Amundi ASSET MANAGEMENT | Smart Beta

Viewpoint

Contradictions and conundrums: understanding factor investing

After much excitement about building portfolios using investment factors, some feel disappointed after a lacklustre year of performance. But rather than abandon this strategy, investors should look to the long-term and better understand what affects the performance of individual factors.

Value factor

Much of the concerns over multi-factor portfolios can be traced back to value, which selects cheap stocks on the expectation these companies will outperform over time. Over the past few years, these excess returns have proved elusive.

The inability of this investment factor to generate returns in the current macro-economic conditions should not be surprising. Shares with this characteristic tend to do well when either the economy is growing or the stock market is rising. But the current economic outlook is uncertain rather than optimistic: there is higher geopolitical tension and an ongoing trade war between the US and China. Economic growth has been constrained as a result.

It's also a difficult environment for central banks with a limited number of tools at their disposal. Interest rates have been low for a long period of time and seem unlikely to increase significantly. The correlation of value to strong economic growth means it performs best when interest rates rise. In this difficult environment for value stocks, investors with a bias towards this factor have experienced a prolonged period of underperformance. ■

Changing fortunes

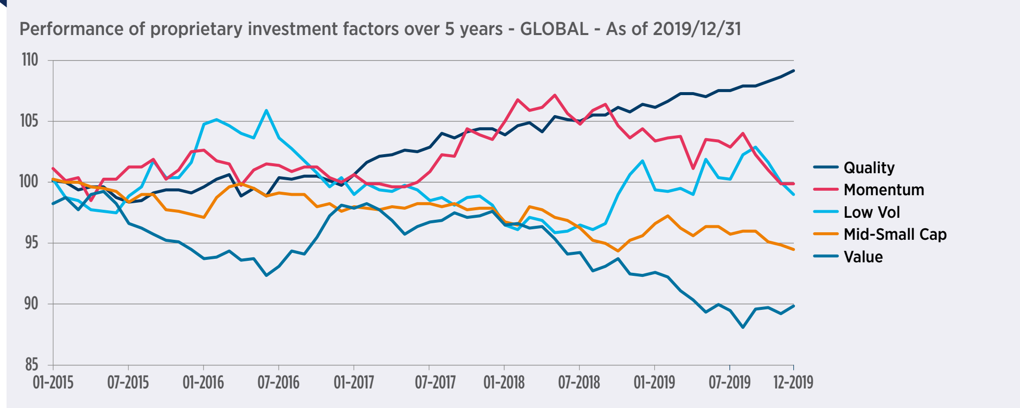
Despite this difficult outlook, value staged a surprise recovery at the end of the summer. That's because this investment factor can perform well when there is unexpected positive news or markets improve sharply.

There was an amelioration of the trade war at the end of August, improving the sentiment about the economic outlook.

In addition, energy stocks saw strong positive price movements when oil fields in Saudi Arabia were attacked. This had a beneficial impact on the value factor because it is currently highly exposed to cyclical sectors such as material and energy shares.

As value started to outperform in September 2019, defensive factors, like low volatility, did not do as well. This had a negative impact on those investors who in response to the underperformance of value, decided to overweight their portfolio in favour of defensive factors. ■

Performance of investment factors over 5 years



Source: Amundi as of 2019/12/31.

Unpredictable

Momentum has proved to be a difficult factor to predict. While risky factors like value and defensive ones such as low volatility and quality tend to be negatively correlated, its characteristics are less easy to read.

Sometimes momentum is more correlated to risky characteristics and other times it moves in line with the defensive factors. For the last 12 months, there has been a strong correlation between momentum, low volatility and quality. This phenomenon is not specific to momentum: stocks' characteristics can evolve over time and according to market conditions.

This defensive correlation meant three out of four factors did badly in September – momentum, low volatility and quality, leading to an overall underperformance of multi-factor portfolios.

Despite the recent rocky performance of investment factors, there is no reason for despair – this is a valid way to build a portfolio. If investors look back through history, there are many periods when individual factors did badly. ■

Historical perspective

For example, during the dotcom bubble of the late 1990s, the value factor underperformed. During this period, these value stocks tended to have a defensive nature so lost out in a market powered by growth stocks.

When the internet bubble burst, value then outperformed as investors switched back to defensive stocks. This value rally lasted through to 2006 but crashed in 2008.

In the first eight years of the new century, the value stocks became riskier as they were heavily skewed towards financials.

These were cheap stocks which were likely to profit from the market expansion. That's why this investment factor crashed during the global financial crisis but value rallied in 2009 when these companies bounced back.

In contrast, stocks with a low volatility characteristic outperformed in 2008. This was the year in which this investment factor became popular, as investors started to understand this attribute tends to do well during periods of uncertainty.

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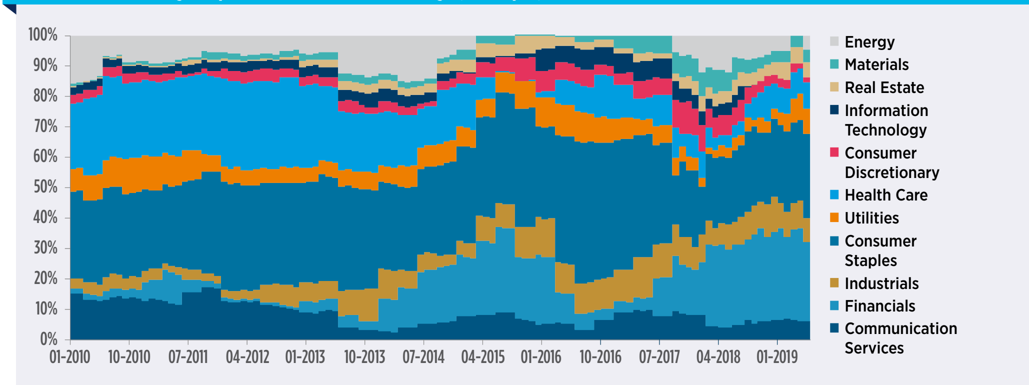
The changing fortunes of the individual factors illustrate how not only the performance can change over time but also that stocks which have particular investment characteristics can alter over time.

For example, an investor might assume low volatility stocks tend to be those with defensive characteristics such consumer staples, healthcare and utilities. While this was the case in 2008, more recently it has been financial companies which have this attribute.

Not only do investors need a longer term perspective when investing in factors but they should monitor how these stock characteristics change over time as the market risks evolve. ■

Factors' industry exposures: Low volatility (Europe)



This chart illustrates the sectorial allocation of Low Volatility investment factor in Europe since 2010.

Investment approach

Given the changing fortunes and nature of individual factors, investors need to decide which approach they want to take when designing a multi-factor portfolio.

Would they like one which focuses on long-term performance and diversifies across all the factors? Or would they prefer a portfolio which tries to time its allocation to individual factors according to which ones are expected to outperform?

Investors favouring the second approach would have looked at the current market conditions and decided it was unfavourable environment for the value factor and decided to underweight their allocations to this characteristic.

Other investors could have changed halfway through the year from a diversified approach to a more tactical call, by underweighting their exposure to the value factor over the summer after many months of underperformance.

Both of these investment approaches could have been caught out by the rally in the value factor in September and the more challenging performance of the other three factors – momentum, low volatility and quality. This illustrates the difficulty of trying to time allocations to particular investment factors. It is possible to analyse the market correctly but get the timing of your investment decision wrong. Also changing market allocations can ratchet up transaction costs.

A more consistent approach to generating long-term performance may be to focus on diversifying a portfolio's exposure to multiple factors to benefit from their outperformance at different times of the market cycle. This can be a more rational approach when the outlook for the equity market is uncertain. ■

Optimal diversification

We believe a risk-based allocation should be favoured in the long term and ensure that the portfolio is correctly diversified across factors.

Not only do investors need to understand the correlation between different investment factors but also monitor how this changes over time – characteristics can move more or less in sync with one another. Investors should make sure they select factors with different characteristics.

An investor who decides to take a diversified approach to investment factors should be aware this will make their portfolio more exposed to mid-cap stocks. This increases diversification and reduces concentration risk which will smooth performance relative to market-capitalisation weighted indices.

If markets correct sharply, a diversified multi-factor portfolio is expected to mitigate the market movements and to perform better. If, however, market cap indices outperform over the short-term, the same portfolio could not do as well. This happened in 2009 when financial stocks did well and in 2017 when performance was led by the US tech giants. ■

Clear investment philosophy

As different strategies can have very different effects on returns, fund managers should have a clear investment philosophy. They should describe how their allocation would work in different scenarios to make expected performance easier to understand.

At Amundi, we believe effective risk management is the key to delivering good long-term performance. In particular, we believe in diversifying factors and favour a risk-based allocation.

In addition, we think that a multi factor allocation should be a complement to market-cap weighted strategies, as this diversifies investment styles.

Factor investing should be seen as a 'solution' rather than a 'product', as it brings new ways to analyse a portfolio. Nor should there be a one-size-fits-all approach: portfolios should be tailored to meet each investor's specific requirements. ■

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