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PREMIA 2.0: DELIVERING DIVERSIFICATION AND PERFORMANCE

LUC DUMONTIER
Head of Factor Investing and Senior Portfolio Manager

Edited by GISELLE COMISSONG
Director, Head of Marketing

The Death of Diversification

The 2007-08 Global Financial Crisis hammered home the point that, on average, most funds: (i) tend to be exposed at best (and in benign conditions) to just a few risk factors and (ii) at worst, and especially in times of risk aversion, to just one, the equity market factor. Figure 1 shows that allocation funds, whether classified as "balanced," "flexible," or even "alternative" have all historically posted performance strongly correlated with equity markets while not succeeding in outperforming equities (on a risk-adjusted basis). In other words, the performance of investment funds (on average) is highly beta-driven.

This phenomenon is well documented in research by Ang, Goetzmann, and Schaeffer (2009). Ang et al. studied active management at one of the largest sovereign wealth funds in the world, the Norwegian Government Pension Fund Global ("GPFG"). Notwithstanding GPFG's sophisticated investment infrastructure and highly qualified investment staff, it turned out that exposure to the equity market factor, i.e. equity risk, accounted for 70% of the portfolio's returns and was the main driver behind a 23.3% loss in 2008.

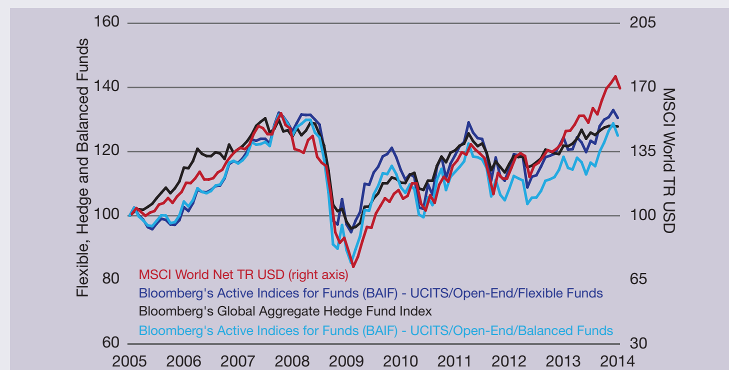
This explains the emergence, starting in 2008, of risk parity solutions that attempted to "force" effective diversification of the equity factor through an equally risk weighted allocation to equities and government bonds. However, a risk parity allocation, which corresponds to a capital allocation of 15% to equities and 85% to bonds, has lost appeal in today's context of globally low yields.

Some Managers are Successful: What is their Secret?

Of course, certain funds and managers have succeeded in beating their benchmark(s). When the components of their returns are assessed, research reveals that these funds are exposed to additional factors besides the equity market factor.

These "alternative factors" were first identified by Nobel Laureate Eugene Fama and renowned researcher Kenneth French, both professors at the University of Chicago Booth School of Business. Their "Fama French Three Factor Model" separated equity returns into three distinct risk factors: (i) equity market risk, plus (ii) the value factor which consists of buying the cheapest stocks versus the most expensive based on their valuation multiples, and (iii) the size factor which consists of buying the smallest capitalization stocks versus those with the highest capitalization.

Figure 1: All Beta All The Time



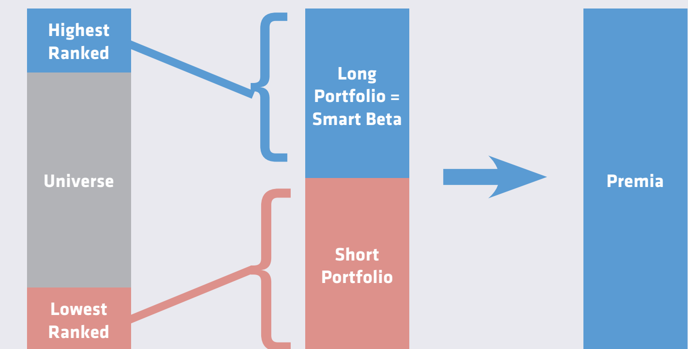
SOURCE: Bloomberg, La Française Investment Solutions ("LFIS")

Smart Beta but Still Beta

Smart beta solutions seek to exploit these alternative factors to drive market neutral returns but in a long-only way. A smart beta fund will, for example, buy more attractive stocks to attempt to outperform its investment universe. However, this approach remains long the underlying market and performance is still irredeemably linked to that of equities.

A premia approach, on the other hand, as illustrated in Figure 2, involves the simultaneous purchase of the most attractive stocks and sale of those that are less attractive. By design, a premia approach has an additional performance driver, capturing not only the "long" leg of typical smart beta (outperformance of the most attractive stocks) but also a "short" leg linked to the underperformance of the less attractive stocks. A premia approach thereby effectively neutralizes the beta exposure of the portfolio. Long and short exposure to markets cancels out for a truly market neutral approach.

Figure 2: From Smart Beta to Premia - A Market-Neutral, Long-Short Approach



SOURCE: La Française Investment Solutions

Expanding the Definition of Premia

The traditional premia approach is focused on the standard alternative factors (value, carry, momentum, etc.) within traditional asset classes and equities in particular. The definition of premia can, however, be expanded to include other factors and assets classes including implied assets (e.g. volatility, dividends) and pure arbitrage strategies (e.g. repo and negative basis trades and convertible arbitrage strategies).

The broad premia universe can be broken down into two types of premia, each with a specific underlying structural rationale. Risk premia include strategies which remunerate investors for exposure to an additional systemic risk factor (economic or financial) that cannot be diversified away. Style premia remunerate investors for the capacity, cash or regulatory, to implement strategies which profit from structural market biases whether behavioral or linked to investment constraints and structural flows.

The foundations of premia strategies are likely to persist. Investors will always require yield to take on additional systemic risk. In the same manner, behavioral biases are so strongly ingrained in most market participants that it will always prove difficult for investors to arbitrate them completely. Finally, the raft of regulation that applies to most of the actors in financial markets (the Basel Accords for banks, Solvency II directives for insurance companies, the UCITS framework for certain asset managers, etc.) are moving us in the direction of more rules and stricter enforcement rather than the opposite. This should also generate more opportunities.

Premia are Promising Portfolio Building Blocks

Premia exist in all asset classes and the rationale behind each premia is different and, as highlighted above, likely to persist over time. As specific premia are driven by different underlying factors, specific premia will materialize at different points in time. A diversified portfolio of multiple premia therefore has the potential to deliver strong, un-correlated risk-adjusted performance over time.

We insist, however, that the "premia" label should be thought of as an analysis framework rather than a

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stand-alone investment strategy. In summary, while the premia investing concept is very attractive on paper, in practice, the pitfalls are numerous and actual performance may differ greatly from historical simulations. The robustness of any premia solution depends first and foremost on the choices made by the team in charge of implementation. Whether one is the provider (portfolio manager) or the user (client or consultant), it is crucial to adopt a comprehensive, forward-looking approach.

LFIS' Approach – Beyond the Academic

LFIS' premia strategy is differentiated by the breadth of investable premia it combines. Our approach goes beyond "traditional" alternative premia to combine approximately 30 strategies across three families:

1. **Academic Premia:** the most common premia including value, momentum, carry, low risk/quality and liquidity strategies across the range of asset classes including equities, bonds, currencies and commodities;
2. **Implied Premia:** on parameters including volatility, correlation, dispersion and dividends and created by asymmetries in risk and return and specific flows linked to: (i) certain investor patterns, (ii) hedging by banks, insurance companies, etc., and (iii) regulatory constraints; and
3. **Liquidity/Carry Premia:** LFIS' cash capacity and set-up allow for the holding of certain liquid assets which other market actors can no longer carry, often for regulatory reasons.

LFIS' Approach – Ensuring Effective Diversification

Diversity across premia strategies is just the beginning. To ensure optimal overall diversification, it is essential to manage correlation, particularly on the downside. LFIS' allocation and risk management approach takes into account correlation at every level. The allocation is defined using an equal risk contribution framework to take into account correlation without over-emphasizing it relative to volatility. Risk management is comprehensive, including: (i) stress tests and drawdown controls based on real market events and bespoke scenarios, (ii) concentration limits at all levels (per asset class / sector / underlying / counterparty / issuer) and (iii) formal "greek" limits including delta, gamma and vega.

LFIS' comprehensive approach is possible thanks to the background of our portfolio management team which combines experience in investment banking and quantitative asset management. This, together with an institutional set-up which includes an extensive set of ISDA agreements and proprietary tools for pricing OTC instruments, positions LFIS to understand the opportunities and dislocations in markets and flows and identify resulting opportunities. The same set-up allows LFIS to negotiate, price, implement, stress test and risk manage strategies that capture resulting premia in a pure, market neutral manner.

'The result is a highly diversified multi-asset portfolio which goes well beyond the alternative beta approaches traditionally implemented'

LFIS Premia 2.0

The result is a highly diversified multi-asset portfolio of risk and style premia which goes well beyond the alternative beta approaches traditionally implemented. Our approach combines diverse premia; some require markets to move, others rely on stability. Strategies can benefit across markets (volatile, trending, range-bound) and materialize at different points in time. Our approach also looks to be carry positive. Performance does not depend on directional market moves and there is no structural, directional exposure to underlying asset classes.

LFIS currently manages $700 million in assets across its premia strategies, including AIF and UCITS fund vehicles.

For further information, please contact us at:
institutionnels-LFGIS@lafrancaise-group.com.

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