

# When Market Direction Changes, So Does Factor Leadership

Morningstar factor indexes highlight a pattern of out-of-favor areas bouncing back and momentum stumbling at inflection points.

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Investors hoping for a quiet summer have been disappointed. The ascendant equity market of 2024's first half, buoyant on the promise of artificial intelligence, ran into turbulence in the third quarter. An unexpected rate hike in Japan and concerns over the US economy, interest rates, earnings, and valuations all contributed. Volatility spiked. Market leadership rotated. Will the third quarter of 2024 be remembered as a minor blip or an enduring turning point? Only time will tell. But market behavior, when viewed through the lens of Morningstar Global Factor Indexes<sup>1</sup>, reveals timeless patterns.

## Exhibit 1 2024's Factor Flip Flop— Out-of-Favor Factors Have Come Back

Morningstar Factor Indexes	Q3 2024 (to date) Return (%)	First Half 2024 Return (%)
Low Volatility	4.73	6.32
Size	3.01	3.36
Yield	2.71	7.23
Value	1.57	6.66
Broad Equity Market	1.49	11.29
Quality	0.23	18.93
Momentum	-0.77	28.39

Source: Morningstar Direct. Gross Returns in USD for Morningstar Global Factor Indexes. Data as of Aug. 15, 2024.

Takeaways from this paper include:

- ▶ Low-volatility stocks showed resilience amid market volatility in the third quarter of 2024, just as they did in the down markets of 2022 and 2018.
- ▶ A change in market direction in the third quarter of 2024 saw a comeback for previously out-of-favor factors, like size (small caps), yield, and value. Value and yield also bounced back in 2022 and 2016.
- ▶ The quality factor hit a speed bump in the third quarter of 2024, coming off a market-beating 10-year run, as well as outperformance in 2023 and the first half of 2024.
- ▶ Momentum, which rode the quality wave in 2024's first half, has been tripped up by a change in market direction. This behavior is consistent with previous market inflection points.

<sup>1</sup> For a full discussion, see: [Construction Rules for Morningstar Global Factor Indexes](#). Morningstar Indexes. May 2024

- ▶ A Periodic Table of factor returns shows that leadership is highly variable. Single factor investing requires patience. For investors who can't stomach prolonged underperformance, factor diversification is sensible.

### Momentum Investors Surfing a Quality Wave

Quality factor investors believe the shares of highly profitable companies with strong balance sheets have performed better historically than less-profitable, more indebted counterparts.<sup>2</sup> The virtues of high-quality stocks have been on display over the short and longer terms. Quality stocks have handily outperformed the broad global equity market over the past decade as many highly profitable companies have only increased their market value. Quality was the best performing factor in 2023 and posted strong returns in the first half of 2024 thanks to a number of high-quality companies benefiting from enthusiasm around artificial intelligence. As displayed in Exhibit 2, several of the Morningstar Global Quality Factor Index top constituents posted exceptionally strong 18-month returns.

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#### Exhibit 2 Many Quality Stocks Performed Well in Both 2023 and 2024's First Half

Morningstar Global Quality Factor Index - Top 5 Current Constituents	2024 - First Half Return %	2023 Return %
NVIDIA	149.50	239.02
Microsoft	19.29	58.19
Alphabet	30.54	58.32
Novo Nordisk	40.71	55.63
Visa	1.19	22.35

Source: Morningstar Direct. Data as of June 30, 2024.

Given their success, it's no coincidence that Morningstar's Global Momentum Factor Index has been loaded with quality stocks. In fact, the momentum index currently overlaps more with the quality index than any of Morningstar's other factor indexes. Momentum strategies target stocks with strong recent returns, based on the premise they are likely to continue to outperform.<sup>3</sup> Chasing last year's winners worked well in the first half of 2024. As displayed in Exhibit 3, most of the Morningstar Global Momentum Factor Index's top constituents rode strong 2023 gains into 2024.

<sup>2</sup> For academic work on quality, see: <http://nm.simon.rochester.edu/research/OSoV.pdf>

<sup>3</sup> For academic work on momentum, see: <https://www.jstor.org/stable/2328882> and <https://www.jstor.org/stable/2329556>

**Exhibit 3** Momentum From 2023 Carried Into 2024 for Many Stocks

**Morningstar Global Momentum Factor Index - Top 5 Current Constituents**

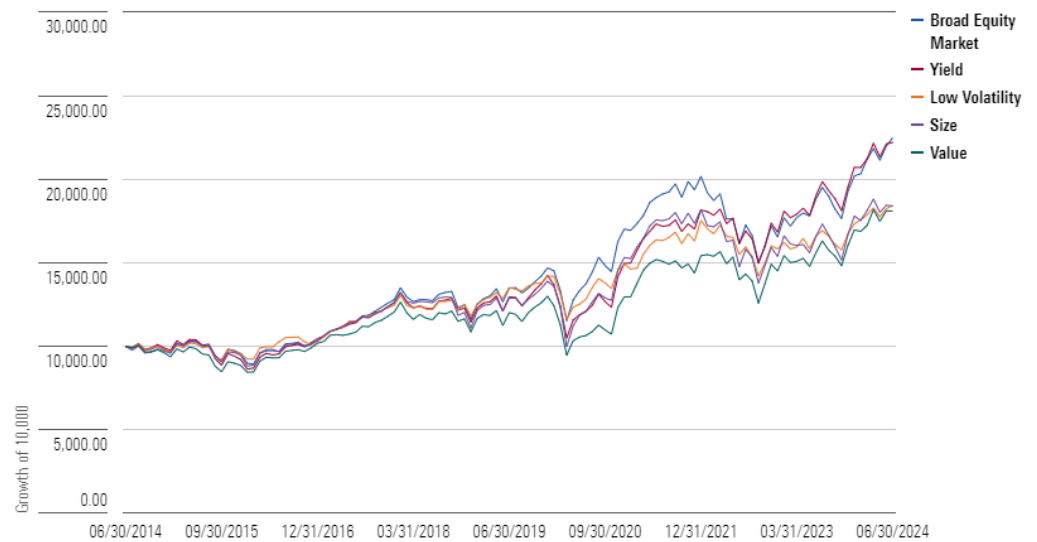
Constituents	2024 - First Half Return %	2023 Return %
NVIDIA	149.50	239.02
Microsoft	19.29	58.19
Meta Platforms	42.74	194.13
Amazon.com	27.19	80.88
Apple	5.36	49.00

Source: Morningstar Direct. Data as of June 2024.

**Most Factors Have Underperformed — in 2024 and Over the Past Decade**

Meanwhile, the four other factors tracked by Morningstar indexes—yield, value, low volatility, and size—all underperformed in 2024's first half. They have also been longer-term laggards. As displayed in Exhibit 4, yield is the only factor to approach the return of global equities over the past decade. The yield factor focuses on companies returning cash to shareholders in the form of either dividends and net buybacks.

**Exhibit 4** Over the Past Decade, Size, Value, and Low Volatility Are Well Behind the Broad Equity Market



Source: Morningstar Direct. Gross Returns in USD for Morningstar Global Factor Indexes. Data as of June 30, 2024.

That's on a global basis, where stocks such as Novartis and UBS have contributed to the global yield factor's competitive return. In the US, the yield factor index has fallen shorter, suffering from a value

bias. The index has neglected some of the market's best performers, such as Amazon.com, which returned more than 1,000% from mid-2014 to mid-2024, and Meta (650% return).

### **A Third-Quarter Rotation**

The story of the third quarter of 2024 is still being written. So far, it has brought volatility and a rotation in market leadership. The drivers will become clearer in retrospect, but they include concern about the US economy, interest rates, valuations, and earnings. The Bank of Japan's unexpected interest-rate hike was a proximate trigger. Nervousness about the narrowness of market leadership, especially in the US, likely contributed to portfolio rebalancing.

**Low volatility** is a factor known for resilience in "risk-off" environments, so its relative strength in the third quarter is unsurprising. Stocks with low past volatility have tended to offer better risk-adjusted performance than those with high volatility.<sup>4</sup> Berkshire Hathaway, Procter & Gamble, Coca-Cola, and Johnson & Johnson—all prominent constituents of the Morningstar Global Low Volatility Factor Index—have been ports in the third quarter's storm.

**Size**, for its part, may be coming into favor as investors look for a broadening of a mega-cap technology-dominated market or view small caps as beneficiaries of interest-rate cuts. Despite academic research<sup>5</sup> showing that smaller stocks have historically outperformed, the size premium has failed to deliver over the past decade. With the valuation gap widening between large- and small-cap stocks, low prices might also have attracted investors concerned about market froth.

**Value** and **yield** may be benefiting from similar trends. Value stocks, many of which pay dividends, have generally been left behind by a market fixated on tech-related trends. Value and yield looked to be making a comeback in the down market of 2022, when energy was the only equity sector in positive territory. But both factors got left behind in the AI-fueled market of 2023. The notion that lower valuations reflect higher expected returns, either as compensation for risk or because of undo pessimism, failed to bear fruit in the first half of 2024 either.<sup>6</sup> Dividend-payers looked sluggish in the AI-dominated market. Then came the rotation.

**Momentum** investing is known historically for getting whipsawed by a change in market direction.<sup>7</sup> When market leadership quickly changes, the rearview mirror is less indicative of the direction in the road ahead. In mid-2023, we wrote about how the momentum factor struggled to navigate a shift in leadership from 2022 to 2023.<sup>8</sup> When Morningstar's momentum indexes reconstituted in December 2022, they added many value-oriented stocks, which had held up relatively well in the down market but ended up lagging badly when a wave of bullishness around AI swept over investors. In 2023, the

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<sup>4</sup> For academic work on low volatility see: <http://rnm.simon.rochester.edu/research/UDE.pdf>  
<https://pages.stern.nyu.edu/~lpederse/papers/BettingAgainstBeta.pdf>

<sup>5</sup> For academic work on small-cap premiums see: [https://www.ivey.uwo.ca/media/3775518/the\\_cross-section\\_of\\_expected\\_stock\\_returns.pdf](https://www.ivey.uwo.ca/media/3775518/the_cross-section_of_expected_stock_returns.pdf)

<sup>6</sup> For academic work on the value factor see: <https://www.jstor.org/stable/2329112>

<sup>7</sup> Lefkowitz, D., & Bryan, A. "Why is the Momentum Factor Lagging So Badly in 2023?" June 2023.

<sup>8</sup> Lefkowitz, D., & Bryan, A. "Why is the Momentum Factor Lagging So Badly in 2023?" June 2023.

momentum factor underperformed badly. Changes in market direction also tripped up the momentum factor in 2016 and 2021.

### Factor Investing Requires Patience

When Morningstar Global Factor Index returns are examined on a calendar-year basis going back to 2014, the variability of factor returns becomes clear. Factors can go from leader to laggard, and vice versa. As displayed in Exhibit 5, momentum went from top in 2015 to bottom in 2016, then did the same between 2020 and 2021. When markets are more unidirectional, momentum investing can thrive. Value has spent many years as the worst performing factor, though it had good years in 2016 and 2022.

**Exhibit 5** Factor Leadership Is Constantly in Flux, With All Factors Capable of Going From Top to Bottom and Vice Versa



Source: Morningstar Direct.

- ▶ What's clear from this exhibit is that single factor investing requires patience and, sometimes, intestinal fortitude. Investors concerned about recent market dynamics should remember that factor cyclicalities are a feature, not a bug. Investors unwilling to suffer through extended periods of underperformance may want to consider diversifying across factors. ■■

### **About Morningstar Indexes**

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