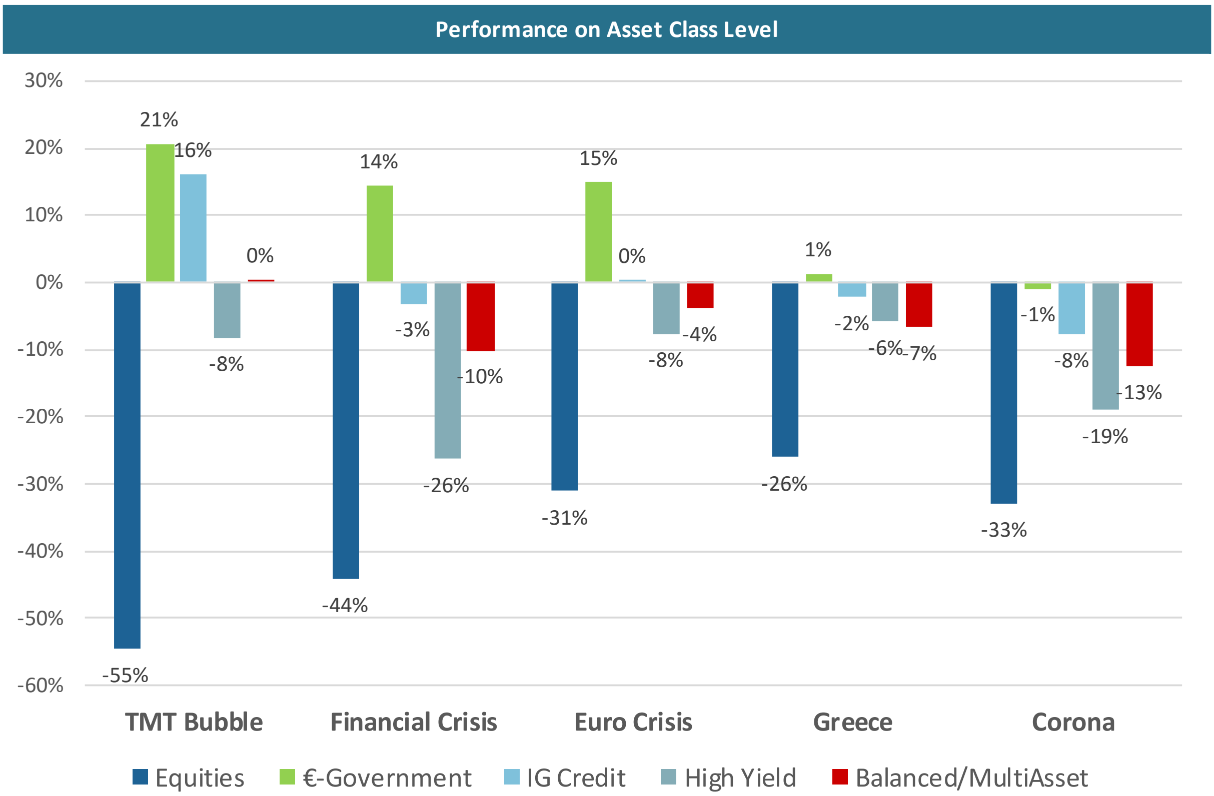
# Risk Mitigation using EUREX Factor Futures….

… on **iSTOXX Europe factors can be a quite useful addition** to multi asset investor´s toolkit in search for risk mitigation strategies. Despite the fact that the COVID-19 related drawdown in equities has been quite unique with respect to factors as **all equity factors underperformed**, the **factor relationships** within the iSTOXX Europe factor family **proved to be quite stable** compared to former episodes of economic drawdowns and crisis. In a recent working paper **"Where is the risk in risk factors? Evidence from Vietnam war to the COVID-19 pandemic"** (available on SSRN), the authors show, that the well-known Fama/French-factors suffered losses, but this episode is "not representative of the previous 10 bear markets from the Vietnam war to the Global Financial Crisis".

As in every major equity drawdown during the last 30 years, an intense discussion developed after the COVID 19-crash about the question how to achieve better diversification results or limit losses using tail risk-hedging strategies. Especially **European Balanced/Multi Asset investors lost more money on average this time than during the financial crisis** or any other crisis opportunity during the last 20 years.




Source: Bloomberg, Alpha Centauri calculations

The reasons are straightforward: **€- denominated government bonds lost their diversification benefits** as yields approached zero or turned negative and delivered zero or even negative performance this time. Most investors replaced their negative yielding government and covered bonds with investment grade- and high yield-bond exposures during the last several years in a hunt for yield. But as the (credit-) risk free component within corporates is non-existent anymore, **investors are basically invested in short puts** (the company credit component). **The delta (and thus equity beta) of corporates increases as equities fall, volatility rises, and spreads widen.** Corporate bonds thus changed their risk characteristics over the last several years as spreads account for more than 100% of overall yield and are now equivalent to low beta equity risk.

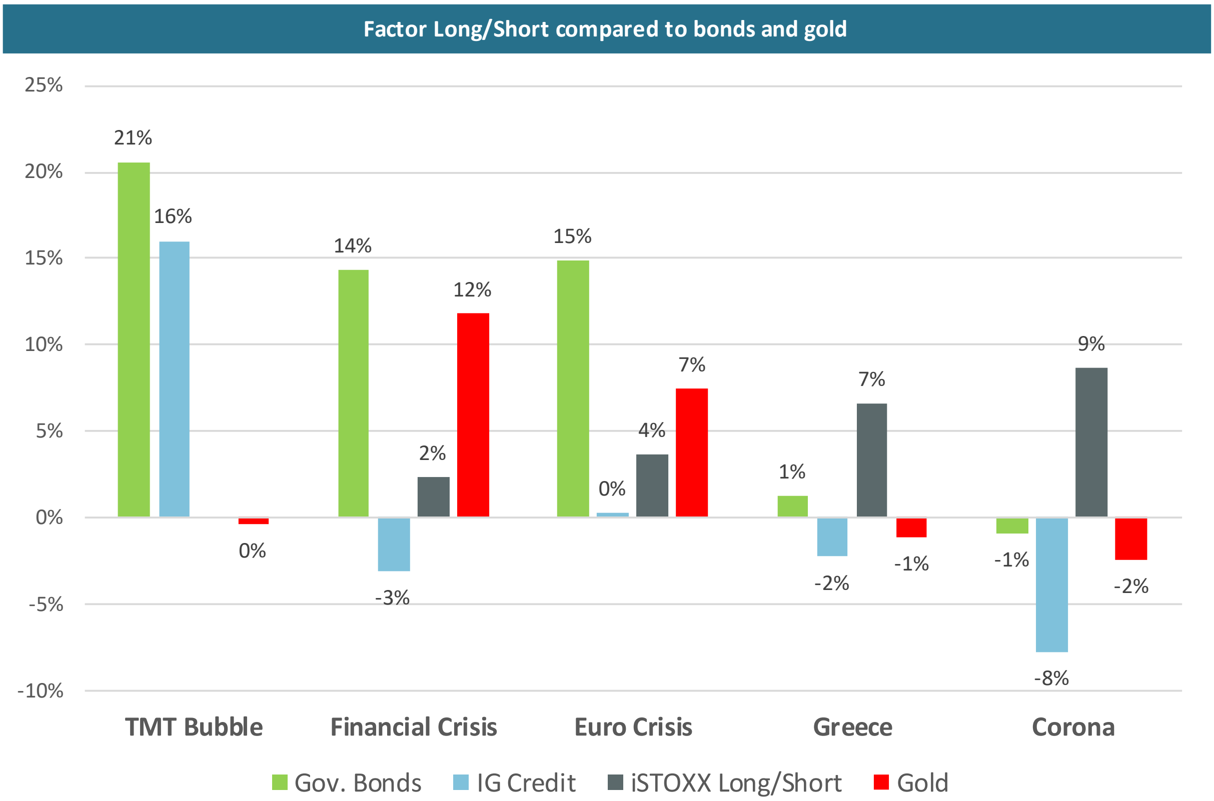
Discussions about the best ways to diversify portfolios led to a **tug of war between proponents of investing in more strategic diversifiers like CTA´s or trend following and those who propose tail-risk hedging strategies** as the grotesque battle between AQR´s Clifford Asness and Nicolas Taleb, the author of "The Black Swan", shows.

From our point of view, **the answer to better diversification and risk management techniques starts with the proper identification and analysis of risk factors** within the portfolio only to be followed by a decision, if there´s a **strategic need for continuous risk mitigation strategies** or if temporary opportunities should be exploited. These answers are important, **because the reaction function, the payoff-profile as well as costs can differ materially between solutions**. For deeper insights into costs and benefits see an AQR paper (Tail Risk Hedging: Contrasting Put and Trend Strategies), discussing the difference between trend following strategies and options as well as a Newfound Research paper (Heads I Win, Tails I Hedge) showing different tactical approaches to option overlay strategies.

For those investors looking to deploy a more medium-term strategy, a Long/Short futures position in EUREX futures on iSTOXX Europe factor futures can be a suitable option as well. As the chart shows, a strategy of going

**Long : Carry, Low Risk, Quality and**
**Short : Value, Size, Momentum**

performed quite well and their diversification properties increased over time while classical government bonds and gold lost diversification benefits, unfortunately when most needed.



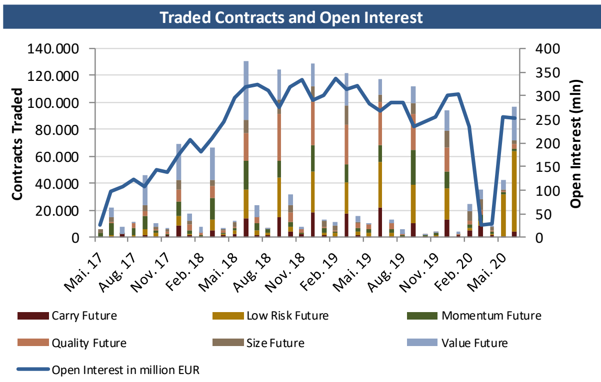

Moreover, as most strategies suffer from materially changing equity betas or deltas, **the future strategy offers a more balanced approach to diversification**, because the betas of all factor indices a continuously (monthly) rebalanced to an ex ante beta of one to STOXX 600 Europe and even realized betas don´t change as much as for example the betas of sectors, which are subject to considerable variation over time.

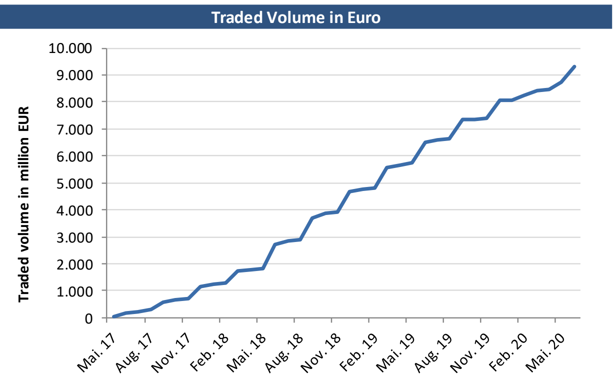
**Conclusion:**

**The Long/Short futures strategy offers an easy to implement and cost-effective way to diversify equity risk**, especially with respect to corporate- and high yield bonds as selling these positions is quite difficult in times of drawdowns (high bid/ask etc.) and CDS are impossible to implement for a lot of investors.

**EUREX Futures**

Open interest recovered from a significant drop doe to the virus outbreak in March and April to levels above 250mln. The graphs show development in traded contracts, open interest and overall traded volumes since introduction in May 2017. The traded volume exceeded 9 bln Euros.




**Factor performance**

All factors outperformed during the second quarter of 2020. Size led the table, outperforming by 3,98% followed by Quality (+1,99%) and Carry (+1,96%). Value is still suffering by a challenging economic environment and ranked at the bottom (+0,16).

# Alpha Centauri Indexing - Data as of 30.06.2020

<u>Description:</u>

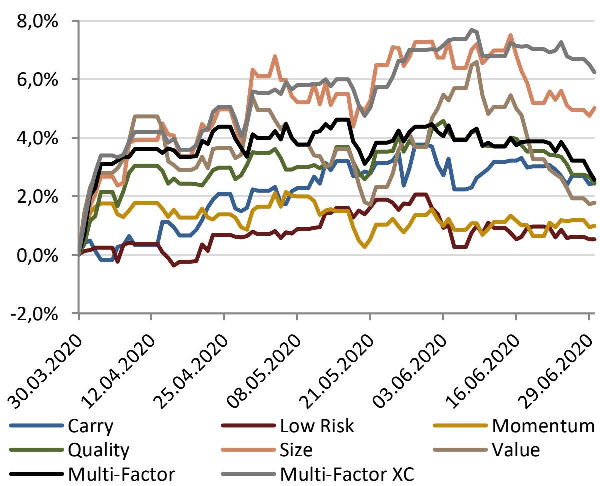
The iSTOXX Europe Single Factor index family developed by STOXX in collaboration with Alpha Centauri offers investors a unique and very innovative way to target and capture premia.
It consists of six single factors that aim to capture well-known risk premia and one multi-factor that aims at simultaneously capturing premia from the aggregate of all single factors rather than from just one source of risk alone.
All indices are constructed to maximize the exposure to their particular factor and minimize unwanted risks. While constructing the final indices the FIS APT risk model is used to measure and restrict risk.

For more information go to **www.alpha-centauri.com** or **www.stoxx.com**

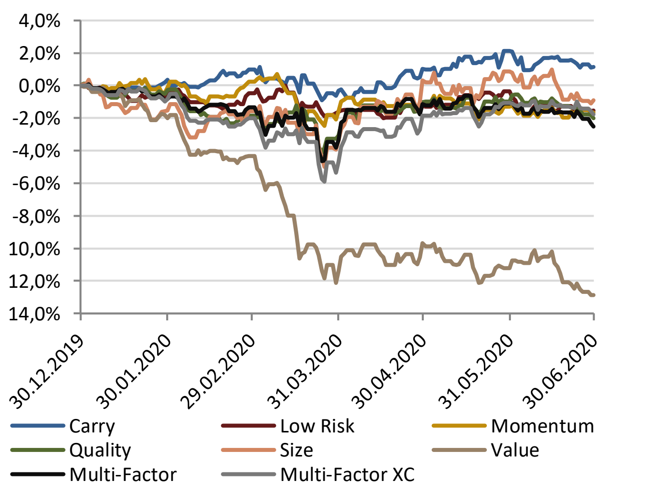
## Performance and Volatility Breakdown

| Name | Ticker | Return 3 Months | Return 6 Months | Return 12 Months | Return Live (1.4.) | Vola pa | Vola pa Live (1.4.) |
|---|---|---|---|---|---|---|---|
| **Carry** | ISECFER Index | 17,8% | -11,1% | -6,2% | 30,2% | 17,6% | 17,0% |
| **Low Risk** | ISERRER Index | 15,9% | -13,7% | -6,7% | 26,3% | 16,5% | 16,1% |
| **Momentum** | ISEMFER Index | 16,4% | -13,9% | -5,6% | 18,6% | 17,3% | 16,7% |
| **Quality** | ISEQFER Index | 17,8% | -14,2% | -6,8% | 18,1% | 17,2% | 16,7% |
| **Size** | ISEZFER Index | 20,4% | -13,1% | -8,7% | 16,4% | 17,0% | 16,5% |
| **Value** | ISEVFER Index | 17,1% | -25,0% | -19,8% | -3,9% | 18,8% | 18,3% |
| **Multi-Factor** | ISEXFER Index | 17,9% | -14,7% | -7,9% | 11,3% | 16,5% | 16,0% |
| **Multi-Factor XC** | ISEXFCR Index | 21,6% | -14,0% | -6,4% | 15,5% | 16,8% | 16,2% |
| **Benchmark** | SXXR Index | 15,4% | -12,2% | -4,3% | 22,0% | 17,7% | 17,1% |

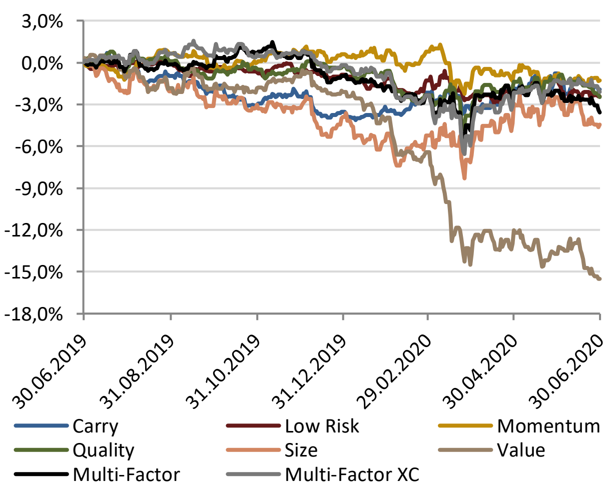
## Excess Return 3 Months




## Excess Return 6 Months




## Excess Return 12 Months




## Excess Return since going Live (1.4.2016)