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Factor Strategies and Market Cycles

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Motivations

Factor strategies

1. Assign portfolio weights to persistent drivers of returns
2. Low correlation to traditional asset classes
3. Low correlation amongst themselves

Diversification \neq perfect hedge

- How to manage your expectations or explain underperformance?

Account for market cycles

1. Major drawdowns
2. Cyclical fluctuations
3. Secular changes

Factor Strategies Beyond Smart Beta

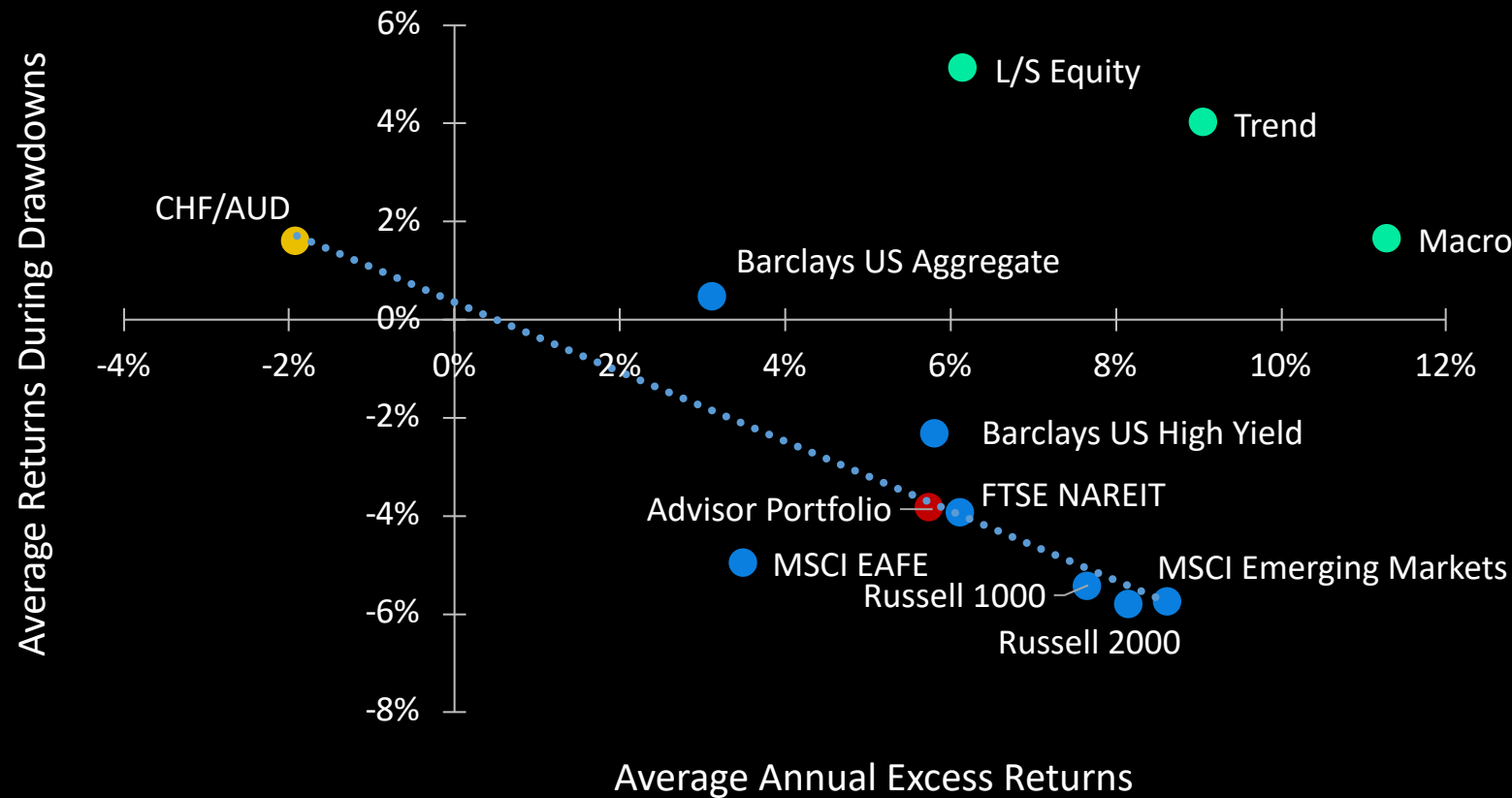
Principles of factor investing extends to alternative investments

	TREND	MACRO	LONG/SHORT EQUITY
MARKETS	Equity Indices, Bonds, Foreign Currencies, and Commodities	Equity Indices, Bonds, Foreign Currencies, and Commodities	Individual Stocks
STYLES	Time-Series Momentum	Carry and Value	Value, Momentum, Size, Quality, and Low Volatility
TYPE OF BETS	Market Timing	Security Selection	Security Selection

Stock Market Drawdowns

Factors Can Offer a Wonderful Hedge

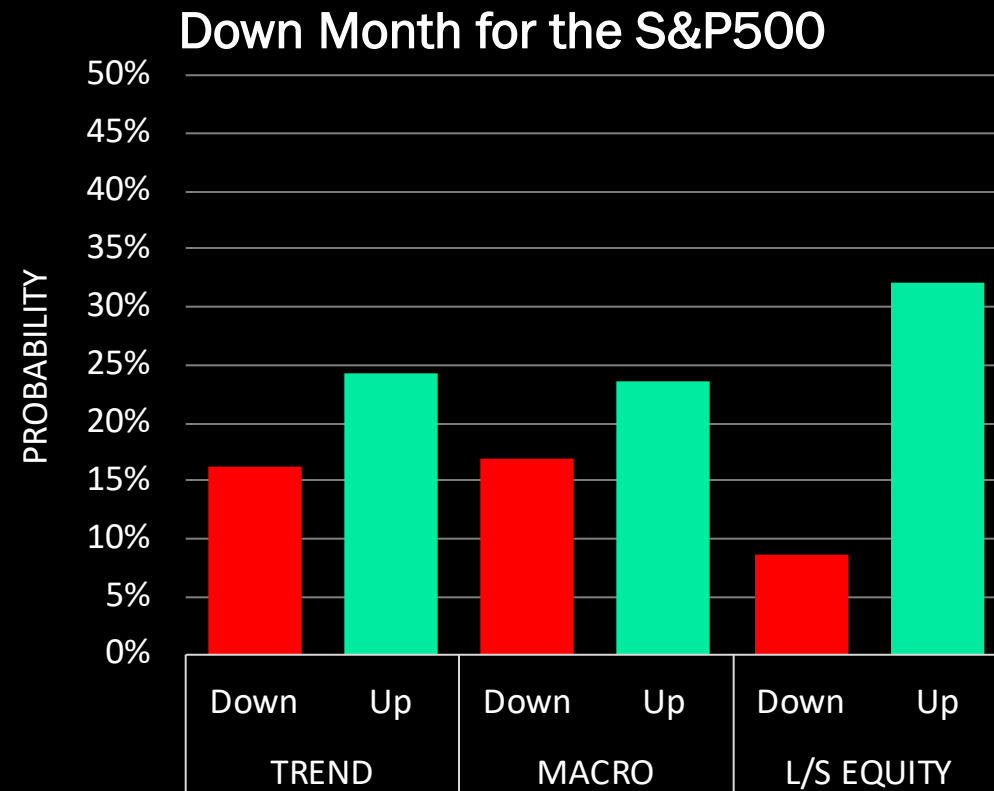
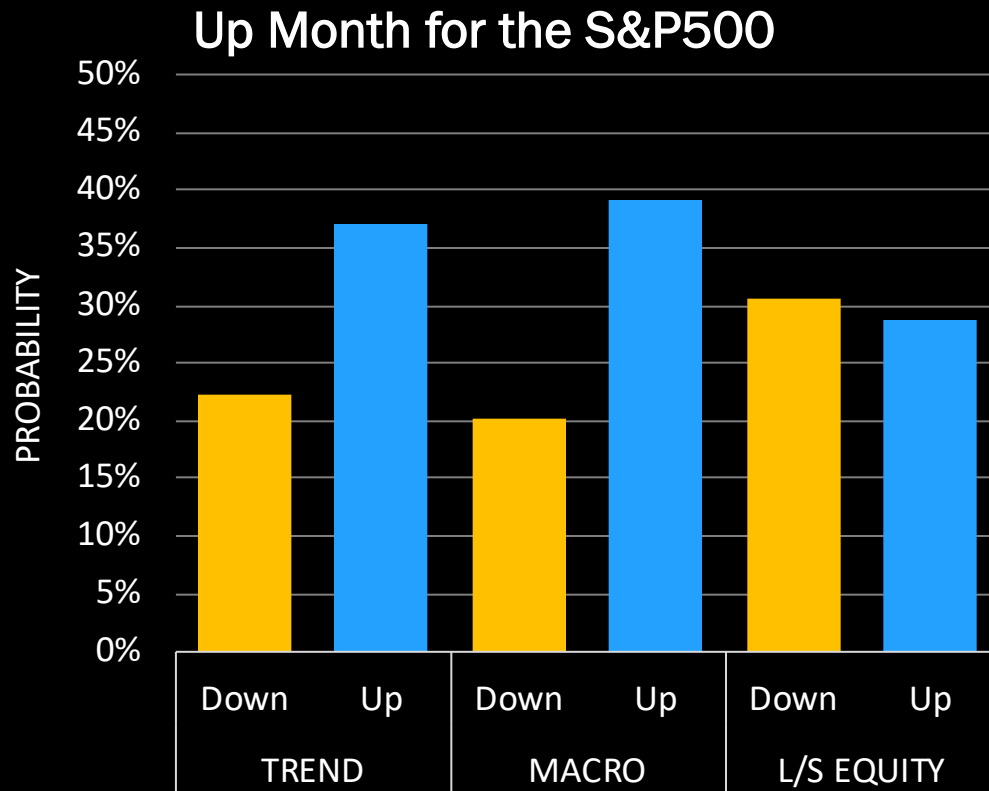
Select the 5 largest S&P500 drawdowns (1989-2018)



Notes: the Advisor Portfolio is composed by an allocation of 26% to Russell 1000, 7% to Russell 2000, 26% to MSCI EAFE, 7% to MSCI Emerging Markets, 22% to Barclays Aggregate, 6% to Barclays High Yield, and 6% to FTSE NAREIT. The figure is based on simulations by Research Affiliates including data from January 1989 to July 2018. Source of the data is Datastream, Bloomberg, and Commodity Research Bureau.

Yet, a Diversifier is Not a Perfect Hedge

Factor underperformance can happen in up and down markets



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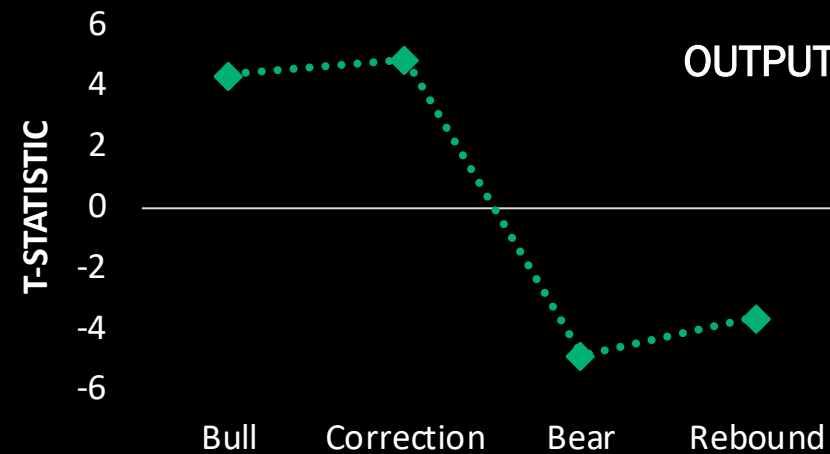
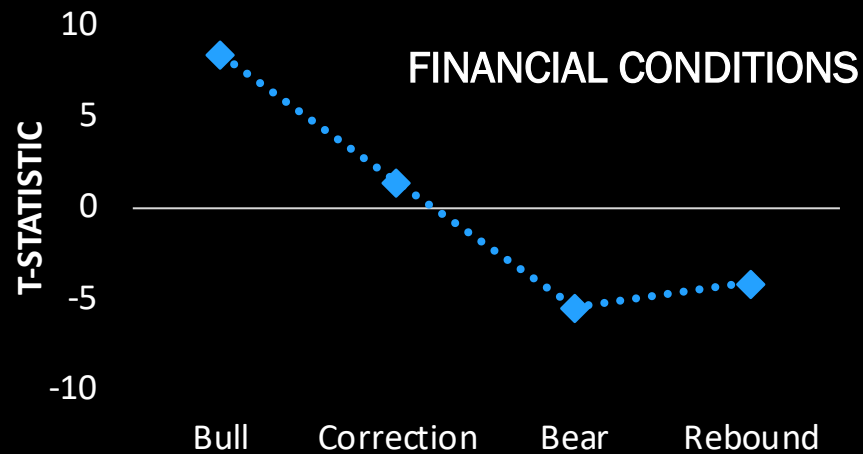
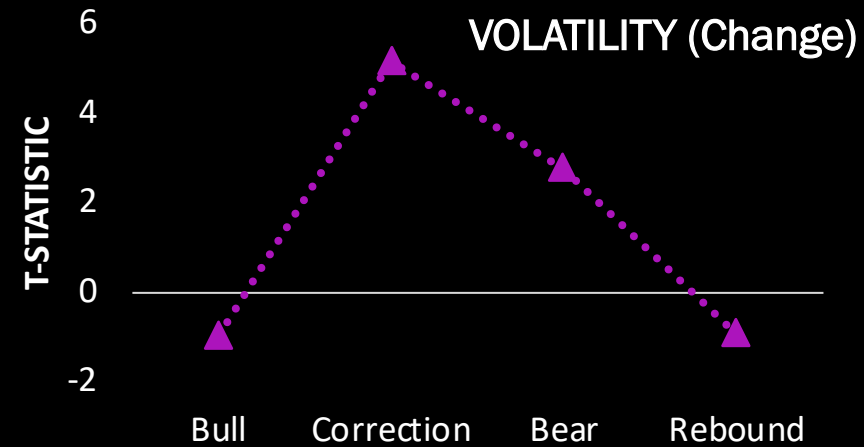
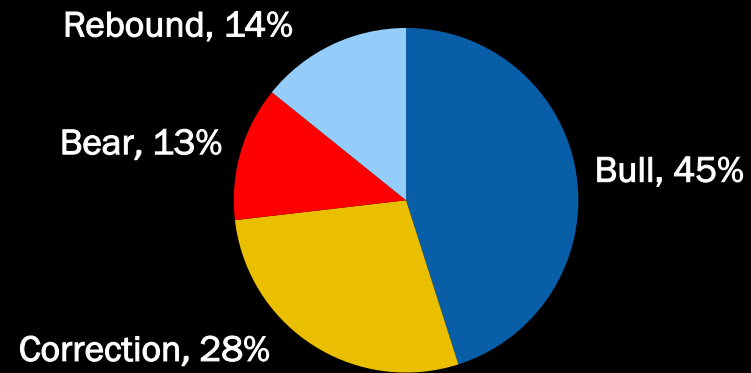
Market Cyclical Fluctuations

Defining Market Cycles

Cross two indicators based on S&P500 index returns

	12-Month Returns > 0	12-Month Returns ≤ 0
1-Month Returns > 0	<i>Bull</i>	<i>Rebound</i>
1-Month Returns ≤ 0	<i>Correction</i>	<i>Bear</i>

Market and Macroeconomic Cycles



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Factor Strategies and Market Cycles

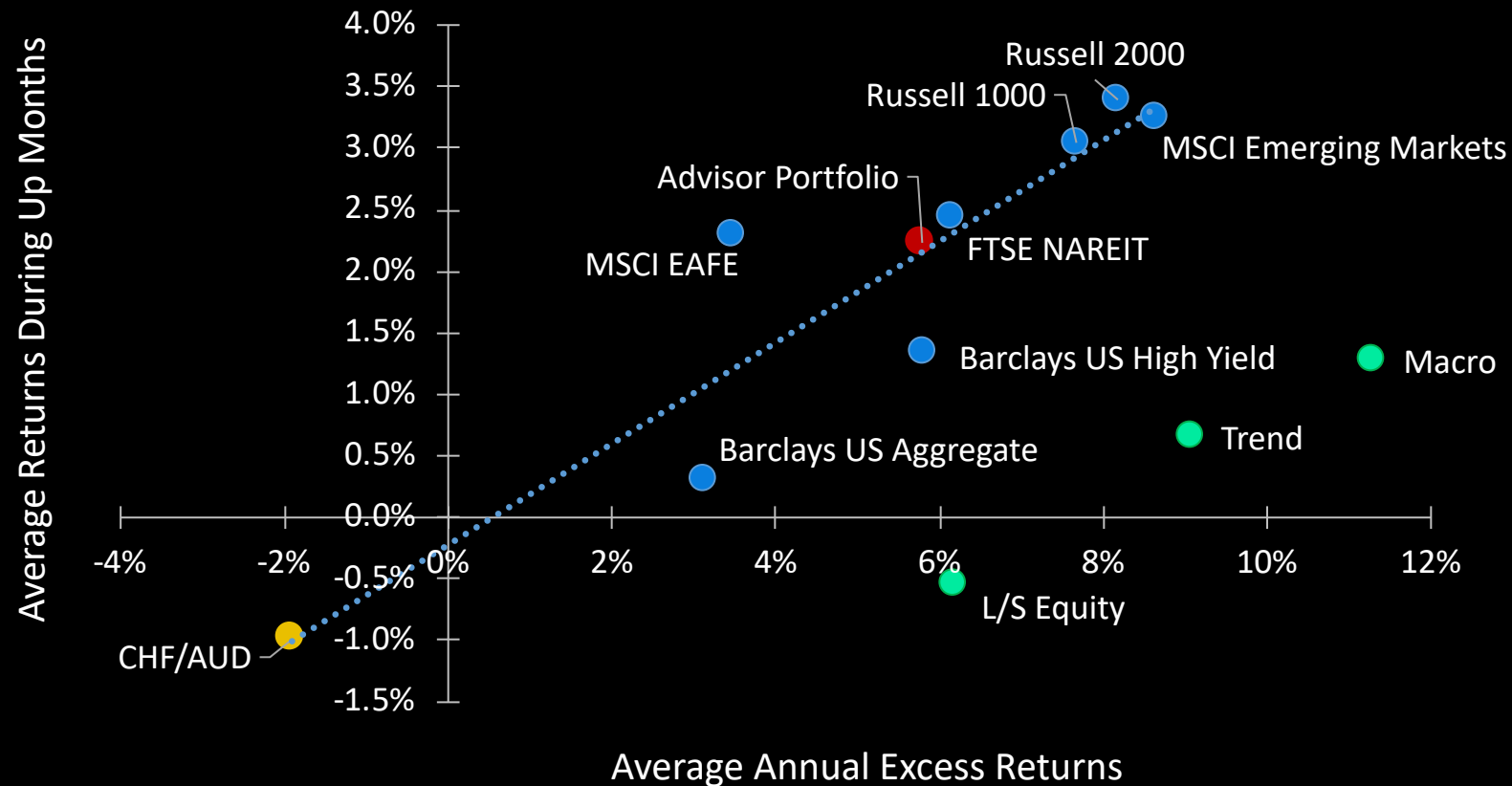
Sample period: 1971-2018

TREND	ALL	BULL	CORRECTION	BEAR	REBOUND
Excess Returns	8.4%	13.7%	0.59%	25.7%	-8.40%
T-Statistic	5.76	6.58	0.22	6.57	-2.27
MACRO	ALL	BULL	CORRECTION	BEAR	REBOUND
Excess Returns	9.94%	11.9%	1.26%	13.3%	17.8%
T-Statistic	6.88	5.60	0.47	3.31	4.71
L/S EQUITY	ALL	BULL	CORRECTION	BEAR	REBOUND
Excess Returns	8.07%	-0.57%	17.2%	44.2%	-14.6%
T-Statistic	5.29	-0.28	6.76	11.63	-4.09
ADVISOR	ALL	BULL	CORRECTION	BEAR	REBOUND
Excess Returns	5.81%	24.2%	-25.2%	-46.4%	39.1%
T-Statistic	2.61	11.1	-8.32	-8.78	8.07

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Bull & Rebound and Portfolios' Performance

Can you resist chasing performances during good times?

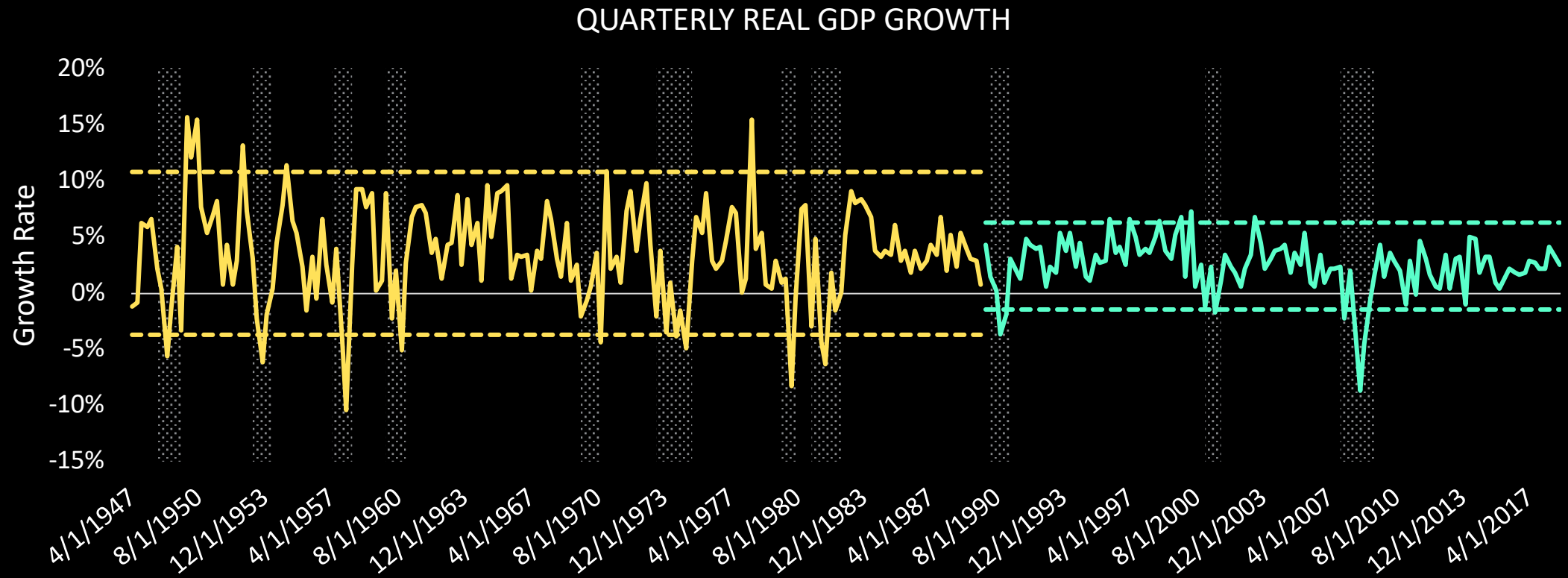


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Factor Strategies and Secular Changes

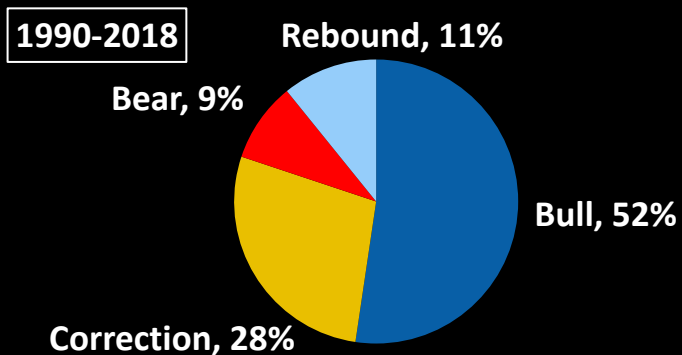
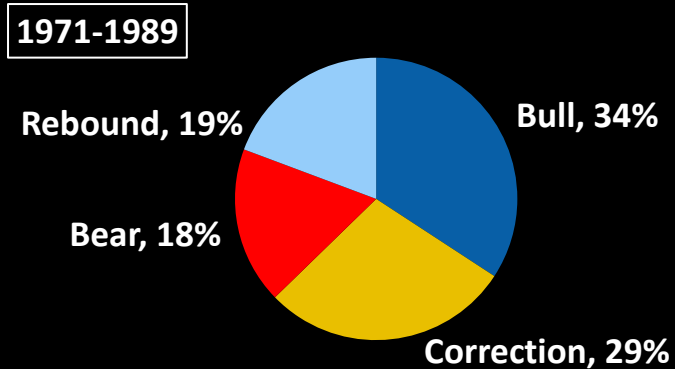
The Great Moderation is Real

Fewer recessions and lower aggregate volatility



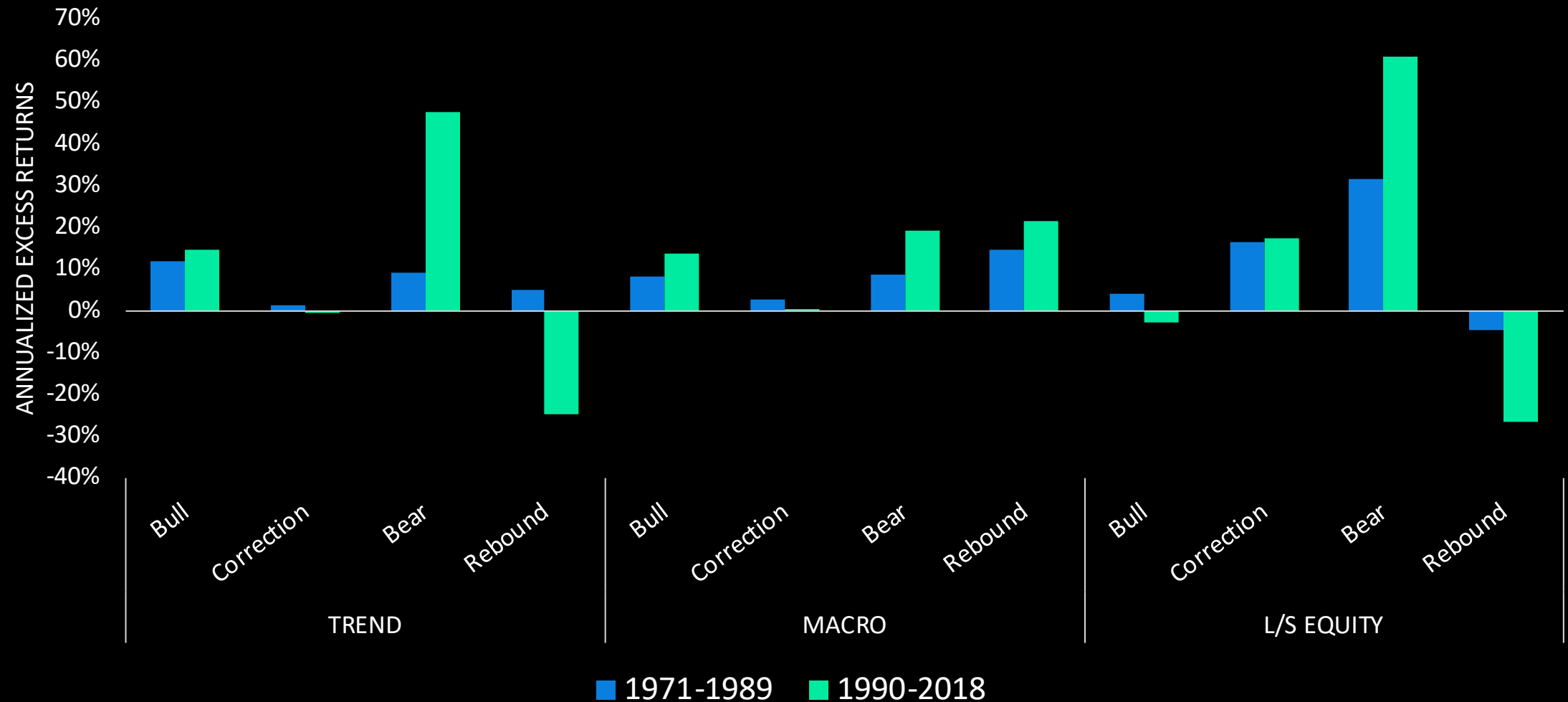
Bull Cycles Have Become More Frequent

And bear markets have become deeper



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Unchanged Hedging Properties



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Concluding Remarks

Influence of Market Cycles

1. Factor strategies can provide a great hedge against major drawdowns
2. Sensitivity to turning points can be substantial
 - Market timing versus security selection
3. Structural changes can help explaining performance shortfalls
 - Resist performance chasing
 - Unchanged hedging properties

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