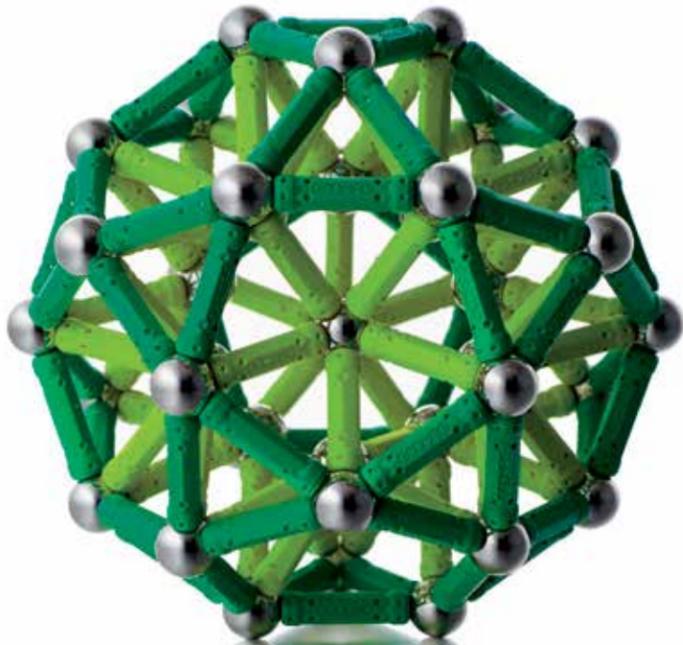


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Style Premia:

More than just Academia

Leif Cussen, manager of the Old Mutual Style Premia Absolute Return Fund, outlines four elements crucial to the selection of factors that can be harnessed to build systematic, liquid and well-diversified strategies.



Factor investing, whereby the fundamental and technical drivers of securities are used to create diversifying strategies, has in recent years become democratised: it is now accessible to investors beyond those willing and able to pay hedge funds 'two and twenty.'

Yet these generic factors – which we call 'style premia,' given they also refer to different investment styles – have proliferated in recent years.

In this piece, we describe our process for selecting from hundreds of potential candidates the style premia factors that can be harnessed to build systematic, liquid strategies – at the same time as being generally uncorrelated to each other and to major asset classes.

Rigorous research

A basis in academic research is our starting point. Intuitively most investors could probably name a number of different factors that generate returns across different asset classes, but in order to create a robust, systematic strategy, we utilise the wealth of research conducted into these approaches over the last few decades.

As such, when examining a factor, we are looking for peer-reviewed research. But a foundation of academic research is not enough to give us confidence in persistent returns going forward. Indeed, a recent paper found over 300 factors with peer-reviewed, published research¹.

Just because one can brandish an academic paper about a factor does not mean it should be included in a portfolio. Given the risk of data-mining we would not necessarily expect all of these factors to deliver persistent returns over the coming years.

Intuition

Next, for any factor, we ask the question: why are we being paid for taking on this exposure?

Typically, for us to seek to use a factor, there is typically at least one of three distinct answers to this question. The first is the 'risk premia' argument: by taking on a particular set of exposures, we are taking a risk – for which the market is compensating us.

The second is that there is a structural inefficiency in the marketplace, which we expect to persist and of which we can take advantage in order to generate returns for our investors. The third reason: there are behavioural biases that we expect to persist in the future, which will also enable us to generate returns.

These answers, or a combination of them, give us some comfort that the factors we are examining are not simply the result of a data-mining model or signal.

Persistence and pervasiveness

Still, having a good story that is backed up by research is still not enough, which is why we look for persistence and pervasiveness in a factor.

We seek persistence in returns over an extended period of time. This does not mean that factors will have only ever gone up: some will certainly have periods of not insignificant drawdowns. But we do look for factors that have delivered persistent positive returns.

“ Just because one can brandish an academic paper about a factor does not mean it should be included in a portfolio ”

¹ Harvey, Campbell R. and Liu, Yan and Zhu, Heqing, ...and the Cross-Section of Expected Returns, SSRN, 2013

Pervasiveness – and effectiveness – across regions and asset classes is also crucial. If it makes sense that a factor should have efficacy in the US, Europe and Japan – but it fails to deliver positive returns in Europe, this would start ringing alarm bells. The cause for this inconsistency might be explained, as an example, by differing micro-structure of each market; however, because we take a conservative approach, we favour those factors that perform well across regions.

Similarly, intuition may suggest that a factor that works in equities should also be applicable to fixed income, FX and commodities. Again, if a factor fails to work across a number of asset classes, this also raises questions

Transparency

Selecting style premia is not simply about picking those factors that, once harnessed, enable us to ‘look under the hood’ of a portfolio and examine the underlying code. We seek to harness transparent, generic factors that enable us to give clearer insights into what is driving portfolio returns.

One of the attractions of generic style premia factors to many investors is the insight it can give them into what is driving portfolio returns. Style premia strategies typically take a more generic approach to factor implementation. This more transparent approach can lead to a better understanding among investors over what is driving portfolio returns and whether a product is behaving as would be expected.

This increasingly popular generic approach has the added benefit of leading to the commoditisation of many factor-based products, which has improved accessibility to these types of strategy.

Four factors

Once all these elements have been taken into account, we are left with a small-yet-robust group of factors from which we can build a well-diversified portfolio. In the Old Mutual Style Premia Absolute Return Fund, these are value, the idea that relatively cheap assets tend to outperform those that appear to be expensive; quality, the idea that high-quality, low-risk assets tend to deliver higher returns on a risk-adjusted basis; carry, the idea that relatively higher-yielding assets tend to generate higher returns; and momentum, the idea that performance trends tend to continue.

Crowding risk

Of course, building a well-diversified portfolio requires more than simply choosing effective style premia. Once these principles have been applied to factor selection, we look at the risks that accompany the implementation of the strategy.

As this type of systematic investing has grown in popularity, so too has the perceived risk of crowding, whereby investors huddle around the same positions, creating problems when the market environment shifts and there is a ‘rush to the exit.’ The purposefully generic nature of the style-premia approach could even compound the risks posed by crowding, namely lower returns and higher chances of significant drawdowns.

As a result of this, it is important for investors who deploy style premia to consider how their portfolios might fare in the event the market suffers risk-off episodes. Strategies aimed at mitigating the downside – such as statistical arbitrage, which we deploy – could be particularly useful under such scenarios.

While style premia present an exciting and low-cost opportunity to capture what had once been within the purview of hedge funds alone, they clearly pose risks, too. This is why we seek to adhere to these four simple principles in factor selection – and have strategies in place for the event that market volatility spikes.



Written by

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