Amundi ASSET MANAGEMENT SMART BETA

Viewpoint

Positioning Value in portfolio construction

The core investment factors - size, Value, momentum, minimum volatility, quality and high dividends - and their relationship with different macroeconomic environments are well understood. But in recent years these factors have not behaved as expected. For instance, the recent outperformance of Value factor points to a more fundamental shift in macroeconomic conditions.

After five years of lacklustre performance, Value factor has sprung back to life. Over the last two quarters of 2016, Value indices have outperformed standard indices by 7% in Europe and by 3% in the US[1].
Buying cheap stocks in the expectation of their prices improving over the long term is a well-established strategy. Investors select Value stocks by looking for those companies with specific financial metrics, such as low price-to-book ratios or price-to-earnings ratios. These discounted stocks tend to be higher-risk companies, often with high levels of debt. Over time, however, investors expect to be rewarded for investing in these higher risk companies with greater potential returns than would be achieved by investing in the overall market. This stock characteristic has been heavily researched by academics and consistently generates outperformance. But despite its well-established credentials, this strategy will sometimes experience long periods of underperformance.

Value stocks tend to perform when economies are expanding

That is because Value stocks tend to perform in specific macroeconomic environments. As Value stocks tend to be risky investments, these companies are likely to outperform when there is a favourable economic outlook.
Amundi has looked at the relative performance of different investment factors over the course of macroeconomic cycles. Value tends to outperform other factors during those times when there is an improvement in GDP growth.
Typical outperformance of Value index compared with a market-capitalisation weighted index is around 1% when GDP growth is increasing. For example, during the economic expansion from mid-2003 to mid-2007, Value indices outperformed blended benchmarks by roughly 2.5% a year[2]. ■

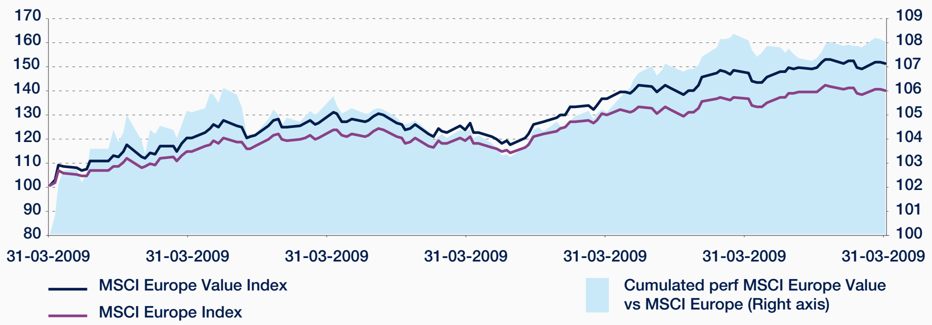
(1) Source: Amundi/Bloomberg performance monitor, Q3 and Q4 2016 - (2) Source: Amundi/Bloomberg performance monitor, Q3 2003 - end of Q2 2007

Value factor performs especially well in early stages of a recovery

Value stocks tend to perform best of all in the early stages of a recovery. During this period, there is sharp relaxation of investors' risk aversion. The early stages of expansion are also a return to normality - it is essentially a mean reversion. And investing in Value stocks is mean reversion strategy - the price of a stock is expected to revert to a price comparable to its competitors.
Over the second and third quarters of 2003, there was an economic recovery following the bursting of tech bubble. During this period, Value indices outperformed standard indices by around 4-5%[3].
Similarly, in the recovery after financial crisis, Value outperformed standard indices in second and third quarters of 2009. Global Value indices outperformed by 4-5% during this period while European Value indices outperformed by 10%[4]. ■

(3) Source : Amundi/Bloomberg performance monitor, Q2 and Q3 2003 - (4) Source : Amundi/Bloomberg performance monitor, between June 2007 and Q1 2009

Value outperformed standard indices in second and third quarters of 2009



Source : Amundi ETF, Indexing & Smart Beta/Bloomberg.
Performance comparison of MSCI Europe Value Index vs MSCI Europe index between April 2009 and September 2009

Past performance cannot be regarded as a reliable indicator for future results, nor can they guarantee future returns.

While Value indices tend to outperform during times of economic recovery, they will underperform standard indices by around 1% when GDP growth is contracting.
During economic crisis, investors shun these riskier stocks in favour of those with safer characteristics. ■

But the normal rules haven't applied to Value factor in recent years

Usually Value factor outperforms in times of economic growth and underperforms in times of contraction. But this has not happened over the past five years, despite many regions experiencing economic growth, albeit at much lower levels.

During the last five years, this macroeconomic expansion has been anything but normal as it has been driven by ultra-loose monetary policy. While monetary policy has underpinned stock market performance, its transmission to the real economy has been less successful. That has been reflected in the low level of business investment.

This ultra-low monetary policy has also re-shaped investment behaviour. As bond yields have fallen, investors have instead turned to high-quality equities to provide them with income.

In addition, the economic recovery has been very fragile and its longevity has been uncertain. As a result, investors have remained risk averse, preferring low-risk to high-risk equities. ■

A return to normality looks more likely

But over the past few months the mood has lightened considerably. An increase in fiscal spending looks more likely under Trump presidency. In addition, the US Federal Reserve has started to raise interest rates, signalling a move to a more normalised macroeconomic environment.

In Europe, where interest rates remain very low, sentiment about economic conditions has improved compared with the fragile and uneven recovery of recent years.

Should this more positive economic outlook persist, Value investment strategies are likely to look attractive to investors, again. ■

There is a range of Value products available to investors

With this more positive economic outlook looking set to persist, Value factor strategies look attractive. Investors now have a plethora of Value investing options at their fingertips. They can, for instance, opt for a cost-effective ETF which has been shown to capture most of the potential Value outperformance.

A more sophisticated solution allows investors to use more specific parameters to limit certain biases present in Value indices. For example, not every company with a low price-to-book ratio will outperform – some are badly run companies that will never recover, known as 'Value traps'.

These more actively managed strategies also can prevent the investor from having too high a proportion of their index exposed to a particular sector, for example, the financial sector where price to book is low, compared with sectors like information technology - where this one is a meaningless metric.

Both 'Value traps' and structural sector bias can be limited by looking at a broader range of financial metrics. And considering different accounting standards around the world can prevent too much of the portfolio being exposed to a particular region or a currency. ■

Hedging with other strategies should be considered

Another way to potentially optimise performance is either to identify those times when Value stocks will underperform or to hedge against these periods by also investing in quality stocks, as these two strategies are negatively correlated.

For example, when Value indices outperformed during the second and third quarters of 2003 and 2009, quality stocks underperformed the standard index in by 5% and 13% respectively.[5]

In contrast, quality stocks can provide a good hedge during periods of deceleration and recession as they tend to be less volatile than Value stocks.

For example, when Value stocks underperformed during the financial crisis from mid-2007 to early-2009, quality stocks outperformed by an impressive 20%[6]. ■

(5) Source: Amundi/Bloomberg. Performance monitor between 01/04/2003 and 30/09/2003 and year 2009 - (6) Source: Amundi/Bloomberg. Performance monitor between June 2007 and Q1 2009

Both institutional and retail investors are increasingly looking for a new approach to equity investing to make the most of available risk premia and to limit the impact of market volatility on the Value of a portfolio. ■

Design and production: Amundi Design Studio - Communication Department - March 2017

Amundi ASSET MANAGEMENT