Amundi ASSET MANAGEMENT | SMART BETA

Viewpoint

Practical applications of Smart Beta

Over the last few years institutional investors have got to grips with the concept of Smart Beta. While many have allocated funds to one or more of these strategies, many remain unaware of its superiority over market capitalisation-weighted indices.

Smart Beta products can provide solutions to specific issues. Investors might be surprised to find these strategies can be used in a range of different scenarios to reduce risk and potentially improve performance while keeping a lid on costs.

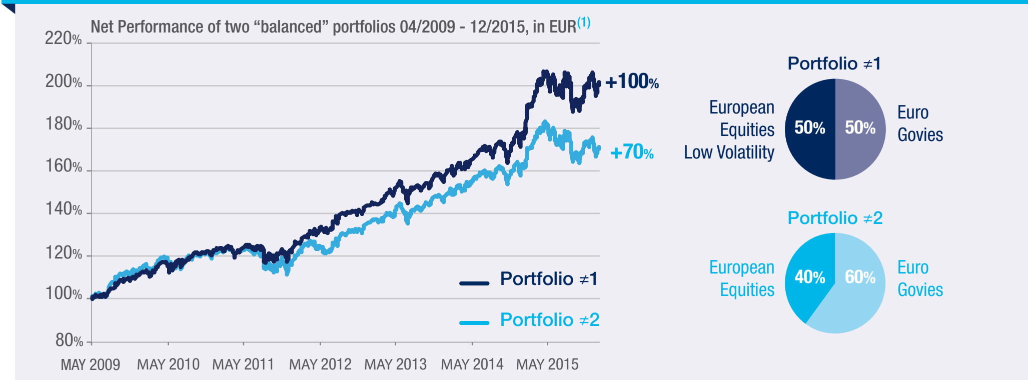
In this paper, Amundi shares a few examples of the way Smart Beta can be used. Every client, however, is different and a well-resourced manager would be able to find solutions according to their requirements.

CASE #1

Improving portfolio returns without increasing risk

Today's peculiar market conditions pose a dilemma for institutional investors. Yields on fixed income securities, whose profile normally is less risky than equities, are nowadays punitively low. Equity securities have more attractive returns but it is riskier because of its higher volatility.
Certain Smart Beta strategies, however, can allow investors to switch a bigger portion of the portfolio to equities while keeping a lid on risk. Switching from a market-cap weighted index to a low volatility Smart Beta product allows the investor to improve the return profile of their portfolio while limiting the impact on portfolio volatility.
For example, let's compare the performance of two diversified allocation strategies between April 2009 and December 2015. One portfolio has 50% invested in European equities with a low volatility approach and 50% in a broad bond index. The other one is invested in 40% in a market-cap weighted European equity index and 60% in a broad bond index. Even though the first portfolio has a higher exposure to equities - which would imply it's a riskier strategy, both portfolios have the same levels of volatility.
The first portfolio allows the investors to increase their allocation to equities without increasing volatility. This can translate into potentially better portfolio returns. During this period, low volatility stocks outperformed the market generating returns of 100% for the first portfolio while the second portfolio posted a rise of only 70%[(1)].

SMART BETA ALLOWS TO REGAIN ASSET ALLOCATION FLEXIBILITY



(1) Source: For illustrative purpose only. Amundi Asset Management as of December 2015 - Past performance cannot be regarded as a reliable indicator for future results, nor can they guarantee future returns.
The Sub-Fund does not offer any performance or capital guarantee and presents a risk of capital loss. Amundi Funds Equity Europe Minimum Variance became Amundi Funds Equity Europe Conservative the 27th July 2015".

CASE #2

Integrating environmental, social and governance factors into a Smart Beta portfolio

A leading Dutch charitable foundation wanted to restructure its whole equity portfolio to reflect its cultural ethos of social responsibility and good governance as well as accessing the potentially greater returns of Smart Beta strategies.
But the foundation board was concerned that too great a focus on environmental, social and governance factors would push the performance too far away for its internal reference benchmark.
The investor was also worried that including an ESG filter would narrow the investment universe too much and dilute the fund's 'Smart' characteristics and reduce portfolio performance.
In the past, the institution had achieved these different investment goals by having a number of asset managers each with specific mandates – some focused on ESG targets while others provided a Smart Beta approach.
But it is not necessary to employ different managers – all these investment aims can be applied to the whole equity portfolio. Firstly, Amundi constructed a fund which accessed a number of different investment factors. Then, an ESG filter was applied.
This filter reduced the investment universe by 40%. Using risk reduction techniques such as minimising volatility and reducing correlation, however, preserved the performance of this fund.
This was an ideal outcome for the Dutch foundation. All the funds could be consolidated with one manager and they could apply a Smart Beta strategy and an ESG filter to the whole equity portfolio. This resulted in lower fees yet performance did not deviate too far from their reference benchmark.

Practical applications of Smart Beta

CASE #3

Using Smart Beta to maintain capital preservation

European insurance companies increasingly use strategies known as Constant Proportion Portfolio Insurance products (CPPI). These products have a dynamic mix of cash and equities which allows the capital invested not to fall below a certain value.

A typical product has a maturity of five years which would provide up to 80% capital preservation.

These products are popular with insurance companies because they have a lower capital cost than other forms of investment, enabling the firm to comply more easily with Solvency II regulations. The capital preservation promise also makes them popular retail products.

When the value of the portfolio falls to a level close to the preserved amount in the product, equities have to be sold to ensure the promise can be met.

Once the threshold level is reached, however, the entire portfolio must be invested in low risk or cash funds as any additional equity holding would undermine the capital guarantee. And once the portfolio is entirely invested in cash or low risk funds, it cannot be re-invested in equities.

While this policy of selling equities will ensure the capital guarantee is met, the ultra-low yield environment makes it hard to produce any returns from a portfolio invested entirely in cash as yields are currently negative.

In addition, the fund is a forced equity seller when values are falling which will reduce returns further. These two characteristics making a cash lock-in is a very negative event.

However, if the fund were to use a low volatility equity strategy rather than a standard market-cap index, the chance of hitting this threshold is less likely – reducing the probability of this extreme event.

CPPI constructed using low volatility equity strategies have been shown to have much less likelihood of triggering this equity fire sale. Between the end of 2008 and January 2016, a CPPI using the Amundi Europe Conservative strategy rather than MSCI Europe stocks maintains a much higher allocation to equities throughout the period.

The fund constructed using Amundi's low volatility fund has a minimum equity exposure of 15% and a maximum of 81% while one constructed using MSCI Europe has a minimum of 4% and a maximum of 75%[(2)]. ■

CASE #4

Using Smart Beta instead of traditional active manager

A Canadian client who had a global equity portfolio was interested in using an active strategy rather than a standard market-cap weighted index. The client wanted the portfolio to have an exposure to stocks with a high dividend yield but wanted these shares to be chosen using fundamental analysis rather than a straightforward systematic approach.

It is now possible to build a Smart Beta portfolio with an emphasis on high dividend stocks using qualitative as well as quantitative factors. That is achieved by using a sophisticated filter which screens for more fundamental metrics such as cash flow generation, low debt levels and profitability. These metrics ensure dividend payments are sustainable over the medium term.

Applying a fundamental analysis by using a high quality filter reduces the universe of 1,600 investable stocks to 650 stocks. Then this universe is filtered for high dividend stocks while ensuring the portfolio has optimum diversification by picking those stocks with minimal reciprocal correlation. The final portfolio is only invested in 100 stocks yet meets all of the client's requirements. ■

The increase both in terms of demand from investors and offer from asset managers around Smart Beta solutions is today particularly significant. These practical application examples tend to prove Smart Beta can be used for a vast variety of purposes, still with the objectives to preserve performance, enhance diversification and reduce risks.

Today investors benefit from a large offering to implement Smart Beta strategies, be it active management, ETFs or index funds, and can go one step further by applying a tailor-made Smart Beta approach to an existing portfolio to keep initial constraints. Amundi, as a leading asset manager in Europe, is fully committed to accompany investors taking up Smart Beta in their asset allocation and build the right solution for their specific needs. ■

(2) Source : simulation on pure algorithmic CPPI management realized by Amundi, based on annualized performance between 31/12/2007 and 29/01/2016.