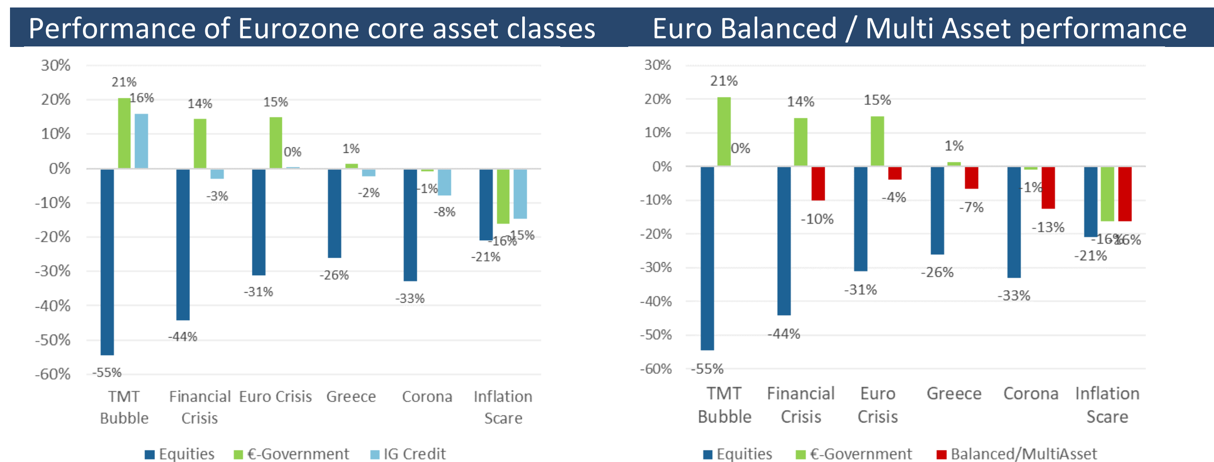
ALPHA CENTAURI

Riskpremia – Made in Germany

If the "golden age of diversification" is over – factors to the rescue?

2022 delivered final evidence for most investors globally, that **government bonds don´t deliver diversification anymore**, something which was already observable within the Eurozone since the 2015 Greece crisis. **Higher inflation rates finally changed the stock/bond correlation**, which has been negative since the triple Asia-/Russia-/LTCM crisis 25 years ago. At that time, inflation expectations - and realized inflation rates - moved towards or lower than the 2% target inflation rate of many central banks and provided **a "golden age of diversification"**. But that age might be over – at the least for the time being.



Source: Bloomberg/ Alpha Centauri calculations

The loss of diversification, which led to larger drawdowns in Balanced and Multi Asset portfolios for a second time (after the Corona shock in 2021) than during the financial crisis, brought renewed interest in **"risk mitigation strategies"**. The low interest rate environment led many investors towards **diversifying into illiquid asset classes like private equity and private debt** over the last couple of years- and **in liquid space, Global Macro-, Trend following/CTA-strategies rank high in discussions with clients as well as protection buying.** Alternative risk premia and equity factors are some of the opportunities, which are considered by investors as well when thinking about alternative sources of diversification beyond bonds and we´ll take a closer look on equity factors in this context.

From our point of view, **investors should become clear about their goals first** when thinking about diversifying strategies, because quite often, realized results differ materially from expectations, which in turn leads to forced liquidations – in many cases just before it finally pays off to be invested in a diversifier. We think, **these strategies can be broadly grouped into three categories:**

- **“Return enhancers”** like private equity and private debt, which can provide higher returns than their liquid counterparts, but their diversification benefits seem to be limited to “mathematical diversification” due to lagged pricing. **Economically they are illiquid versions of equity- and credit risk.** Sooner or later, fundamentals will apply.

- **“Negative beta providers”,** which can be divided into **two subgroups – permanent and temporary**. **Permanent negative beta** comes with a cost in form of a loss of equity risk- or variance risk premium (i.e. put option, long volatility etc.). **Temporary or variable negative beta** can be achieved via Global Macro- and Trend following strategies among some others. The resulting **payoff profile is reflecting optionality as well as it resembles a long straddle/strangle**, i.e. making money on both sides of market developments. These strategies **work well in persistent trends and typically lose money during sideways markets and around turning points** (top/bottom), as most of these strategies are not adaptive enough during these types of market environments.
  One important thing to consider in these strategies is, that investors are **exposed to additional beta compared to strategic allocations during upward trending markets** as these strategies are long market risk (or short volatility). Turning points around tops can be quite painful due to this leveraged position.

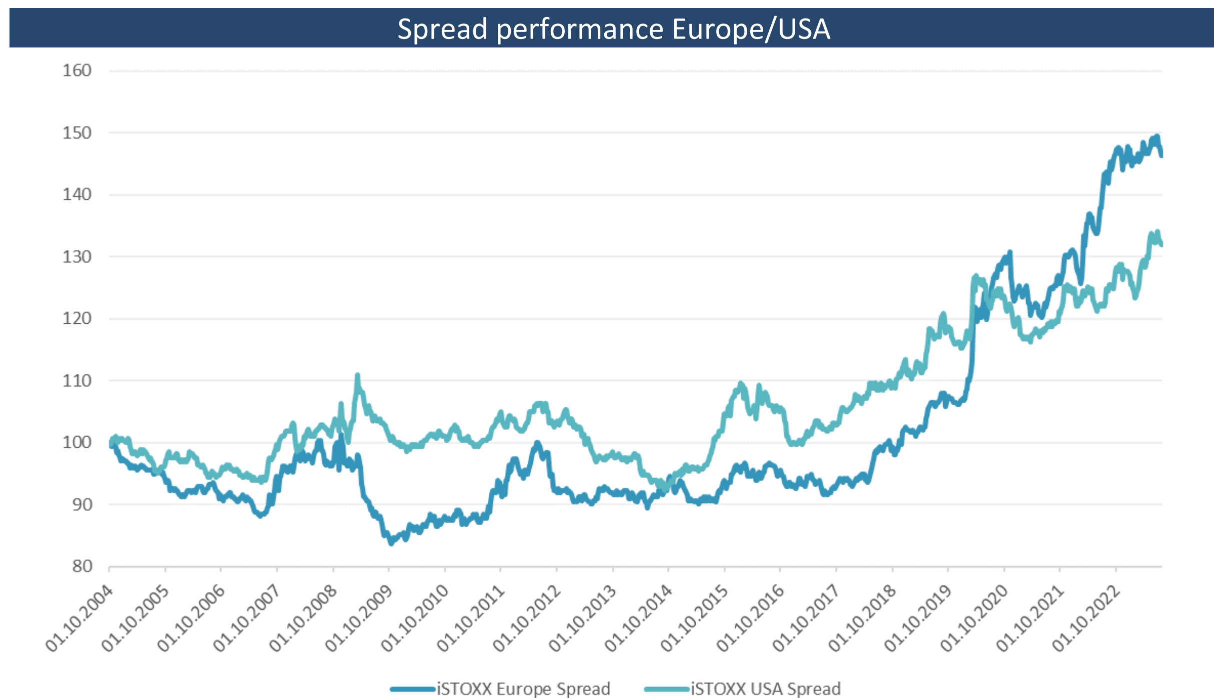
- **Independent sources of returns and risk**
  Market neutral strategies are another category, which are considered when thinking of alternative diversifiers. But a lot of market neutral or long/short strategies exhibit a structural long bias and in this sense are basic asset class risk (with lower volatility) in disguise, which **can be replicated by a combination of an asset class in question and cash**. Moreover, investors should be aware of the fact, **that even an uncorrelated exposure “on average” in the long term can turn into a correlated exposure in the short term, even if there is no economic causation per se**. It is the opposite of the old saying: “correlation doesn´t equal causation”.

Liquid alternative risk premia and equity factors provide a broad spectre of opportunities but a lot of them shouldn’t be considered as a “true diversifier” to equity-, credit or interest rate risk. Variance risk premia strategies are one example as variance risk is as basic part of all asset class risk premia and the drawdown profile is a mirror image of that. That doesn´t make variance risk a bad investment per se, but economic background and drawdown profile are not suited to deliver diversification just when it is needed. The same is true for many carry premia- among others.

The track record of equity factors as a provider of diversification seems to be mixed in the long term despite the fact, that they worked well over the last couple of years. We already elaborated on the opportunities during the Corona crisis in a Quarterly entitled *“Risk Mitigation using EUREX Factor Futures”* . In this publication, we built a position in iSTOXX Europe factors with:

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

basically, a combination of more “defensive” factors vs. those, who are deemed to be more positively correlated to economic- and earnings cycles.



Source: Bloomberg/ STOXX/Alpha Centauri calculations

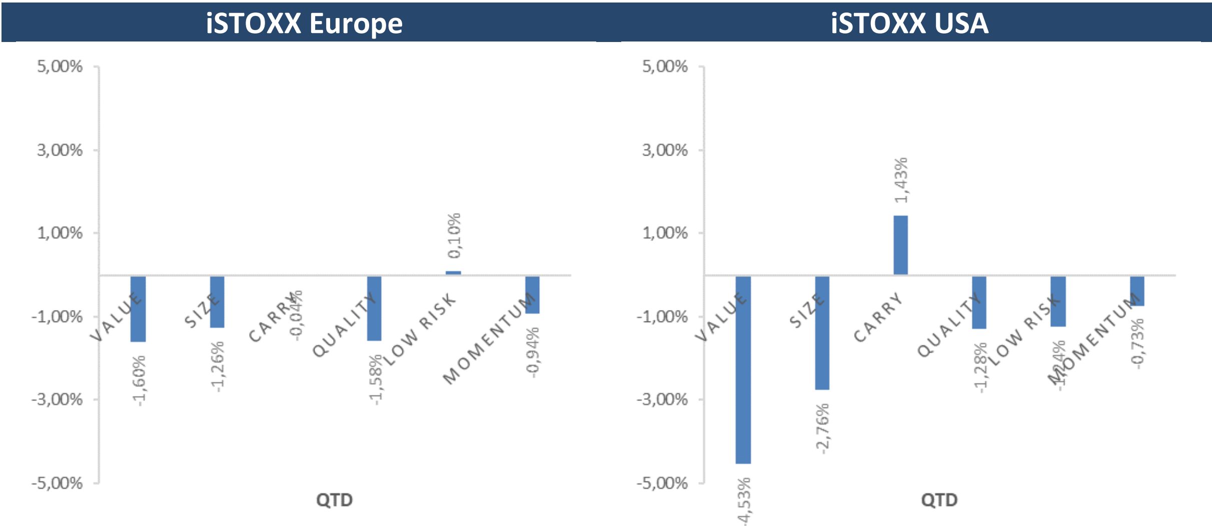
When looking at the performance of this combination, one can observe, that until 2017, the positioning lived up to expectations during phases of market stress - but gave up most of the gains after markets calmed down. Since then, the defensive position started to outperform even beyond stressed markets. But **investors shouldn´t extrapolate this result indefinitely.** Value and Size underperformed massively on both sides of the Atlantic since then due to the rush into “large cap growth”. Even Momentum suffered from a reduced opportunity set as only a small group of stocks gained, while most stocks delivered low returns or even losses. Over time investors should expect this position to deliver similar economic results as it is the case with sectors: **in the long run, the (out-) performance of all “purified” factors should be the same.**

Conclusion:

- Factor spreads can help to diversify Balanced/Multi asset portfolios.
- Opportunities seem to be limited without active management.
- Factor rotation strategies can help to improve results, but some important topics should be considered
- Finally and most important: **“Diversify your diversifier” as nothing works on all occasions.**

Factor performance

Due to continued large cap outperformance, the overall factor performance was quite weak during the second quarter of 2023. Low Risk in Europe and Carry within the US delivered marginal positive results while all other factors underperformed. US Value suffered the most as the “magnificent seven” stocks provided nearly 100% of the performance of the largest 500 companies in the US while 493 stagnated on average.



Alpha Centauri Indexing - Data as of 30.06.2023

Description:

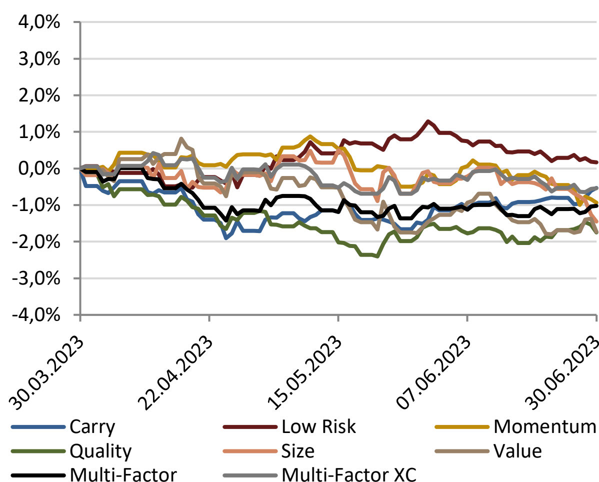
The iSTOXX Europe Single Factor index family developed by STOXX in collaboration with Alpha Centauri offers investors a unique and very innovative way to target and capture premia.
It consists of six single factors that aim to capture well-known risk premia and one multi-factor that aims at simultaneously 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**

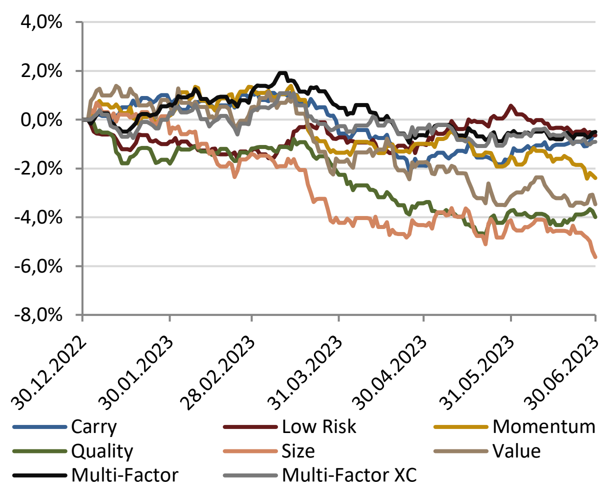
Performance and Volatility Breakdown

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	2,4%	10,2%	12,3%	74,7%	14,1%	13,7%
Low Risk	ISERRER Index	3,1%	10,2%	14,5%	76,8%	13,1%	12,8%
Momentum	ISEMFER Index	2,0%	8,5%	13,1%	57,2%	13,9%	13,6%
Quality	ISEQFER Index	1,2%	6,9%	10,8%	59,6%	13,8%	13,5%
Size	ISEZFER Index	1,5%	5,2%	1,9%	48,3%	13,7%	13,4%
Value	ISEVFER Index	1,2%	7,4%	5,0%	7,9%	15,0%	14,7%
Multi-Factor	ISEXFER Index	1,9%	10,4%	12,3%	52,2%	13,3%	13,0%
Multi-Factor XC	ISEXFCR Index	2,4%	9,9%	12,7%	55,8%	13,4%	13,0%
Benchmark	SXXR Index	3,0%	10,9%	16,5%	68,4%	14,2%	13,9%

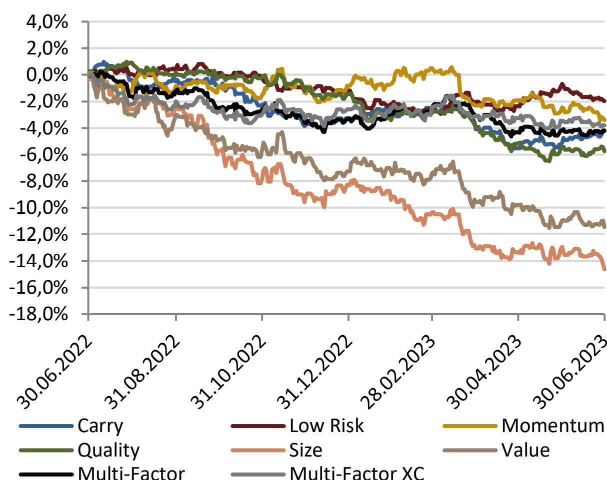
Excess Return 3 Months



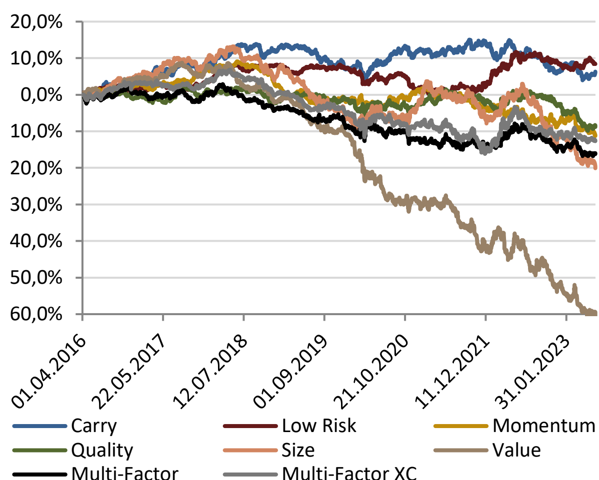
Excess Return 6 Months



Excess Return 12 Months



Excess Return since going Live (1.4.2016)



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