The flexibility of factor investing facilitates the creation of low carbon active strategies

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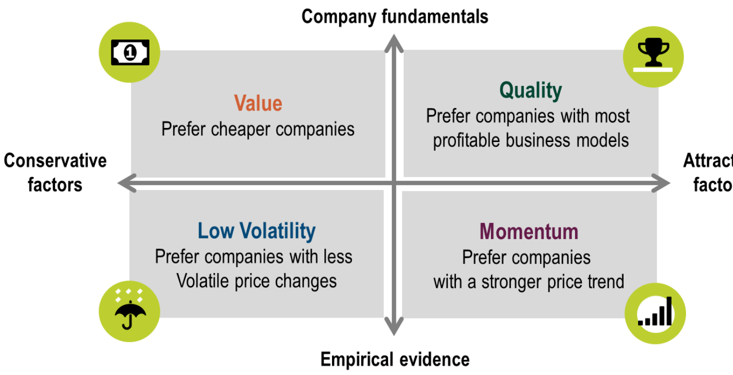
In a research article published in 2012 in the Journal of Portfolio Management, entitled *"Demystifying risk-based strategies: A simple alpha plus beta description"*[1], BNP Paribas Investment Partners was already demonstrating that the excess return of traditional smart-beta strategies could be explained by their factorial exposures. Therefore, consciously choosing factor exposures to define strategies is in our view a logical way of creating persistent and diversified excess return, which is exactly the idea behind factor investing. Indeed, one can say that factor investing is the natural extension of smart beta.

From an investment philosophy viewpoint, the similarity between smart beta and factor investing can be seen in the focus on risk. Both approaches consider that one does not achieve outperformance simply by 'looking for alphas', but rather by choosing the 'right kind of risks' to take. Those 'right risks' have been widely documented in financial research: notably, overweighting cheap stocks (value factor), selecting outperforming stocks (momentum factor), focusing on companies achieving good operational performance (quality factor) and overlooked stocks (low volatility factor). These have shown themselves on average to be effective ideas. Overweighting small capitalisation stocks, which has also shown itself to be a factor of outperformance over the long term, is more questionable due to liquidity issues.

Combining different factors in a single strategy can significantly improve the stability of a portfolio's performance because each of the factors also has its dark side. For instance, value is subject to the 'value trap' – the fact that a cheap stock might be cheap because of a recent scandal – which may be obvious from the momentum factor, but not the value factor. To use more traditional terms, we could say that a blended style may offer superior returns to those from a combination of separate growth and value styles. Factor investing is well adapted to creating active blend-style investment strategies, which has the potential to do well in any market conditions.



For illustrative purpose, Source : THEAM, March 2016

Another attractive feature of factor investing is that it can be adapted to most large equity universes and most reasonable constraints, while keeping track of the cost of those constraints. There is no need to hire more analysts or to change the core of the strategy to adapt it to a new universe. This adaptability comes from the investment process, where the factors can provide an 'opinion' on each individual stock in the universe. Therefore, when one wants to add a constraint that forbids a given stock, it is always possible to find an alternative stock that is sufficiently similar in terms of factors to maintain the same performance behaviour of the global portfolio. This is exactly the crucial result from the research paper – *"An integrated risk-budgeting approach for multi-strategy equity portfolios"* – published by our Financial Engineering team in 2014 in the *Journal of Asset Management*[2].

One particular adaptation facilitated by factor investing and currently drawing increased interest is that relating to low carbon. Following the COP21 climate change conference in Paris last December, many institutional investors are becoming aware that their portfolios have a carbon footprint, measured typically by the emissions of the underlying companies, and are seeking to reduce this footprint. ERAFP, the French public sector pension fund, has spearheaded this trend in France. To spread the word, ERAFP has sponsored a new amLeague[3] notional mandate to promote low-carbon investment in a transparent way. The interesting feature of this amLeague paper-trading game is that it combines three aims: to follow socially responsible investing (SRI[4]) principles, to reduce the carbon footprint of notional portfolios and to create excess performance.

Working hand in hand with the SRI teams of BNP Paribas Investment Partners (BNPP IP), THEAM is taking part in this competition with a factorial strategy based on its multi-factor model, while applying BNPP IP's standard SRI and carbon philosophy via the sector-based ranking provided by SRI analysts. This factorial low-carbon strategy targets a 5% tracking error relative to the relevant benchmark (STOXX® Global 1800) of which about half is used to comply with the SRI and carbon guidelines, while the rest is used to attribute risk equally to the four 'right risk' factors: low volatility, value, quality and momentum. It is therefore reasonably balanced in terms of investment style. The competition only started in December 2015, but we expect this strategy to outperform both the benchmark and the peer group. This would in our view be a further demonstration that factor investing does not run against active management, but rather can actually be combined with it to create new efficient integrated solutions. At the end of February, this strategy had already achieved second place in the competition among more than 20 competitors. Its performance[5] can be followed in real time on the amleague.com website.

The investments in funds are subject to market fluctuations and the risks inherent in investments in securities. The value of investments and the income they generate may go down as well as up and it is possible that investors will not recover their initial outlay.

FOOTNOTES
1 Journal of Portfolio Management, Spring 2012, vol 38, N°3 pp 56-70, by Raoul Leote de Carvalho, Xiao Lu and Pierre Moulin : *"Demystifying risk-based strategies: A simple alpha plus beta description"*
2 Journal of Asset Management, February 2014 : *"An integrated risk-budgeting approach for multi-strategy equity portfolios"* by Raoul Leote de Carvalho, Xiao Lu and Pierre Moulin
3 Trademark, copyright, and other intellectual property rights are and remain the property of their respective owners
4 SRI : Sustainable Responsible Investments
5 Past performances or achievement is not indicative of current or future performance

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