Amundi ASSET MANAGEMENT | SMART BETA

Viewpoint

Using factor investing to navigate choppy, low-return markets

While the performance of stock markets has been strong since the financial crisis, a more sophisticated approach is now required. The volatility of financial markets in the last 12 months highlights the current challenges. Risks of lower economic growth are curbing the medium-term return potential of equities while bouts of volatility threaten to erode the value of the portfolio.

Investors are increasingly looking for a new approach to equity investing to make the most of available risk premia and to minimise the impact of market volatility on the value of a portfolio. Smart Beta solutions can answer these needs, as they provide improved diversification compared with market capitalisation-weighted indices by addressing many of their limitations. These products aim to help investors reduce volatility and access potentially better returns as well as mitigate losses in bear markets.

After defining Factor Investing, Amundi takes a look at the different strategies investors can implement with this Smart Beta approach.

Characteristics of factor investing

An investor can access a more diversified exposure to stocks and shares using index construction techniques which take a more risk balanced approach. This could include building an index by equalising the risk contribution of individual stocks, minimising volatility or maximising a diversification measure.

An even better risk-return profile can be achieved, however, by tilting a portfolio towards stocks with certain characteristics. Academic research[1] has shown stocks with specific characteristics can have consistent and persistent risk premia, which are known as investment factors. Well-known factors include value, size, momentum, minimum volatility, dividend and quality. ■

THE SIX MAIN FACTORS

VALUE

Value stocks have low prices relative to their fundamental valuation but outperform higher valued stocks over time. These stocks can be identified looking for instance at price to book and price earnings.

MINIMUM VOLATILITY

Shares with lower historical volatility are likely to perform better than their more volatile counterparts over time. This is captured by looking at the standard price deviation.

SIZE

Smaller companies generate potentially better returns over time than larger cap stocks. These stocks can be easily identified by looking at market capitalisations.

DIVIDEND

Those stocks with high and sustainable dividends outperform those with lower dividends. This is easily spotted using dividend yields.

MOMENTUM

Stocks which performed well in the past are likely to continue to outperform those which did not. Looking at the relative performance of stocks over different time periods highlights those with this factor.

QUALITY

Companies with low debt and stable earnings growth outperform less high quality companies. Looking at return on equity, stability of earnings and balance sheet strength identifies these characteristics.

Improving the return profile of an investment factor portfolio

Constructing a portfolio which tilts towards these investment factors can improve performance compared to market-cap weighted indices because it allows investors to capture additional returns. As well as capturing the equity risk premium, they will also capture the additional risk premia associated with these investment factors.

Not only investment factors are expected to generate better potential returns than the overall market, some factors can also reduce the volatility of the equity portfolio, particularly the quality and low volatility factors. By including these defensive factors in the portfolio tilt, investors can somewhat mitigate the risk profile of their portfolio.

Investors can increase portfolio diversification by adding more than one factor /...

(1) Amundi Quantitative Research: "Equity Factor Investing according to the macroeconomic environment", November 2015.

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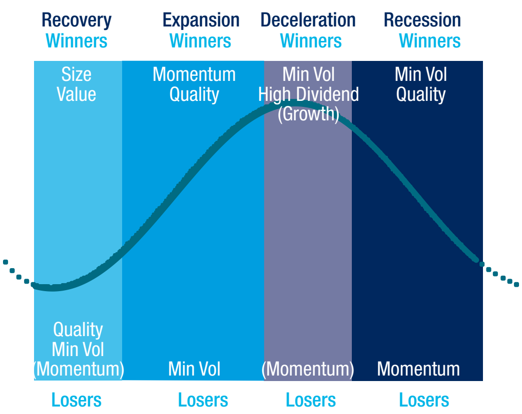
…/ into the portfolio. As demonstrated by academic research[1], factors will show different performances at different points of the economic cycle. An exposure to a broad set of factors can improve the ability of the portfolio to generate alpha, irrespective of the economic cycle. This would reduce the frequency and likelihood of underperformance.

The exposure to different factors can also be managed dynamically, according to the economic cycle. For example, during the first two quarters of the year 2016 several indicators were suggesting world economic growth could decelerate. In such an environment, defensive factors like minimum volatility and high dividend could be useful asset allocation choices. From the end of 2015 to the end of June 2016, those investment factors have been the best performers[2], illustrating the benefit of allocating to these defensive factors when there is a risk of a slowdown in economic growth. More recently, with the improvement of the macroeconomic output, and with softening concerns about "Brexit", more dynamic factors such as value and size are closing the gap[3].

RISK FACTORS AND ECONOMIC CYCLE



Source: Amundi Quantitative Research, June 2015.

If, however, the outlook should worsen and a recession seemed probable then minimum volatility and quality factors should be considered. When a recovery seems imminent, a shift to size and value stocks would produce better returns. And if economic growth starts to accelerate, then high momentum stocks are more likely to outperform[4].

By using the economic cycle to manage the factor portfolio dynamically, investors can generate better returns, compared to a portfolio with a static investment factor allocation. ■

(1) Amundi Quantitative Research: "Equity Factor Investing according to the macroeconomic environment", November 2015. (2) Amundi Quantitative Research: Performance monitor between 31/12/2015 and 30/06/2016 — (3) Amundi Quantitative Research: Performance monitor between 30/06/2015 and 31/10/2016 — (4) Source: Amundi Smart Beta Academy.

Risk customisation

The customisation of an investment factor portfolio can be taken further than managing a multi-investment factor portfolio dynamically – weighting can be defined by risk budgets. An investor can simply take the straightforward approach of allocating equally to each investment factor. Or the investor can decide to allocate weighting in compliance with a particular set of desired contributions to portfolio risk, which could be an absolute target or one relative to a market-cap weighted index.

Another risk approach is to apply the benefits of an alternative index construction tool to an investment factor portfolio. Stocks are selected according to a particular or to several investment factors and the portfolio is then constructed using one or a combination of more efficient weighting metrics, such as risk parity, low volatility or optimum diversification. This would produce a more risk-balanced investment factor portfolio. These portfolios effectively combine both 'Smart Beta' approaches: they use more risk balanced portfolio construction tools as well as accessing known sources of risk premia. ■

Do-it-yourself implementation

Investors can now choose from a wide range of 'Smart Beta' products which allow them to access individual or combinations of investment factors. However, exchange-traded funds are one of the most useful product ranges available as they give cheap, highly liquid and transparent access to these factors.

The simplicity and range of products allow investors to use these investment vehicles as building blocks to construct a portfolio to meet their specific investment criteria. Moreover, there is constant ETF product innovation which gives investor access to a broad and evolving investment toolkit. ■