

Capturing the equity premium through factor investing

Factor investing can help address key challenges, including the concentration currently embedded in equity markets and the impact of climate change, while capturing the equity premium in a consistent manner.

By Bruno Taillardat

Factor investing, which relies on quantitative techniques and robust portfolio construction, seeks to simplify a complex problem into a disciplined and well-structured investment process.

Factors are cyclical: their performance and risk profile vary over time. Multi-factor equity strategies build on diversification principles and are therefore better balanced in their factor exposure compared to the index, leading to a more robust performance over the long term.

Equity factors such as value, momentum, size, quality and low volatility are expected to deliver positive performance over the long term, but have different performance cycles

due to their underlying characteristics. For example, value would be categorized as a risk premium factor, meaning that its risky profile enables investors to capture strong upside markets but tends to underperform during more turbulent times. This factor also tends to react positively in a context of high interest rates and inflation. By contrast, the low volatility factor is more defensive and tends to perform better during periods of high volatility and low interest rates.

Concentration risk

To reinforce their efficiency, the factor-based equity portfolio may be adjusted when new risks emerge or become material. For instance, the stock market is experiencing an unusual episode of concentration, which has not been seen during the last three decades, especially in the US. This concentration is mainly driven by the IT sector and very large cap stocks. As Figure 1 shows, the top 10 holdings represent more than 30% of the holdings of the S&P 500.

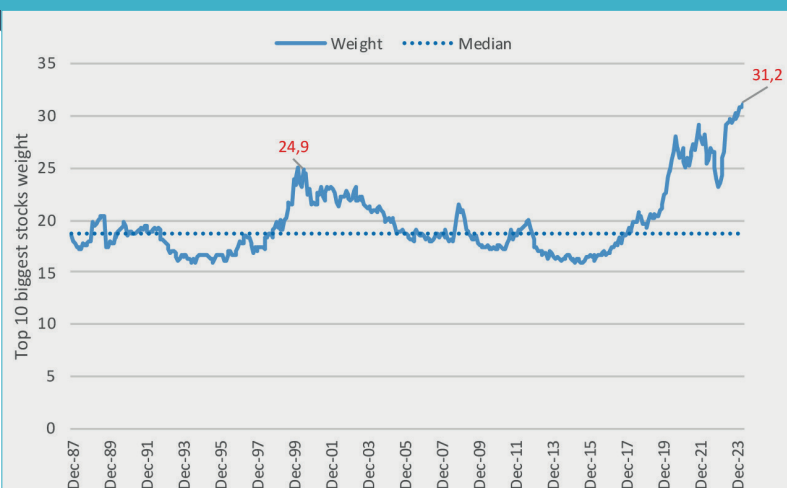
One may question the sustainability of such dominance of just a few stocks. As rational investors, we could wonder whether this level of concentration does not lead to a high idiosyncratic risk associated with the continuity of the underlying oligopolistic business models. Certainly, when concentration risk is so high, equity markets cannot absorb any adverse market context such as the deterioration of the global economic conditions and the war in Ukraine in 2022, or the burst of the internet bubble in 2000.

When managing multi-factor equity strategies, some dynamic adjustments may be needed in order to respond to market pressures, such as this concentration risk, which may affect certain factors more than others.

For instance, the momentum factor has been significantly affected by the recent concentration risk, in particular in the US market. Figure 2 shows the exposure of the S&P 500 index to the momentum factor as well as the composition of this factor.

In a Z-score range, the exposure of the S&P 500 index to momentum is at an all-time high since 2019. The composition of the momentum factor exhibits a high exposure to the Magnificent Seven stocks.

FIGURE 1: CONCENTRATION IN THE S&P 500, % WEIGHT OF TOP 10 BIGGEST STOCKS



Source: Amundi

‘When concentration risk is so high, equity markets can’t absorb any adverse market context.’

This factor also starts to exhibit a stretched valuation as its current price-to-earnings or price-to-book ratios are very high compared to long-term historical standards. The momentum factor thus experiences a risk of instability, due to high concentration coupled with high valuation.

Integrating net zero objectives

Integrating net zero objectives into equity portfolios is another key challenge that investors have to address.

Factor investing is an efficient way to maintain a good portfolio diversification across rewarded factors, while finding the right trade-off between net zero objectives and positive expected returns provided by equities over the long-term.

Imposing a strong carbon reduction in an optimized portfolio leads to underweighting the most carbon-intensive companies and overweighting the least carbon-intensive

ones. As a result, a high and drastic level of decarbonization may lead to the compression of entire economic sectors, such as energy or utilities. This, in turn, would have a negative impact on diversification and potentially increase the overall portfolio risk.

Alongside decarbonization, financing the climate transition is an important aspect to consider when targeting a net zero objective. Transition metrics, such as Green CAPEX, enable portfolio managers to identify companies that demonstrate a willingness to transition to a more sustainable economy, even within sectors that can be perceived as more carbon-intensive.

Portfolio managers have to deal with multiple objectives and multi-faceted data. Quantitative, factor-based equity strategies are designed with the purpose of managing a large amount of data which are sometimes based on heterogeneous distributions. Their portfolio construction is structured to determine the right trade-off between a large spectrum of dimensions. ■

Disclaimer
Source: Amundi AM, FactSet, S&P as of 30/04/2024. Past performance is not a reliable indicator of future results or a guarantee of future returns.



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SUMMARY

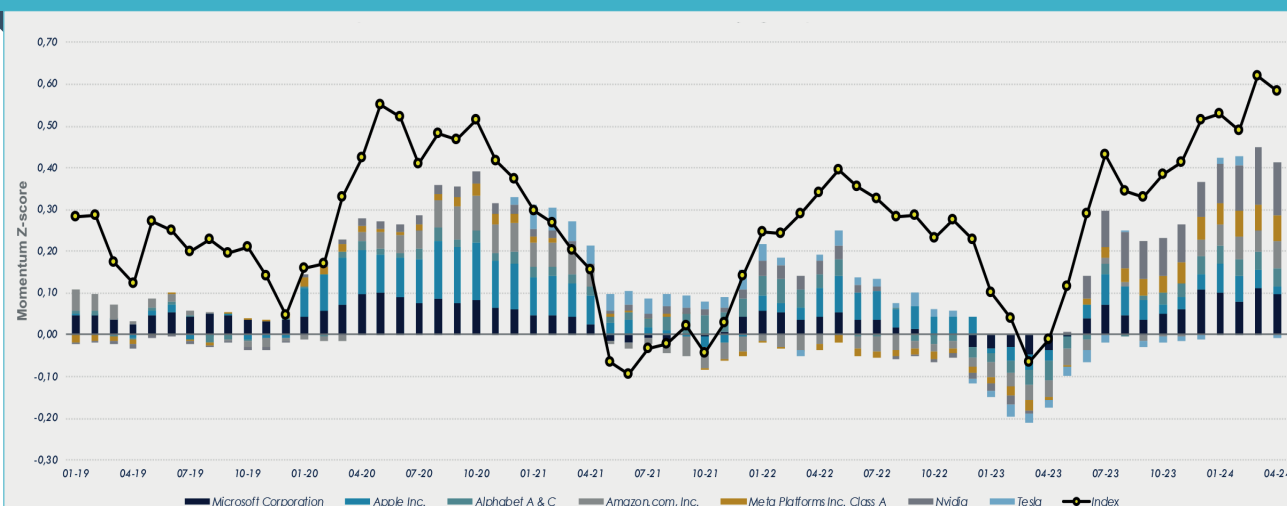
Factor investing: robust way to capture long-term equity premium while addressing key investor challenges.

Risk associated with current concentration affecting equity markets is a major challenge for investors and triggers the need for dynamic adjustments when managing multi-factor equity strategies.

Integrating net zero objectives into an equity portfolio requires a well-structured investment process.

Quantitative, factor-based equity strategies that can manage diverse sets of data are well suited to determine the right trade-off between a large range of dimensions, like net zero considerations.

FIGURE 2: EXPOSURE OF THE S&P 500 INDEX TO MOMENTUM/UNDERLYING COMPOSITION OF THE FACTOR



Source: Amundi