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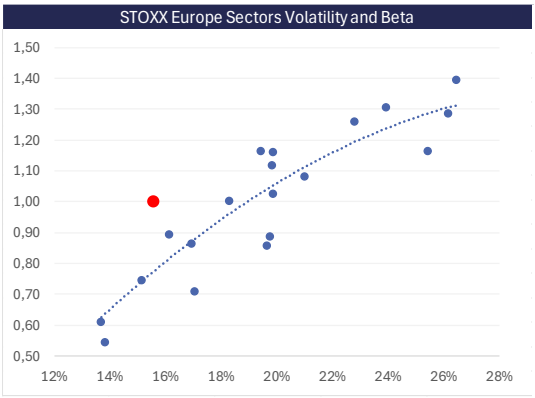
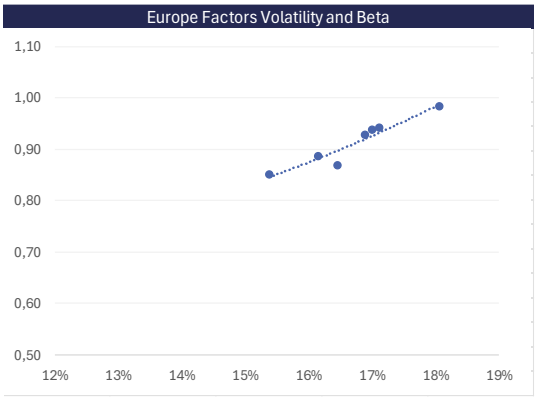
Factors vs. Sectors in Asset Allocation Decisions

With the ongoing weakness of government bond markets, liquid alternative strategies seem to come back in focus as Value and Momentum factors delivered double-digit excess returns in Europe and high single-digit outperformance within US during 2025. Apart from strategic considerations to invest in alternative risk premia and equity factors, exploiting tactical opportunities is one of the major questions quite often asked by investors. Within equities, "sector- vs. factor timing" has often been discussed among practitioners and academics as papers like "*Factors vs. Sectors in Asset Allocation: Stronger Together?"* (Briere/Szafarz) or "*Perspective: Asset Classes versus Risk Factors or Asset Classes and Risk Factors?"* (Page) among many others show. We discussed the opportunities and challenges of factor timing in 2019 in our Q3-quarterly entitled "Factor Timing and the "Fundamental Law of Active Management" and we believe, that the basic conclusions for factor timing are still valid.

When discussing sectors vs. factors, most investors seem to have factor indices (or products on those) of the larger index providers in mind – especially when talking about "value vs. growth" or "cyclical vs. defensive". As most of these offerings are "non- purified", which means they exhibit large sector-, country-, currency or other systematic risk factor bets compared to their benchmark, these factor indices contain large exposures to market-, growth- or inflation cycles. Consequently, the excess returns of these factors are highly correlated to those of many sectors and sector rotation is mainly a beta-play on the economic-, earnings- and market cycle. Viewed from this angle, there shouldn´t be any meaningful difference. But investors might consider additional points like:

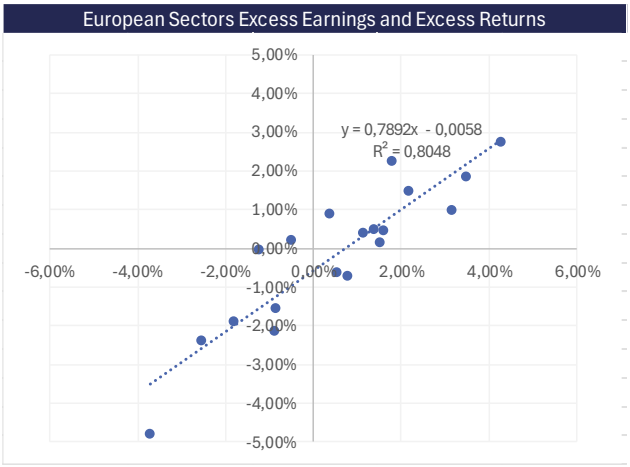
- sectors are spanning the whole market, which means they add up to market weight and every stock can only be a member of one sector; factors don´t span the market.
- the weighted sum of all sector betas is one compared to the market overall – but not for factors.
- the difference in volatilities and betas of sectors is materially higher than that of "purified factors". As the graphs show, the span between lower and higher volatility and beta of European sectors has been 13% in volatility- and 0,85 beta – points over the last 20 years on average while those of "purified factors" with respect to beta has been around 0,13. The red dot in the left graph represents market data.





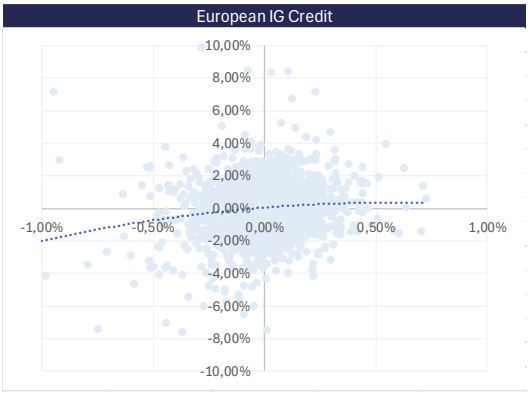
Source: Bloomberg; Alpha Centauri calculations

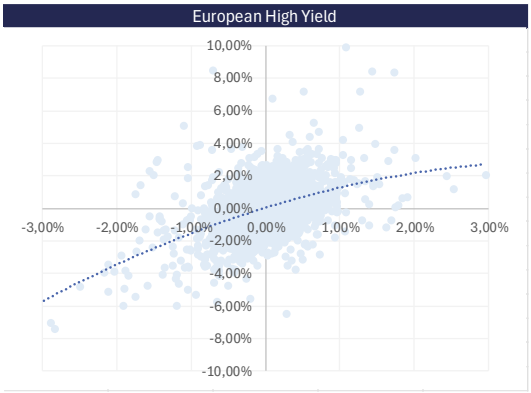
- factors provide “risk premia” beyond market risk – they are “paid risk factors”. Sectors shouldn´t provide excess returns in the long run but the variation might be quite high even for a decade or more. Sector excess returns are following excess earnings, which is not necessarily true for factors. In “*The race of our lives revisited*”, GMO researchers provide evidence with the performance of US sectors over the long run being more or less the same while the history for Europe over the last 30 years looks different. The correlation between excess earnings and excess returns is 0,90.



Source: Bloomberg; Alpha Centauri calculations

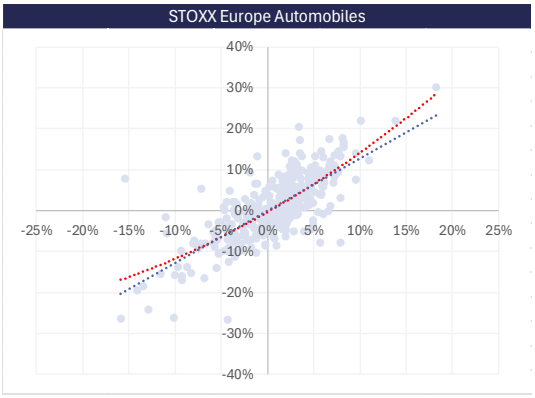
- according to Merton (Merton, 1974), “all liabilities can be replicated with options” where corporate bonds replicate a short put while equities display a long call profile with a strike price on the book value on a company’s assets. The graph shows the payoff structure of European investment grade credit and high yield.

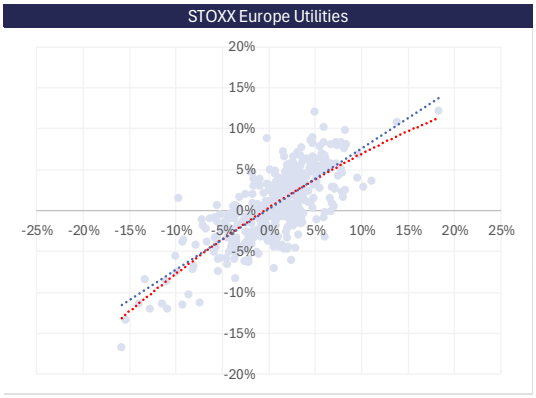




Source: Bloomberg; Alpha Centauri calculations

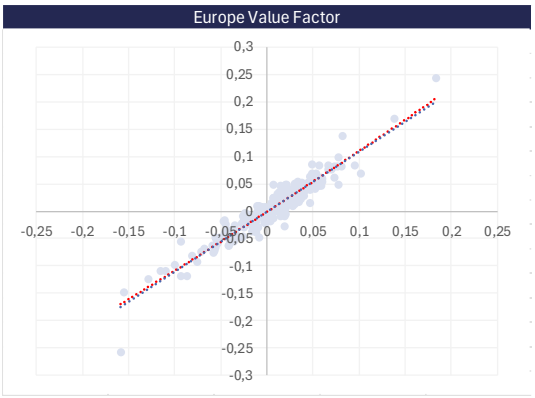
- the payoff of individual sectors – STOXX Europe Automobiles (left) and Utilities (right) in the graphs below show a convex – call option-like – picture for the former and a more concave – put option-like – profile for the latter. In a merely earnings- growth- driven environment and rising markets overall, the beta of more cyclical sectors rises while that of non-cyclical falls – and vice versa in drawdowns, which can be seen in the difference between a linear- and a non- linear line of best fit. Low volatility sectors resemble the behaviour of credit as they are next to corporate bonds when taking an additional step on the volatility staircase. That´s why they are called “bond proxies” quite often.

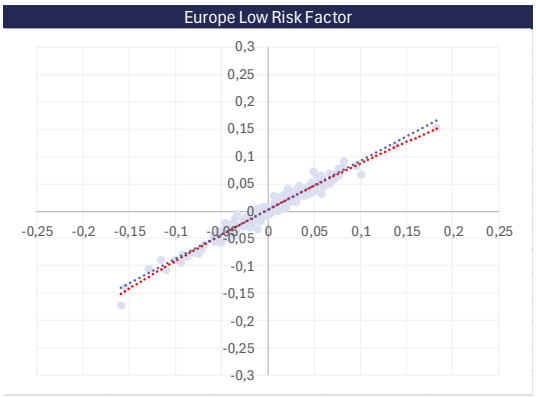




Source: Bloomberg; Alpha Centauri calculations

Looking at "purified factors", the picture is different, because these factors don´t exhibit the large risk bets in the direction of sectors, countries or currencies compared to benchmark. Thus, their pay-off profile is different – or more linear – in comparison to sectors or non-purified factors. The following graph shows European Value (left) and Low Risk (right).





- finally, the number of sectors is typically higher than the number of factors in a market. Theoretically and like the volatility- and beta-span, a larger opportunity set should provide more performance all else equal.

Conclusion:

From our point of view, sector rotation seems to be a better instrument for investors who either don´t use tactical asset allocation (i.e. equities vs. bonds or cash) to play market beta or who look to spread their bets down from asset allocation into asset classes. From an "opportunity set"- perspective, the number of sectors is higher, beta-span is wider, and convexity is more pronounced in rising markets for economic more sensitive sectors. Finally, liquid listed sector derivatives are available for Europe and US, which is not necessarily true for factors. Investors, who can work with both approaches might follow Briere/Szafarz:

"Our results show that sector investing is effective for reducing risk through diversification while factor investing is better for capturing risk premia and so pushing up returns. This suggests that there is room for potentially fruitful combinations of the two styles. Presumably, by combining factors and sectors, investors would benefit both from the diversification potential of the former and the risk premia of the latter."

Factor performance:

Value (+5,92%) and Momentum to a lesser extend continued to outperform in Europe during Q4/2025 while Quality (-6,04%) and Low Risk (-2,98%) faced heavy headwinds again. With these single-factor results, December displayed a mirror image of the whole year in Europe in which Value (+18,8%), Momentum (+22,23%) and Multifactors (+18,54%) delivered high double-digit excess returns.

Within US, only Value maintained its recent streak of outperformance during the quarter, gaining +4,41% for a full year excess return of +9,32%. Momentum lost some of it´s 2025 dynamics and underperformed by -2,86% during Q4 for a full year excess return of +8,41%. Low Risk held the red lantern with a quarterly excess return of -1,85% which finally drove ytd. excess returns into negative territory – the only underperforming factor within US in 2025.

Source: STOXX; Alpha Centauri calculations

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