Amundi ASSET MANAGEMENT | Smart Beta

Viewpoint

Deep dive in factor definitions and behaviors to better combine them

Anticipating the economic and financial environment evolution and its impact on equity market is not easy. A combination of several factors can offer investors an efficient way to navigate within market contexts. Stocks will be grouped depending on their volatility, size, value, intrinsic quality, dividend level or their momentum. These factors, which can be seen as “style” characteristics, are more or less favored depending on the market regime.

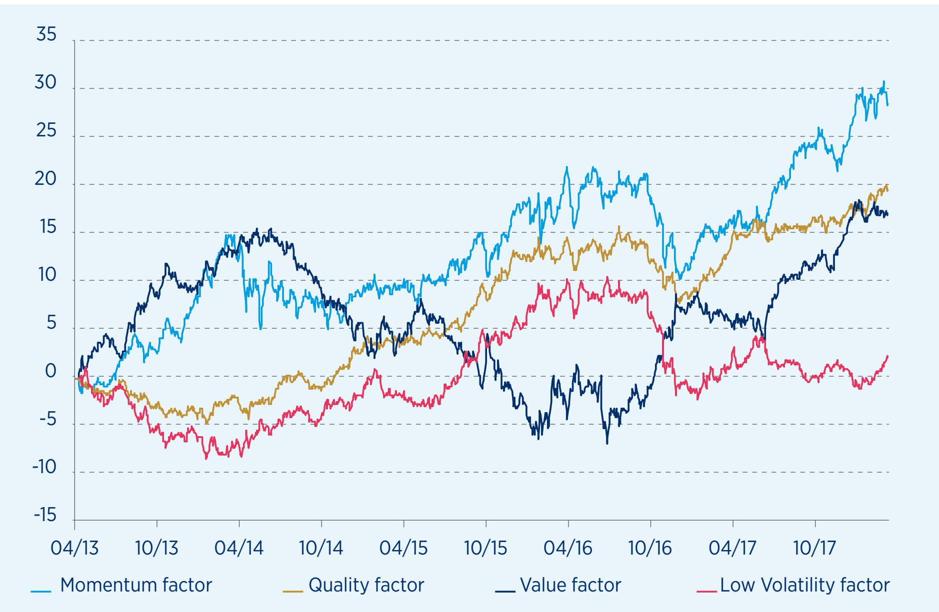
Which factors for a defensive approach ?

The “low volatility” factor is rather defensive, and thus particularly adapted for turbulent markets. Focused on low volatility stocks, it works very well in slowing markets, or even during economic contractions, which translate into bear markets and volatility hikes. On the contrary, it will underperform in a bull market which could be characterized by a rate hike.

This behavior can also be found in the “dividend” factor, that is to say companies that deliver high dividends on a durable scale and offer a defensive profile. When building a multifactorial portfolio, this factor is probably a bit less diversifying than others but can make sense when used as the main component of the portfolio, in a search for yield perspective. Likewise, the “quality” factor shows to be rather defensive, since it puts emphasis on healthier companies: low debt, more profitable than the market average and generating comfortable and regular cash flows.

If, as low volatile stocks, these companies offer less added value in expansion periods, they distinguish themselves by their good resilience to rate hikes as they carry a small amount of debt. ■

Amundi proprietary factos - Performance relative to Stoxx Europe 600 index



Source: Amundi/Factset, gross performance data as of March 29th 2018. Past performance are not a reliable indicator of future results.

Some factors are more adapted to a growth context

On the opposite, the “value” and “size” factors are favored by rising markets. The “value” factor is rather risky – that is to say built on a risk premia – as it groups stocks that have a low valuation, thus neglected by investors. By definition, these stocks offer a considerable value increase potential, particularly in a context of economic expansion, thus inflation and rate increase, which encourages investors to take more risks. The “size” factor, that also appears as a relatively risky factor, focuses on small and mid caps and the liquidity risk premium they offer. These companies need a positive environment and can be impacted by a stagnant growth.

On its side, the “momentum” strategy can be an asset when included within a long cycle. It focuses on stocks that are the most performing at a point of time, counting on a pursuit of the economic trend in place. In counterparty, this strategy is affected by market cycle reversals. ■

Combining factors to better manage risks

Smart Beta and Factor Investing strategies answer an investment philosophy that aims at implementing risk management, to deliver a more robust performance over the long run. Yet, risks are multidimensional and evolve over time.

Thus, one of the main challenges of a good portfolio construction is avoiding to accumulate similar risks. Combining factors, thus stocks that have complementary behavior throughout different market phases, reinforces portfolio diversification, notably versus cap weighted indices. ■

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