eastspring investments

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FACTOR INVESTING – FOCUS ON LOW VOLATILITY

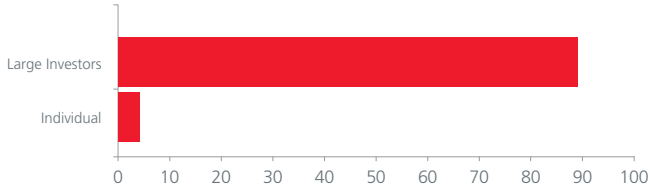
Active equity managers have for decades endeavoured to construct portfolios that could outperform the broad market, typically represented by market-capitalisation ("market-cap") weighted indices, through careful selection of investments to maximise returns while minimising risk. Market-cap weighted indices are constructed with individual components that are weighted according to their total market capitalisation; larger companies carry higher percentage weightings while the smaller companies have lower weights. These indices are also known as market value-weighted indices; examples include the US S&P 500 Index and the MSCI Asia Pacific ex Japan Index.

Most asset managers are measured, or benchmarked, against these types of market-cap indices and tend not to take much active risk. As a result, the largest stocks in these indices are usually heavily owned by asset managers. This crowding is further compounded by passive managers and Exchange Traded Funds ("ETFs") which track these indices even more closely.

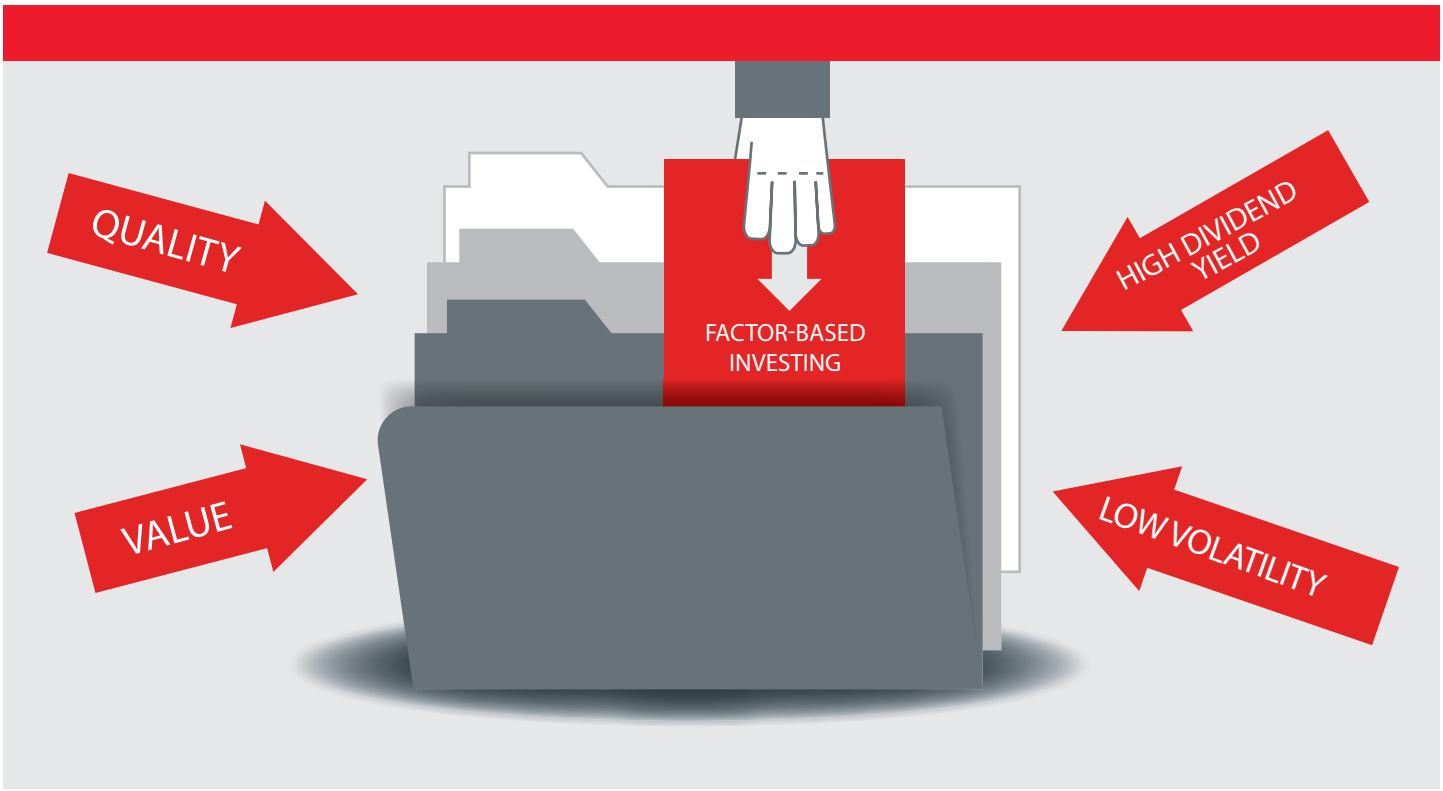
Active equity managers construct portfolios around these indices and attempt to lower risk by diversifying across sectors and/or countries through the selection of stocks with different profiles. However, episodic market events such as the Global Financial Crisis unveiled that those investments which seemed diversified turned out to be highly correlated during periods of stress when investors sought to redeem their money simultaneously. The resulting plunge in asset prices was amplified, leading to extreme volatility in the commonly owned large stocks.

The MSCI Asia Pacific ex Japan Index, for example, is a typical benchmark used by asset managers investing in Asian equity markets. The lopsided shareholder representation of large investors and institutions in the 10 largest stocks in this index (refer to Fig. 1) reflects the concern above.

Fig.1. Shareholder Types of the Top 10 Largest Stocks in MSCI Asia Pacific ex. Japan (Average, %)



Source: Bloomberg, 29 September 2016. Top 10 Largest Companies of the MSCI Asia Pacific ex Japan Index as of 31 August 2016. "Large investors" includes insurance companies, sovereign wealth funds, pension funds, banks, corporate and governments.



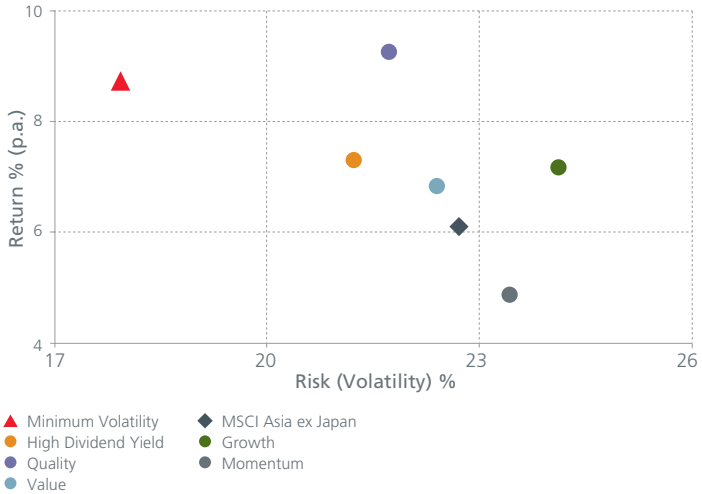
SHARPENING OUR TOOLS

Factor-based investing can help mitigate these problems and has become an increasingly accepted approach to portfolio management. Factors are observable and quantifiable security-level characteristics that can explain systematic return patterns in the equity market (and other asset classes). Certain factors such as Value, Quality, High Dividend Yield and Low Volatility, have historically earned a long term risk premium in equity markets and represent exposure to systematic sources of risk. Factor-based investing is the process by which portfolio managers harvest these risk premia by exposing portfolios to these factors (or characteristics) while minimising all other sources of risk.

At its core, this concept is not new. In traditional finance theory, such as the Capital Asset Pricing Model (CAPM) that was set out by Treynor, Sharpe et al in the 1960s, there is a single equity market factor, measured by beta. In the CAPM model, beta is the factor whose risk premium compensates investors for holding equities rather than less risky assets. Where traditional finance theory leaves a gap is that it does not account for the presence of factors other than the market factor. The move towards factor-based investing caught greater traction only after the 2009 financial crisis. A January 2013 research paper entitled "Can alpha be captured by risk premia?" by Morgan Stanley International Capital showed that 80% of the alpha generated by active managers from 2002-2012 could be attributed to underlying factor exposures. Constructing portfolios that give exposures to factors can thus be a systematic way to enhance performance over the long term.

Such factor-based approaches have shown historically to have delivered superior absolute and risk-adjusted returns over the long term (refer to Fig. 2).

Fig.2. MSCI Asia ex Japan Factor Indices vs MSCI Asia ex Japan Index 10 Years Risk-Reward (31 August 2006 – 31 August 2016) USD



Source: Bloomberg, 31 August 2016. Volatility is annualized and calculated based on monthly total returns.

If we look beyond traditional asset classifications and market-cap weighted indices as foundations to portfolio construction, there is much to be gained from allocating assets on the basis of factors which have historically earned a risk premium over long periods of time.

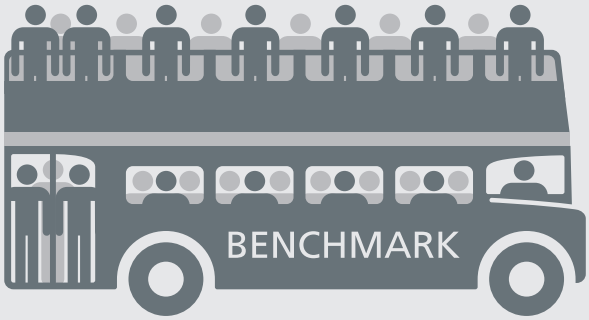
Of these, the Low Volatility factor has piqued investors' interest as it has performed well historically, especially in turbulent market conditions. Further, it contravenes one of the most basic tenets in finance; that an investor needs to take more risk to achieve a higher return.

LOW VOLATILITY ≠ LOW RETURNS

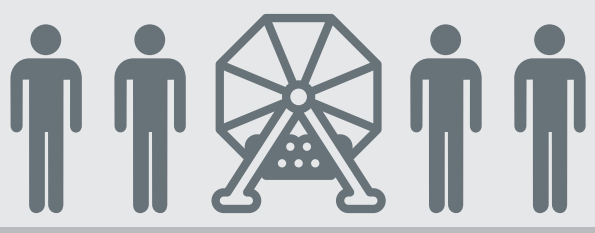
Interest in Low Volatility ("low-vol") equity investing has risen in recent years as investors have increasingly come to terms with the low-vol anomaly. A low-vol approach to equities investing offers not only lower risk but also returns that are similar or superior to portfolios which have higher volatility. This phenomenon runs counter to common financial theory that investors are rewarded for bearing risk (i.e. generating higher returns comes necessarily with higher risk).

THERE ARE A FEW REASONS WHY THE LOW-VOL ANOMALY EXISTS.

1. Firstly, most asset managers are benchmark driven and seek to derive alpha from high stock specific risk. The disadvantages of constructing portfolios around market-cap weighted indices have been discussed at the start of this article. Low absolute risk stocks are seen as high relative risk for these asset managers as these often tend to have lower betas; overweighting them may lead to higher tracking errors which need to be justified by sufficient excess returns (alpha). As an outcome, higher absolute risk stocks may become overpriced, while lower absolute risk stocks become underpriced, creating incongruence in risk compensation.

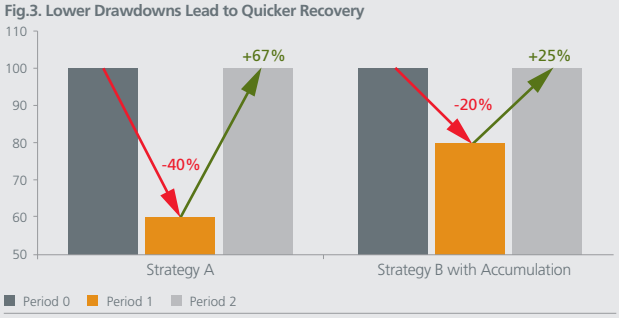


2. Secondly, the anomaly may also be caused by behavioural biases among investors; the "Lottery Effect" is one example. In this instance, investors often overpay for risky stocks in the hope that they yield large returns albeit with low probability and ignore lower risk stocks which deliver lower returns but with a higher probability.



3. Lastly, the effect of compounding leads to the fact that compensating for large negative losses takes much more than a gain of the same magnitude; this is an irrefutable relationship based on mathematics. Simply put, should a low-vol portfolio fall less than the market, it needs only to rise by a smaller magnitude in order to return to the same level (refer to Fig. 3). The low-vol approach therefore potentially accumulates greater wealth over the long term as it typically falls less in each period of market decline.

Fig.3. Lower Drawdowns Lead to Quicker Recovery



Source: Eastspring Investments. The above is an illustration and should not be construed as an indication of Fund performance.

The era of managing portfolios against market-cap weighted indices with traditional asset classes as building blocks could be at the turn. Nevertheless the motivation for most asset managers to pivot may remain lacking. Further, behavioural biases for both professional and private investors are likely to persist as these are inherent.

To the uninitiated, low-vol equity investing may seem like a fad but we think that the anomaly is likely to persist. A portfolio which is constructed around factors is also likely to be able to exploit the anomaly more optimally. Discerning investors would find this strategy befitting as a core part of their investment portfolio.

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