Amundi ASSET MANAGEMENT | Smart Beta

Viewpoint

# Risk Premia investing: Covid-19 outbreak and beyond

Covid-19 outbreak unfolded one of the most severe crises of the past decades, with a brutal change in market conditions, rapid emergence of dislocations and major changes in investors' positioning. **Periods of severe stress often lead to a scarcity of diversification at a time when it is most needed.** This is due to the well-documented polarization of traditional asset classes during crises, which tend to behave either as risky-assets with equity-like properties or as safe-havens with bond-like properties.

Contrarily to traditional risk premia that are long-only, **Alternative Risk Premia (ARP) are long/short portfolios building dynamic exposures within or across asset classes. Their potential for decorrelation as individual risk factors is therefore higher than for traditional assets.** These features explain the growing adoption of ARP over the recent years, as most investors are seeking to increase diversification in their portfolios. Although they are assumed to be robust and to exhibit low correlations over the long run, ARP can, as any other investment strategy, underperform during specific periods of time.

| Risk free | Market Risk Premia<br>Long-Only | | Alternative Risk Premia<br>Long & Short | | | α |
|---|---|---|---|---|---|---|
| | Equity<br>Risk Premia | Bond<br>Term Premia | Carry | Trend | Style | |

Market Risk Premia and Alternative Risk Premia. Source: Amundi.

In this viewpoint, we provide a short review of ARPs' behaviour during the Covid-19's outbreak, questioning their diversification benefits across premia and over time. We also propose some insights on the performance of Alternative Risk Premia funds.

## Alternative Risk Premia: consistent behaviour amid extreme conditions

Covid-19 outbreak has been challenging for Alternative Risk Premia, as most strategies exhibited significant drawdowns over the period. Against this backdrop, we aim to analyse ARP results - relying on Amundi proprietary risk premia framework - from both an absolute risk/return perspective and from a portfolio construction angle.

Overall, Alternative Risk Premia managed to absorb in a rather consistent and resilient manner the Covid-19 outbreak. **Although negatively affected by the recent events, it is reassuring to note that ARP strategies behave in line with expectations during extreme market conditions.** Eventually, we believe that Alternative Risk Premia's losses over Q1 2020 are consistent with the underlying nature of the strategies as well as their historical results. Furthermore, beyond the initial shock, most ARP have proven to be robust in the subsequent phase from mid-March to end-September. This said, **multiple performance patterns have been observed during market recovery**.

First, we can easily notice that the **magnitude of drawdowns is directly linked to the degree of directionality of each ARP strategy**. Particularly, Trend-following strategies, that are taking directional (long and short) positions across markets, are usually more sensitive to short term volatility spikes than Style Premia, which seek to extract performance via ensuring market neutrality at all time. Carry's relative resilience during February-March 2020 is surely more interesting, especially as Carry drivers are often compared to selling insurance policies and one could expect them to suffer significantly amid such market context of a Covid "black swan". Here **we would like to highlight that our proprietary Volatility Carry strategy has proven to be an important diversifier and posted positive returns over the period**.

A second observation can be drawn comparing recent losses to the historical behaviour of ARP strategies. We see that **Trend is the only strategy slightly exceeding**

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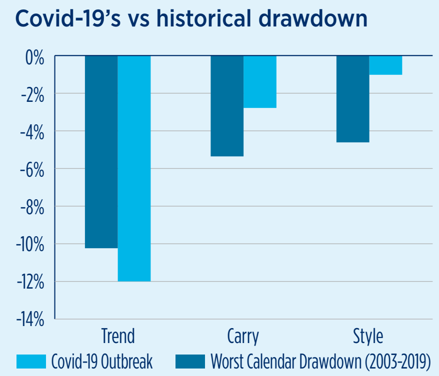
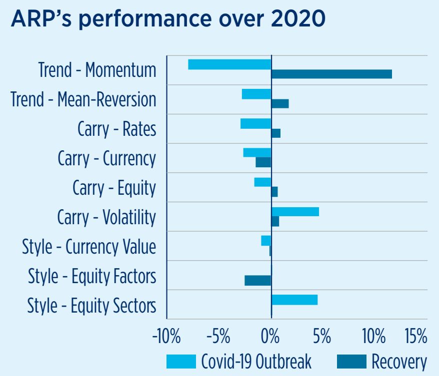
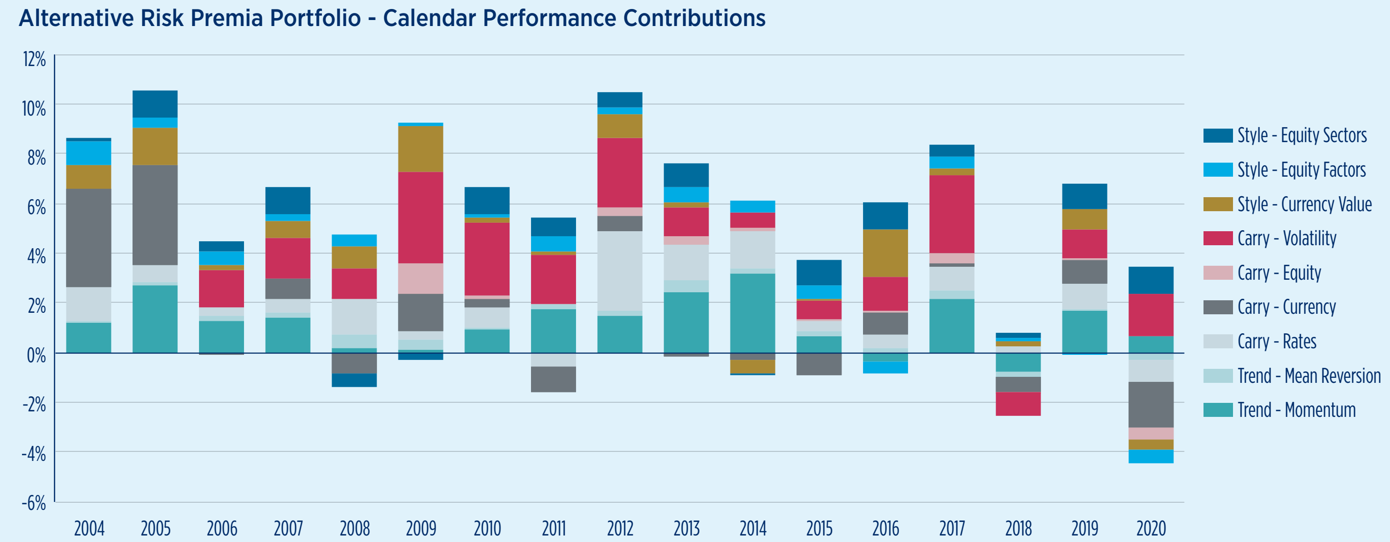
**its maximum-recorded calendar drawdown (2003-2019) on the Covid-19 episode, while Carry and Style are clearly below.** Also, during the Covid-19 outbreak, Trend strategies lost their golden status of "best diversifier" acquired during the 2008's Global Financial Crisis. However, this was to be expected as, with a brutal market reversal following an "ultra-bull" market, it is often the case that Trend does not act as a diversifier: clear examples are the 2013's "Taper Tantrum" or the February 2018's volatility shock.

Beyond the period spanning between February and March, one should also investigate ARP's behaviour during market recovery. Notably, Trend-Momentum managed to recover rapidly, and the strategy even exhibits a positive performance in 2020 at the end of Q3. A different pattern can be observed looking at long-short equity factors portfolios. After proving to be a steady diversifier amid market collapse, **Style premia tend to detract performance during the recovery period, mostly due to a significant underperformance of Value and Low Volatility.** While 2020 provides a good example to illustrate the compensation effect across ARP strategies, looking at historical results remains key. We show below the calendar performance contributions of an ARP portfolio with a fixed allocation across strategies. From our point of view, this highlights that **the degree to which ARP diversify across market cycles tends to be higher than for traditional asset classes, conditional on a proper portfolio diversification.** Indeed, building exposures to multiple independent performance drivers is paramount in order to maximize chances to reach effective diversification, considering these would be affected differently depending on the nature of the market stress. It is also interesting to note that even if 2018's market stress was less brutal than 2020, it remains one of the very few periods of time where diversification did not play across Alternative Risk Premia. Although such scenario has to be kept in mind, **the last quarters have reinforced our core belief that ARP are and will remain an importance source of diversification for investors.** ■




Source: Amundi, as of September 30th 2020. Given for illustrative purpose only. Simulated performances and drawdowns are a front estimate, gross of fees and net of estimated transaction fees, based on Amundi proprietary risk premia strategies. Past performance is not a guarantee or a reliable indicator for current or future performance and returns.




Source: Amundi, as of September 30th 2020. Given for illustrative purpose only. Simulated performance contributions are a front estimate from Structura Alternative Risk Premia simulated portfolio, gross of fees and net of estimated transaction fees, based on Amundi proprietary risk premia strategies. Past performance is not a guarantee or a reliable indicator for current or future performance and returns.

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## How to read ARP managers disparate results?

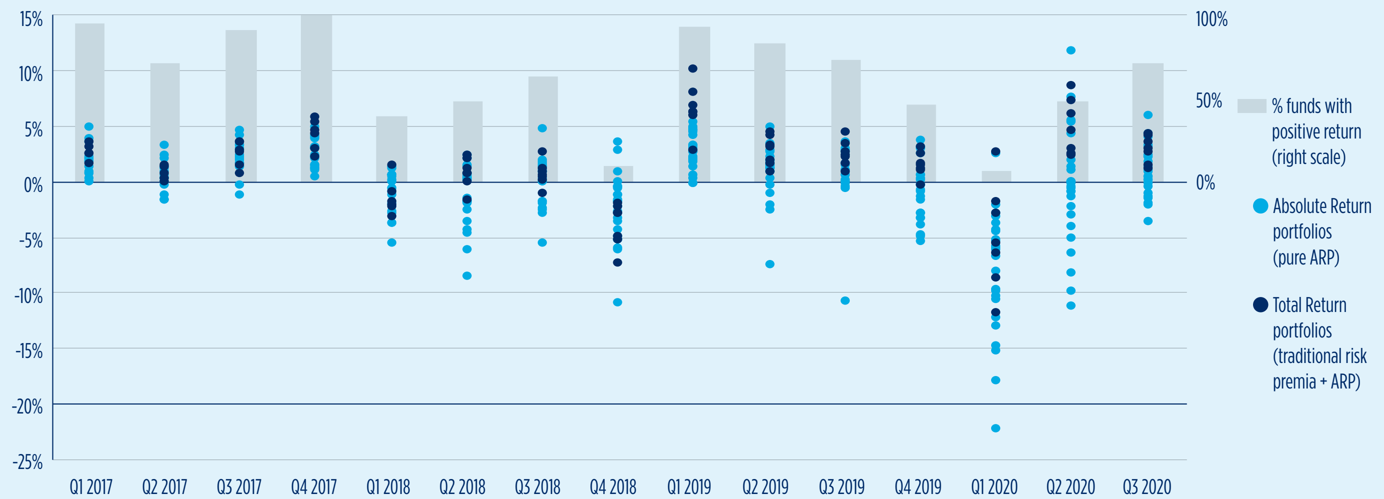
While some risky assets returned near historical highs, the last 3 years have been challenging for Alternative Risk Premia strategies. Considering disparate results across managers and the large spectrum of available products, some investors began to question their ARP investments. Nonetheless, overall appetite for alternative assets remains solid amid ultra-low yield environment and persistent uncertainty. We believe the recent period provides keys to analyze ARP strategies, hence strengthening investors' due diligence process.

**Although most Risk Premia managers posted negative returns during Covid-19's outbreak, the majority managed to contain losses.** Over Q1 2020, the median performance of our internal peer group of 30 funds was near -6.5%, with approximately 1/3 of the strategies experiencing returns above -5%. However, a few strategies have been significantly impacted by the brutal market dislocation, and exhibit returns in line with traditional risky assets.

It is interesting to note that the **worst performers are not necessarily portfolios mixing traditional and alternative risk premia, but pure ARP strategies** - supposed to be more market neutral. Although leverage can be at play here, we believe that some "hidden" tail risks - such as illiquidity risk - materialized and contributed to increase losses over the period. Beyond realized performance, liquidity, transparency and time-consistency of ARP strategies have been key elements for investors. Following this idea, research-driven managers implementing proprietary methodologies may have a competitive edge.

To some extent, **we believe recent developments would reinforce the dichotomy between "academic-driven" ARP managers** - primarily harvesting well-established Premia across liquid markets via rule-based methodologies - **and "market practitioners"** - primarily driven by alpha generation leveraging managers' skills.

**Risk Premia Portfolios - Quarterly returns since 2017**




Source: Amundi, Thomson Reuters Datastream, as of September 30th 2020. Given for illustrative purpose only. Performance are net of fees in USD. Internal universe of 30 mutual funds, representative of Multi-Asset Risk Premia strategies. Past performance is not a guarantee or a reliable indicator for current or future performance and returns.

Beyond the Covid-19's outbreak, **it is important to highlight the extreme disparity of ARP funds' performances during the following market recovery, especially as it differs significantly from the pattern observed during market recovery in H1 2019**. Over Q2 and Q3 2020, nearly half of our panel of funds posted negative performance (vs only 16% in 2019, when most strategies participated to market rebound). From our point of view, several elements could explain the dispersion among managers. First, it is important to distinguish the strategies according to their investment outcome (e.g. total return vs absolute return) and associated degree of market directionality. Indeed, total return approaches mixing traditional and alternative risk premia tend to experience higher exposure to "beta" vs pure ARP / market neutral portfolios. Therefore, these **total return approaches tend to better capture the market recovery vs the latter**. Furthermore, one should also pay attention to specific risk management techniques implemented by managers. In some cases, systematic de-risking might have negatively affected the road to recovery, especially when applied at the overall portfolio level.

Eventually, **the allocation across Risk Premia might be an important factor explaining performances' discrepancy over the recent period**. While some managers seek to provide a risk-balanced allocation across multiple performance drivers, some portfolios might exhibit a preference for a specific ARP. As an example, a portfolio tilted toward Equity Value (long/short) would have been penalized over the last few months, while Carry-driven approaches would have experienced a relatively smooth recovery and Trend-followers recoup losses more rapidly. ■

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## Conclusion

While traditional assets re-correlated significantly between February and March of this year, **Alternative Risk Premia strategies experienced a less polarized behavior,** thus constituting an optimal source of diversification for investors. More importantly, it was verified that major academic Premia behave as expected amid extreme market environment.

**Current market conditions still advocate for increasing portfolios' diversification, and we believe that ARP are and will remain an important tool for investors to do so.** From our point of view, having a clear taxonomy and a risk-driven approach is paramount when it comes to designing strategic allocation. We believe that a well-diversified portfolio should allocate risk across beta and alpha drivers, across multiple payoffs. **Favoring liquid and transparent methodologies is also key when selecting ARP managers.** As the ARP market develops and matures, investors have more and more concrete elements to improve their due diligence process. In that sense, we are convinced that 2020, as 2018, will remain an important marker for Alternative Risk Premia.



Amundi Asset Management, French "Société par Actions Simplifiée"- SAS with capital of €1 086 262 605
Portfolio Management Company approved by the AMF under number GP 04000036
Registered offce: 90, boulevard Pasteur - 75015 Paris – France - 437 574 452 RCS Paris.

Design and production: Amundi Design Studio - Communication Department - November 2020.

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