compares to that of the MSCI World Index. Values above (below) 0.10 are denoted as + (-).

EM Factor lens

We also advocate quality in EM, through equity markets with a high tech tilt like Taiwan and South Korea, which also have a low-vol bias. This is within an overall neutral stance on EM, where there is a higher level of scarring from the Covid-19 shock vs. DM. As we progress through the Covid-19 pandemic, quality offers ballast in equities and the high tech tilt offers exposure to the underlying structural trends which have been accelerated during the pandemic.

Indicator / Regions	China	Korea	Taiwan	India	Brazil	South Africa	Russia	Mexico	Turkey	Poland
Valuation		–	–		+	+	–	+	+	
Relative Strength	–		+	+	–	–	+		–	+
Low Volatility	+	+	+		–				–	–

+/– *means better / worse than peers or historically*

Sources: BlackRock, MSCI and Factset as of 30/09/2021. Analysis is run on a rolling 10-year period using the BlackRock World Risk Model. For Valuation, the +/- is determined by whether the latest value of the respective risk factor in the risk model is above or below the 10-year average. For Momentum, Quality and Low Volatility the +/- is determined by how the latest value of the respective risk factor in the risk model compares to that of the MSCI World Index. Values above (below) 0.10 are denoted as + (-).

DM & EM A comprehensive range of country indices

Developed Markets

North America		APAC		Europe		
US	Canada	Japan	Pacific	UK	Switzerland	Other
S&P 500	MSCI Canada	MSCI Japan	MSCI Pacific Ex Japan	MSCI UK	SMI	MDAX
Nasdaq 100		MSCI Japan IMI	MSCI Australia	FTSE 250	SMI Mid	DAX
MSCI USA		Nikkei 225		FTSE 100	SLI	FTSE MIB
MSCI USA Islamic		MSCI Japan Small		MSCI UK Small		FTSE Italia Mid-Small
MSCI USA Small		Nikkei 400		UK Div		ATX
DJ Industrial Average						AEX
S&P Small 600						MSCI France
						Ibex 35
MSCI USA ESG Screened		MSCI Japan ESG Screened		MSCI UK IMI ESG Leader		OMX Stockholm
MSCI USA ESG Enhanced		MSCI Japan ESG Enhanced				DAX ESG
MSCI USA SRI		MSCI Japan SRI				
S&P 500 Paris-Aligned						

Emerging Markets

Asia				Latin America		Eastern Europe		Other
MSCI China	MSCI India	MSCI Korea	MSCI Taiwan	MSCI Brazil	MSCI Mexico	MSCI Russia	MSCI Poland	MSCI South Africa
MSCI China A								MSCI Saudi Arabia
DJ China Offshore								MSCI Turkey
MSCI China Large cap								

Source: BlackRock, as at end September 2021. Reference to individual investments mentioned in this communication is for illustrative purposes only and should not be construed as investment advice or investment recommendation.

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