Factor investing: harvesting alternative risk premia

In a context of low expected returns for most traditional asset classes, building strategic portfolios with attractive expected returns and diversification properties is challenging. Rather than looking for “alpha”, investors could take exposure to style factors that capture different risk premia than those usually captured by traditional balanced strategies.

A style factor is any characteristic commonly shared by a group of assets which consistently explains the return relative to that asset class (cross section return). The most famous factors are the equity size and value factors. Interestingly, some factors can be invested across all asset classes, offering strong diversification properties.

HSBC Multi-Asset Style Factors, relevant for a strategic asset allocation

- **Diversified and diversifying.** The strategy is exposed to 3 style factors: carry, momentum and value; each implemented across the main equity, bond and currency markets. It offers diversification across styles and asset classes: within a specific asset class, correlations across styles are low; likewise, for a given style, correlations across asset classes are low.

- **Focused and disciplined.** We have selected 3 well established and robust style factors that have been delivering persistent risk premia across equity, bond and currency markets.

  The investment process is systematic and transparent: the style portfolios are built using simple and intuitive metrics and are then combined to maximise diversification across styles and asset classes. There is no manager intervention to tilt the portfolio away from this systematic approach.

- **Liquid and cost efficient.** The strategy is implemented using highly liquid derivatives only: index futures, interest rate swaps, currency forwards. This makes the portfolio easy to look through in a Solvency II context.

Investment process

The strategy uses a systematic approach aiming to harvest 3 style premia across 3 asset classes through 9 customised style portfolios. The allocation of each style portfolio simply derives from the ranking of the investment universe on a defined metric: the style portfolio is long the better ranked assets, while being short the lower ranked.

The 9 style portfolios are then combined to maximise diversification across styles and asset classes, with no factor timing.

The strategy is implemented using highly liquid derivatives only. Only one portfolio is actually implemented, once all style portfolios positions have been netted.

Portfolio manager

Mathieu Guillemet
Portfolio Manager | Multi-Asset
HSBC Global Asset Management (France)
Joined HSBC in 2003
14 years of experience in the industry

Overview

- A diversified strategy which seeks to provide diversification when combined with a traditional asset allocation investment
- A combination of 3 style factors - value, carry and momentum - invested across equity, bond and currency markets
- A systematic approach implemented using liquid derivatives only
- Investment objective\(^{(1)}\): aims to provide long term total returns with a low correlation to traditional asset classes
- An expected volatility\(^{(1)}\) comprised between 6 and 8%

**Typical allocation guidelines\(^{(1)}\)**

<table>
<thead>
<tr>
<th>Equity markets</th>
<th>-150% / +150%</th>
<th>-75% / +75% on average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Duration (bond markets)</td>
<td>-16 years / +16 years</td>
<td>-8 years / +8 years on average</td>
</tr>
<tr>
<td>Currency markets</td>
<td>-100% / +100%</td>
<td>-50% / +50% on average</td>
</tr>
<tr>
<td>Total leverage</td>
<td>-375% / +375%</td>
<td>-250% / +250% on average</td>
</tr>
</tbody>
</table>

\(^{(1)}\) The above mentioned target/limits/objectives are to be considered on the recommended minimum investment period (at least 3 years) and do not constitute a commitment from HSBC Global Asset Management; there can be no assurance that the strategy will achieve this objective. Source: HSBC Global Asset Management. December 2017.

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HSBC Credentials

- A robust experience of over 20 years in Multi Asset management
- USD 83.1bn under management in multi-asset worldwide as at 29 December 2017
- Numerous segregated accounts and mandates for institutional investors

What are the main risks of this strategy?

It is important to remember that the value of investments and any income from them can go down as well as up and is not guaranteed.

- **Interest rate risk**: as interest rates rise debt securities will fall in value. The value of debt securities is inversely proportional to interest rate movements.
- **Equity risk**: portfolios that invest in securities listed on a stock exchange or market could be affected by general changes in the stock market. The value of investments can go down as well as up due to equity markets movements.
- **Foreign exchange risk**: where overseas investments are held, the rate of exchange of the currency may cause the value to go down as well as up.
- **Emerging market risk**: Investments in emerging markets have by nature higher risk and are potentially more volatile than those made in developed countries. Markets are not always well regulated or efficient and investments can be affected by reduced liquidity.
- **Derivative risk**: the value of derivative contracts is dependent upon the performance of an underlying asset. A small movement in the value of the underlying can cause a large movement in the value of the derivative.
- **Counterparty risk**: The portfolio is exposed to Over the Counter (OTC) markets for all or part of its total assets. The portfolio will therefore be subject to the risk that its direct counterparty will not perform its obligations under the OTC transactions and that the strategy will sustain losses.
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