Introduction

I am pleased to introduce the latest issue of the EDHEC Research Insights supplement to Investment & Pensions Europe, which aims to provide European institutional investors with an academic research perspective on the most relevant issues in the industry today.

We first look at the use of academically grounded factors in investment practice. We observe that the factor finding process often maximises the risk of finding false factors, so most factors used in commercially available tools and products are likely to be false. We conclude that the use of non-standard factors can lead to unintended exposures and misunderstandings concerning the risk exposures.

Scientific Beta’s defensive offering relies on three different indices to satisfy investors’ various objectives and constraints. In line with the defensive objective, they deliver good levels of volatility reduction and capital protection in bear markets relative to the cap-weighted index.

We examine changes that are made to indices. Methodologies of factor-based equity indices undergo frequent changes, leading to inconsistencies over time. Inconsistencies in index methodology make it difficult for investors to evaluate index offerings and may expose them to a risk of relying on spurious performance records.

We propose to apply the principles of goal-based investing to the design of a new generation of ‘flexicure’ retirement investment strategies, which aim at offering the best of both worlds between insurance products and asset management products. These strategies can be used to help individuals and households secure minimum levels of replacement income while generating upside exposure through liquid and reversible investment products.

We present the main results of the EDHEC European ETF and Smart Beta and Factor Investing Survey 2018, produced as part of the Amundi ETF, Indexing and Smart Beta Investment Strategies research chair at EDHEC-Risk Institute. Responses to our survey provide interesting insights on benefits and challenges with smart beta and factor investing strategies. Adoption of such approaches is still partial despite a decade of discussion in the industry, with the vast majority of adopters investing less than 20% of their portfolio in such approaches.

In research that is also drawn from the Amundi ETF, Indexing and Smart Beta Investment Strategies research chair at EDHEC-Risk Institute, we propose a detailed empirical study of implementable unconditional and conditional carry strategies in the US Treasury market. The aim is to assess whether the level factor remains conditionally and unconditionally rewarded when strategies are implemented using actually traded bonds rather than ‘virtual’ discount bonds.

In new research from the EDHEC Infrastructure Institute (EDHECinfra), supported by the Long-Term Infrastructure Investors’ Association (LTIIA) as part of the EDHEC/LTIIA research chair on Infrastructure Equity Benchmarking, we show that systematic risk factors can largely explain the evolution of average prices but also that valuations have shifted to a higher level. We show that unlisted infrastructure equity prices do not exist in a vacuum but are driven by factors that can be found across asset classes.

We hope that the articles in the supplement will prove useful, informative and insightful. We wish you an enjoyable read and extend our warmest thanks to IPE for their collaboration on the supplement.

Noël Amenc, Associate Dean for Business Development, EDHEC Business School, CEO, Scientific Beta

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The articles in this supplement have been written by researchers at EDHEC-Risk Institute, Scientific Beta and EDHECinfra. IPE’s association with the supplement should not be taken as an endorsement of its contents. All errors and omissions are the responsibility of EDHEC-Risk Institute, Scientific Beta and EDHECinfra.
The risks of deviating from academically validated factors

Felix Goltz, Research Director, Scientific Beta, Head of Applied Research, EDHEC-Risk Institute; Ben Luyten, Quantitative Research Analyst, Scientific Beta

Common investment practices do not employ academically grounded factor definitions.

The factor finding process often maximises the risk of finding false factors.

Thus most factors used in commercially available tools and products are likely false.

The use of non-standard factors can lead to unintended exposures and misunderstandings concerning the risk exposures.

The promise of factor investing

Factor investing offers a big promise. By identifying the persistent drivers of long-term returns in their portfolios, investors can understand which risks they are exposed to, and make explicit choices about these exposures. This idea has gained popularity among long-term investors ever since the publication in 2009 of an influential report by finance professors on the performance of the Norwegian sovereign fund (Ang et al [2009]).

An often-cited analogy is to see factors as the ‘nutrients’ of investing. Just as information on the nutrients in food products is relevant to consumers, information on the factor exposures of investment products is relevant to investors. This analogy also suggests that factors cannot be arbitrary constructs. What would you think if Nestlé used its own definition of ‘saturated fat’ for the information on its chocolate packets and if McDonald’s also had its own, but different, definition for the content of its burgers? Further, would it not be curious if both definitions had nothing to do with the definition that nutritionists and medical researchers use?

When it comes to information about factors, however, this is exactly the situation that we find. Investment products that aim to capture factor premia have gained popularity. Furthermore, investors rely heavily on analytic toolkits to identify factor exposures of an investor’s portfolio. However, neither investment products nor analytic tools necessarily follow the standard factor definitions that peer-reviewed research in financial economics has established.

Investors only benefit from understanding and controlling their exposure to factors if these factors are reliable drivers of long-term returns. Factor definitions that have survived the scrutiny of hundreds of empirical studies and have been independently replicated in a large number of data sets are of course more reliable than ad-hoc constructs used for the specific purposes of a product provider.

Perhaps more importantly, the process by which factors are defined in practice is inherently flawed. Common practices in designing these factors increase the risk of retaining factors that will ultimately be irrelevant as drivers of long-term returns.

This article will discuss factor definitions used in investment products and analytic tools offered to investors and contrast them with the standard academic factors. We also outline why the methodologies used in practice pose a high risk of ending up with irrelevant factors.

Are factors grounded in academic research?

Factor models link returns of any investment strategy to a set of common factors. In addition to the market factor, commonly used factors include size, value, momentum, profitability and investment, which capture the difference of returns across firms with different characteristics. In financial economic research, a small number of models have become workhorses for analysing asset returns and fund manager performance, given the consensus understanding that they contain the factors that matter for asset returns. Providers of factor-based investment tools and strategies unequivocally claim that their factors are “grounded in academic research”. However, we will show that the factors used are instead completely inconsistent with the factors that are supported by a broad academic consensus.

5 or 500 factors?

Figure 1 provides an overview of the workhorse models in academic finance. There are three obvious insights:

- Different models use identical factor definitions;
- The number of factors is limited to about a handful of factors;
- Factors are defined by a single variable.

These three properties ultimately mean that the different factor models draw on very few variables, which have been identified as persistent drivers of long-term returns.

In contrast, the factor tools from commercial providers typically include a proliferation of variables. MSCI’s Factor Box draws on 41 different variables to capture the factor exposures of a given portfolio. S&P markets a Factor Library which, despite including more than 500 variables “encompassing millions of backtests”, wants to help you “simplify your factor investing process”. BlackRock proudly announces “thousands of factors” for its Aladdin Risk tool.

This raises the question of why the standard models avoid such a proliferation of variables. First, the need for more factors is often rejected on empirical grounds. For example, Hanna and Ready (2005) show that using 71 factors does not add value over a model with two simple factors (book-to-market and momentum). Similarly, Hou, Xue and Zhang (2015) show that a model with four simple factors does a good job at capturing the returns across a set of nearly 80 factors. Second, academic research limits the number and complexity of factors because a parsimonious description of the return patterns is likely to be more robust. Increasing the number of variables will obviously improve fitting the model to a given data set but will also reduce the robustness when applying model results beyond the dataset of the initial tests.

These two points are analysed in more detail later in the article.

1. Factor definitions in equity factor models that are predominant in the academic literature on mutual fund performance evaluation and asset pricing

<table>
<thead>
<tr>
<th>Factor definitions for</th>
<th>Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>Size</td>
<td>2</td>
</tr>
<tr>
<td>Value</td>
<td>1</td>
</tr>
<tr>
<td>Momentum</td>
<td>2</td>
</tr>
<tr>
<td>Profitability</td>
<td>2</td>
</tr>
<tr>
<td>Investment</td>
<td>2</td>
</tr>
<tr>
<td>Book/market</td>
<td>2</td>
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<td>Book equity</td>
<td>1</td>
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<tr>
<td>Size/Value</td>
<td>5</td>
</tr>
<tr>
<td>Profit/Size</td>
<td>4</td>
</tr>
<tr>
<td>Return</td>
<td>1</td>
</tr>
<tr>
<td>Value/profit</td>
<td>3</td>
</tr>
<tr>
<td>Book equity</td>
<td>1</td>
</tr>
</tbody>
</table>
Non-rewarded versus rewarded factors

Before we proceed, it is necessary to clarify a common source of confusion. Several definitions of the term ‘factors’ exist, with some of them focused on the variability in returns (ie, short-term fluctuations) and others on the expected returns of assets (ie, long-term average returns). Martellini and Milhau (2018) provide a taxonomy of factors that distinguishes between these different definitions and their uses. A first type of factors can be used to describe the common sources of risk across securities, while the second are variables and correlations among the assets that are driven by exposures to a certain set of factors. While this information can provide some understanding of the fluctuations in a portfolio, it does not explain what the driver of long-term returns is. Such factors are referred to as non-rewarded factors. Naturally, there are a number of such non-rewarded factors that can help capture short-term fluctuations. For example, short-term fluctuations of the equity portfolio may be explained by its sector exposures, its country exposures, exposures to currency or commodity risks, among many other possibilities. However, since such factors are not rewarded, an investor does not gain additional returns from such exposures.

Rewarded factors are factors that explain differences in the long-term expected return in the cross-section of the assets. From an allocation point of view, knowledge about these factors enables an investor to tilt a portfolio towards stocks with high exposure to a factor that is positively rewarded. This results in a higher long-term expected return for the portfolio. Investors need to be cautious to avoid misinterpreting a factor offered in commercial factor tools as rewarded, when it is actually not. Dividend yield, for example, is included in the factor model of MSCI because it is a source of “time-varying return and risk”. However, it does not explain cross-sectional differences in the long-term expected return (Hou et al [2015]).

Figure 2 provides an illustration to explain this distinction further. Suppose an investor in an equal-weighted equity index wants to understand the common sources of risk at the level of selecting single variables. For this purpose, he is interested in the portfolio’s exposure to an industry factor that is proxied by the performance of the given dataset. However, these factors most likely will have no actual economic rationale as to why the exposure to this factor constitutes a systematic risk that requires a reward, and why it is likely to continue producing a positive risk premium (Kogan and Tian [2013]). In short, factors selected on the sole basis of past performance without considering any theoretical evidence are not robust and must not be expected to deliver similar premia in the future. This is emphasised by Harvey (2017), who argues that “economic plausibility must be part of the inference”.

In addition, there are statistical tools to adjust results for the biases arising from testing a large number of variables. A recent study, Chordia et al (2017), also emphasises the factor-fishing problem. They show that it is easy to find great new factors in backtests but such factors add no real value to standard factors. They create more than 2 million factors (levels, growth rates and ratios) from 156 accounting variables and assess whether these factors generate performance. While they find that there are 22,337 (7) great factors, the winning ratios do not make any economic sense (such as the ratio of common stock minus retained earnings to advertising expense). Moreover, these factors do not survive more careful vetting. None of the 20,000-plus factors that appear significant survives after adjusting for the well-known standard factors (size, value, momentum, profitability, investment and market) and for selection bias. These results emphasise that it is easy to discover new factors in the data if enough fishing is done, but such factors are neither economically meaningful nor statistically robust.

Of course, exposure to non-rewarded factors with an unreliable backtest performance will not prove useful to an investor going forward. The past will give an inflated picture of the factor-based performance that can be expected for the future.

2. Risk and return influence of the technology minus utilities (TMU) factor on an equal-weighted portfolio

<table>
<thead>
<tr>
<th>Regression results</th>
<th>Coefficient</th>
<th>P-value</th>
<th>R²</th>
</tr>
</thead>
<tbody>
<tr>
<td>Explaining Wall market factors (0.16)</td>
<td>0.40</td>
<td>0.11</td>
<td></td>
</tr>
</tbody>
</table>

The top row of the table shows the regression results of the excess returns of the equal-weighted portfolio over the risk-free rate on the TMU factor. The bottom row shows the long-term performance of the TMU factor. The analysis is based on daily total returns for the period 19 June 1970 to 29 December 2017. The stock universe consists of the 500 largest US stocks. The equal-weighted portfolio is represented by the EDHEC-Risk Long-Term United States Maximum Deconcentration Index. The TMU factor returns are calculated as the returns on the cap-weighted portfolio of the technology stocks in the universe minus the returns on the cap-weighted portfolio of the utility stocks in the universe. The secondary market US Treasury Bills (3M) is the risk-free rate.

**Spurious factors**

A severe problem with commercially used factors is the process by which they are defined. This process increases the risk of falsely identifying factors, due to weaknesses in the statistical analysis. In fact, providers will analyse a large set of candidate variables to define their factors. Given today’s computing power and the large number of variables representing different firm characteristics, such an exercise makes it easy to find so-called ‘factors’ that work in the given dataset. However, these factors most likely will have no actual relevance outside the original dataset. That data mining will lead to the identification of false factors is a problem that is well known to financial economists. Lo and MacKinlay (1990) provided an early warning against careless analysis: “[...] the more scrutiny a collection of data is subjected to, the more likely will interesting (spurious) patterns emerge”.

**Selection bias**

It is well known that simply seeking out factors in the data without a concern for robustness will lead to the discovery of spurious factors. This is due to a ‘selection bias’ of choosing among a multitude of possible variables. Harvey et al (2016) document a total of 314 factors with positive historical risk premia showing that the discovery of the premium could be a result of data mining (ie, strong and statistically-significant factor premia may be a result of many researchers searching through the same dataset to find publishable results). The practice of identifying merely empirical factors is known as ‘factor fishing’ (see Cochrane [2001]). Therefore, a key requirement for investors to accept factors as relevant in their investment process is that there be clear economic rationale as to why the exposure to this factor constitutes a systematic risk that requires a reward, and why it is likely to continue producing a positive risk premium (Kogan and Tian [2013]). In short, factors selected on the sole basis of past performance without considering any theoretical evidence are not robust and must not be expected to deliver similar premia in the future. This is emphasised by Harvey (2017), who argues that “economic plausibility must be part of the inference”.

In addition, there are statistical tools to adjust results for the biases arising from testing a large number of variables. A recent study, Chordia et al (2017), also emphasises the factor-fishing problem. They show that it is easy to find great new factors in backtests but such factors add no real value to standard factors. They create more than 2 million factors (levels, growth rates and ratios) from 156 accounting variables and assess whether these factors generate performance. While they find that there are 22,337 (7) great factors, the winning ratios do not make any economic sense (such as the ratio of common stock minus retained earnings to advertising expense). Moreover, these factors do not survive more careful vetting. None of the 20,000-plus factors that appear significant survives after adjusting for the well-known standard factors (size, value, momentum, profitability, investment and market) and for selection bias. These results emphasise that it is easy to discover new factors in the data if enough fishing is done, but such factors are neither economically meaningful nor statistically robust.

Of course, exposure to non-rewarded factors with an unreliable backtest performance will not prove useful to an investor going forward. The past will give an inflated picture of the factor-based performance that can be expected for the future.

**Composite scores**

In the discussion thus far, we have emphasised that a stark problem arises from a practice where providers of factor tools select flexibly from among many variables. It turns out that the actual problem is even worse in practice. Providers of factor products and tools do not stop their data-mining practices at the level of selecting single variables. Instead, they create complex composite factor definitions drawing on combinations of variables.

Research by Novy-Marx (2015) shows that the use of composite variables in a practice yields a particular pernicious form of data-snooping bias”, the overfitting bias. Intuitively, this bias arises because, in addition to screening the data for the best-performing variables, combining variables that give good backtest results provides even more flexibility to seek out spurious patterns in the data. The author concludes that “combining signals that backtest positively can yield impressive back-tested results, even when none of the signals employed to construct the composite signal has real power”.

When combining variables to improve back-tested factor performance, providers can yet again increase flexibility for capturing spurious patterns in the data. Additional flexibility is easily achieved by attributing arbitrary weightings to the variables used in a composite definition. For a given combination of variables, changing the weight each variable receives in the factor definition may have a dramatic impact on factor returns. Figure 3 illustrates this point. The graph plots return differences over three-year horizons of two factor-tilted portfolios that draw on the same three variables to define a quality score. The only difference between the quality factor definitions is the weighting of the three component variables (profitability, leverage and investment). The difference in weightings used in the final composite factor definitions leads to return differences that often exceed 5% annualised. Such pronounced differences suggest that, in a given sample, it is easy to improve factor returns by specifying arbitrary weightings for composite factor definitions.

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What do providers do?

Given the well-documented risk of biases leading to useless factors, providers of factor products should use the academically validated factor definitions. Indeed, many providers claim that their factors are grounded in academic research. MSCI, for example, recently issued a report that clearly emphasises this. It states that its “factor research is firmly grounded in academic theory and empirical practice”. FTSE also mentions the broad academic consensus that exists for the factors used in its global factor index series. It is important to highlight, however, what having a strong academic foundation should mean. To claim that a specific factor is “firmly grounded” in academic research means that it should fulfil two criteria. First, its existence should be replicated and documented across different independent studies. This gives investors the assurance that the methodologies are externally validated and that the factors also exist outside of the original data set. Second, a risk-based explanation should support the existence of the factor. Without this, there is no reason to expect the persistence of the factor performance. Post-publication evidence is needed to confirm that the factor does not disappear after it is published. To support a claim for academically grounded factors, providers should be able to list the independent studies on which the factor definitions are based.

This does not mean that using new or proprietary factors will necessarily fail out of sample. However, the problem is that it is not possible to obtain the same assurances for the effectiveness of the factor compared to academically grounded factors. Hou et al (2018) show that the majority of anomalies in financial research cannot be replicated. This means that there is no reason to assume that they will be useful for an investor going forward. A prudent approach is thus to select only factors that have indeed been independently replicated. With this in mind, why would one rely on provider-specific research concerning a new factor when you have free due diligence from the academic community concerning a standard set of factors? Consequently, it is clear that the use of proprietary factors exposes an investor to risks that can easily be avoided.

Whereas the factor names are usually based on factors that are presented in the literature, the actual implementation of most product providers is very different. Figure 4 gives some examples of variable definitions being used by different index providers as a proxy for the factors. These can be compared to the definitions academic uses for the factors, as displayed in figure 1 earlier. It is clear that provider definitions are more complex than academic factor definitions and differ substantially from the externally validated factors despite using the same factor labels, such as ‘value’ and ‘momentum’. A relevant question for investors is whether the ‘upgraded’ definitions of standard factors, like ‘enhanced value’ and ‘fresh momentum’ add value only in the backtest or whether the benefits hold post publication (ie, in a live setting). Moreover, in the absence of external replication of such factors, investors are fully reliant on provider-specific results.

Figure 4 also shows that many providers use composite scores in their factor definitions. As discussed above, this opens the door for an overfitting bias, even if composites are equal-weighted across constituent variables. Providers add even more flexibility to their factor definitions by making decisions on how to weigh the different variables within the composite. For example, one provider uses an approach involving “intuition […], investors’ expectations or other measures” to attribute weights when combining variables into composites. Another provider uses a statistical procedure to weight variables making up a composite factor.

Overall, product providers explicitly acknowledge that the guiding principle behind factor definitions is to analyze a large number of possible combinations in short data sets and then retain the factors that deliver the highest backtest performance. In fact, providers’ product descriptions often read like a classical description of a data-snooping exercise, which is expected to lead to spurious results. For example, one provider states that “factors are selected on the basis of the most significant t-stat values”, which corresponds to the technical definition of a procedure that maximises selection bias. Despite a lack of empirical or economic grounding, factor definitions used by providers may appear to be advantageous in practice. This is the case notably when index providers offer both analytics tools and indices, and ensure that factor definitions in their indices correspond to those used in their tools. If an analytics tool and a set of indices are based on the same factor definitions, the indices will show an exposure to the factors by construction. Other investment strategies may be more difficult to explain by the proprietary factor definitions of the provider and thus appear more difficult to interpret to investors. However, if the factors are flawed to start with, such correspondence of course does not add any real value to investors.

### Redundant factors

For many factors used in investment practice, it is well known that they fail to deliver a significant premium. For example, different analytics packages include the dividend yield, market capitalisation, and sales growth as factors, while all of these factors have been shown not to deliver a significant premium (for the dividend yield, see Hou et al [2015], for leverage see Koyosev et al [2016], for growth see Lakonishok et al [1994]). Factors may also be redundant with respect to consensual factors from the
We use the MSCI World Index as the broad cap-weighted index. The latter defines quality as a “composite of profitability, efficiency, earnings quality and leverage”\textsuperscript{14}. The data on the regressors are taken from the data library of Kenneth French, where we use the five-factor model, including a market, size, value, profitability and investment factor, together with the momentum factor.\textsuperscript{15} Contrary to the quality definition used in the quality indices, these factors are part of standard multi-factor asset pricing models that are extensively used and scrutinised in the academic literature, have a considerable post-publication record and have been explained as compensation for risk.

Panel A of figure 6 shows the results for the MQI and panel B shows the results for the FQI. The first observation from these results is that the t-statistic points to a significant exposure to all the different factors, except from the investment factor in the MQI case and the size factor in the FQI case. As would be expected for a quality index, the exposures to profitability are the most clear with betas of 0.39 and 0.27.

However, for the MQI, the exposures to the market, size and value factors are also sizeable, but negative, with betas of –0.06, –0.20 and –0.26, respectively. For the FQI, we obtain similar results with a significantly negative beta of –0.02 and –0.19 for the market and value factors, respectively. Obtaining strong negative exposures to factors that are unrelated to quality is an important, presumably unintended, consequence of investing in these quality indices. Apart from the market exposure for the FQI, these exposures are also larger in absolute value than the respective exposures to the investment factor, which would be expected to show a relatively stronger influence on a quality index. Instead, the investment exposure is estimated to be zero for the MQI. Clearly, the composite quality indices expose an investor to a range of standard factors other than the quality-related profitability and investment factors.

When we look at the contribution of the different factors to the average annualised excess return of the indices over the period, we see that for the two quality indices, only 51.79% and 52.81% respectively of the impact on the excess returns comes from the quality-related factors profitability and investment. A large part of excess returns can be attributed to other standard factors or are unrelated to any factors. In fact, a big part of performance (30.04%) remains unexplained by any of the standard factors in the case of the MQI.

Taken together, these results show that the composite quality indices are only moderately related to the academic profitability and investment factors, while a large part of their performance is either driven by other factors such as the market, or remain unexplained by the set of standard factors used in the model. An investor in these indices will thus expose himself or herself to a large amount of unintended risk factors unrelated to quality.

This risk is present in any index based on non-standard factor definitions. Proprietary factor definitions lead to a risk of misunderstanding factor exposures.

14 We use the MSCI World Index as the broad cap-weighted index.
15 See https://www.msci.com/documents/10139/344aa35f-d4f5-4b09-20a808f024865
17 See http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html

### 6. Exposure of composite quality factor indices excess returns to standard factors

<table>
<thead>
<tr>
<th>Panel A: MSCI World Quality index results</th>
<th>Exposure (beta)</th>
<th>t-stat</th>
<th>Performance attribution</th>
<th>Impact on performance</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Panel A: MSCI World Quality index results</strong></td>
<td><strong>Annualised alpha</strong></td>
<td><strong>t-stat</strong></td>
<td><strong>Performance attribution</strong></td>
<td><strong>Impact on performance</strong></td>
</tr>
<tr>
<td><strong>US Long-Term</strong></td>
<td><strong>Low (01)</strong></td>
<td><strong>Quartile 2</strong></td>
<td><strong>Quartile 3</strong></td>
<td><strong>Quartile 4</strong></td>
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<tr>
<td>Average return</td>
<td>0.90%</td>
<td>0.46%</td>
<td>0.75%</td>
<td>1.08%</td>
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<tr>
<td>F-stat</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
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<td><strong>CAPM model</strong></td>
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<tr>
<td>Unexplained</td>
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<td>–0.06%</td>
<td>–0.06%</td>
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<tr>
<td>Market exposure</td>
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<tr>
<td>Size</td>
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<td>Value (HML)</td>
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<tr>
<td>Profitability</td>
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<td>ROI</td>
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### 6. Exposure of composite quality factor indices excess returns to standard factors

<table>
<thead>
<tr>
<th>Panel B: FTSE Developed Quality Factor index results</th>
<th>Exposure (beta)</th>
<th>t-stat</th>
<th>Performance attribution</th>
<th>Impact on performance</th>
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</thead>
<tbody>
<tr>
<td><strong>Panel B: FTSE Developed Quality Factor index results</strong></td>
<td><strong>Annualised alpha</strong></td>
<td><strong>t-stat</strong></td>
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<td>Size</td>
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<td>–0.22</td>
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<td>Momentum</td>
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<td>0.04</td>
<td>0.04</td>
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<tr>
<td>Profitability</td>
<td>0.27</td>
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<tr>
<td>ROI</td>
<td>0.16</td>
<td>0.16</td>
<td>0.16</td>
<td>0.16</td>
</tr>
</tbody>
</table>

Analysis is based on weekly return data for the period starting on 20 June 2002 and ending on 30 June 2018, for which we have data for both indices. The first two columns of each panel show the regression basis together with their t-statistic. The third column shows how much of the annualised excess return of the index can be attributed to the different regressors based on their average returns and their exposures. The last column shows the relative size of the impact each of the factors had on the index excess returns, calculated as the absolute value of its performance attribution divided by the sum of the absolute values of the performance attributions.

### Conclusion: Revisiting the promise of factor investing

Factors used in investment practice show a stark mismatch with factors that have been documented by financial economists. Commercial factors are based on complex composite definitions that offer maximum flexibility. Providers use this flexibility to seek out the factors with the highest performance in a given dataset. Such practice allows spurious factors to be found. Spurious factors work well in a small dataset but will be useless in reality. Therefore, many factors that appear in popular investment products and analytic tools are likely false.

Even though many providers claim their factors are grounded in academic research, we have emphasised that two important conditions to support this claim are often not fulfilled. The factor definitions should have been used and validated across different independent studies and a risk-based explanation should support the existence of the factor. Without these assurances, there is no reason to assume the persistence of the factor.

We have also shown that relying on proprietary factor definitions can lead to unintended exposures. For example, investors who tilt towards a composite quality factor will end up with a strategy where, depending on the index we consider, only about one third or half of the excess returns are driven by
exposure to the two well-documented quality factors (profitability and investment). This means that the part of the excess returns that is unrelated to quality factors can be as high as two-thirds, an obvious misalignment with the explicit choice to be exposed to quality factors (see figure 6). Even if the quality factors perform as expected by the investor, this performance will not necessarily be reflected in portfolio returns, which are in a large part driven by other factors and idiosyncratic risks.

Available factor products thus do not deliver on the promise of factor investing, described almost a decade ago in the Norway study. Understanding the factor drivers of returns increases transparency and allows investors to formulate more explicit investment choices. However, being aware of exposures to useless factors, which have no reliable link with long-term returns, is equally useless.

A good idea can easily be distorted when implemented with poor tools. For a meaningful contribution to the ability of investors to make explicit investment choices, factor investing should focus on persistent and externally validated factors. It is time to reconsider the good idea of factor investing.

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References

Scientific Beta’s defensive offering relies on three different indices to satisfy investors’ various objectives and constraints. Our indices are constructed based on the Smart Beta 2.0 framework and thus benefit from good diversification of unrewarded risks.

The high factor intensity filter very strongly reduces the poor exposures of low volatility or minimum volatility strategies to other rewarded factors and as such, benefits from a much better excess return capacity over the long term. In line with the defensive objective, they deliver good levels of volatility reduction and capital protection in bear markets relative to the cap-weighted index.

Compared to the popular MSCI Minimum Volatility index, they deliver much higher Sharpe ratios and information ratios as well as lower exposures to macroeconomic risks.

For investors wary of rising interest rates, our sector-neutral index offers very low exposures to the T-bill and term spread factors.

A more robust defensive offering

Daniel Aguet, Deputy Research Director, Scientific Beta; Noël Amenc, Associate Dean for Business Development, EDHEC Business School, CEO, Scientific Beta; Felix Goltz, Research Director, Scientific Beta, Head of Applied Research, EDHEC-Risk Institute

I

vestors looking for defensive equity strategies want to participate in bullish markets while protecting their capital in bear periods by limiting their losses relative to the cap-weighted index. This concern for capital protection leads to equity investors usually investing in low volatility or low beta strategies, the main objectives of which are to offer defensive payoff profiles and to benefit from a superior risk-adjusted performance relative to cap-weighted indices. The fact that a portfolio is less risky than a cap-weighted index can generate outperformance on a risk-adjusted basis runs counter to the main the financial theories, and it has been popularised under the name of the low volatility anomaly. The low volatility anomaly has its roots in the failure of the Capital Asset Pricing Model (CAPM) to explain the cross-section of expected returns. Indeed, according to the central prediction of the CAPM developed by Sharpe (1964) and Lintner (1965), there is a linear relationship between systematic risk or market beta and expected returns. However, this prediction was soon contradicted by many academic publications, Friend and Blume (1970), Black, Jensen and Scholes (1972), Miller and Scholes (1972) and Haugen and Heine (1972, 1975), highlighting a negative or flat relationship between systematic risks and expected returns in the cross-section of stock returns. Following the work of Black (1972), Frazzini and Pedersen (2014) derive an equilibrium model that provides a risk-based justification of the low volatility anomaly. One major prediction of their model is that a ‘betting against beta’
(RAB) strategy that goes long low-beta assets and short high-beta assets, adjusting both long with leverage to have a market neutral portfolio, produces significant positive risk-adjusted returns that are not explained by the size, value and momentum effects of Fama and French (1992, 1993) and of Jegadeesh and Titman (1993). They show that the poor returns of the BAB strategy occur when funding constraints become tight, which is consistent with liquidity-constrained investors having to sell leveraged positions in low-beta assets in bear markets.

Several other academic works provide the same finding on persistence and existence of the low volatility anomaly on US and international universes. Ang et al (2006, 2009) show that stocks with high recent idiosyncratic volatility have low average returns that are not explained by standard risk factors (size, value, momentum). Finally, Blitz and van Vliet (2007) show that low volatility stocks have higher risk-adjusted returns than high volatility stocks and that standard risk factor cannot explain the alpha resulting from a long/short portfolio. Overall, the low volatility anomaly is one of the strongest risk factors found in the academic literature (along with size, value, momentum, low investment and high profitability), with a strong annual premium of 8.7% over the period 1926 to 2012 (Frazzini and Pedersen [2014]).

There are two main approaches to benefit from the low volatility factor reward and obtain a defensive portfolio based on i) Modern Portfolio Theory and ii) factor investing. The former approach tries to build the portfolio with the lowest risk on the efficient frontier (Markowitz [1952]) by combining stocks with low volatilities and low pairwise correlations. This minimum volatility portfolio, achieved through an optimisation, is known to produce very concentrated portfolios. This is why most commercial solutions use very tight constraints (like min-max weights) to force the optimiser to generate less concentrated allocations. Moreover, optimisers, used to solve minimum volatility allocations, are very sensitive to outliers and to parameter estimation errors that can lead to dramatic changes to the optimal weights leading to high turnover and sub-optimal allocations that do not reach minimum volatility ex-post.

The second approach is the one we pursue at Scientific Beta for harvesting rewarded risk factors. The Smart Beta 2.0 framework is the cornerstone of the construction of our smart factor indices. It favours a clear separation of the stock selection and weighting phases. The stock selection objective is to exclude the portfolio towards a desired and rewarded factor tilt, like the low volatility factor, and the weighting objective is to diversify away idiosyncratic risks in order to obtain a well-diversified portfolio. The latter is key to achieving the highest possible risk-adjusted performance over the long term. Amenc et al (2012) show that this approach is more robust for achieving well-diversified defensive portfolios that produce a similar level of outperformance with higher risk reduction than portfolios based solely on Modern Portfolio Theory.

Scientific Beta’s defensive offering relies on three types of indices to address the various objectives of investors:

- The High Factor Intensity Low Volatility Diversified Multi-Strategy (4-Strategy) index;
- The High Factor Intensity Low Volatility Diversified Multi-Strategy (4-Strategy) (Sector Neutral) index; and
- The Narrow High Factor Intensity Low Volatility Diversified Multi-Strategy (4-Strategy) index.

The objective of the first (standard HFI) index is to be exposed to the low volatility factor in order to provide a reduction in volatility compared to the cap-weighted index and to provide protection in bear markets. Moreover, it aims to maintain high factor intensity by using a high factor intensity (HFI) filter and delivering the best risk-adjusted performance through the diversification of idiosyncratic risks. This index is clearly defensive, since it offers good risk reduction and capital protection while benefiting from a high risk-adjusted performance over the long term, due to its strong factor intensity.

The second (sector-neutral HFI) index has two main objectives. The first is to provide exposure to the low volatility factor. The second is to deliver low relative risks compared to the cap-weighted index through a sector-neutral objective. The latter implies that the index will have less exposure to the low volatility factor than the standard HFI index and consequently a lower reduction of volatility and less protection in bear markets. Nonetheless, we will show that the index delivers better relative performance and lower exposure to interest rate risks, because of its reduced sector deviations relative to the cap-weighted index. The latter can be suitable for investors seeking to benefit from both defensive characteristics and rewards of the low volatility factor but who are worried by the unexpected consequences of minimum volatility strategies’ exposures to fixed income risks.

The last (narrow HFI) index is for investors who seek the highest factor exposure to the low volatility factor through a narrow selection of low volatile stocks. Its objectives are similar to the standard HFI index, but the narrow selection increases the concentration to the low volatility factor, thus increasing the defensiveness and hence the protection in bear markets. It comes at the cost of lower exposure to other rewarded risk factors and important losses in bull markets. This index can be used in overlay strategies that target the modification of the global exposure of a portfolio with only a limited investment in a smart factor index.

The rest of the article is organised as follows. In section one, we discuss our construction philosophy based on the Smart Beta 2.0 framework and the way we tackle negative factor interaction with the HFI filter. We also present our defensive offering in more detail. In the following sections, we compare our offering to the MSCI Minimum Volatility index on two universes: SciBeta USA and SciBeta Developed. More particularly, in section two, we show that our offering delivers a better risk-adjusted performance and a better volatility reduction compared to the cap-weighted index. In section three, we show that our offering has a high factor intensity and good factor deconcentration. In section four, we show that our offering improves relative performance, extreme relative risks and probabilities of outperformance. In section five, we show that our offering delivers good protection in bear markets. In section six, we analyse the macroeconomic sensitivity of our offering, such as interest rates or credit spreads and show that our offering has weaker sensitivities, in particular our sector-neutral HFI index. Finally, section seven concludes.

Robust smart factor design

A key element in Scientific Beta smart factor index design is that each index not only tilts towards a desired factor, but also achieves a sound level of diversification of specific risk, in keeping with the Smart Beta 2.0 methodology introduced by Amenc and Goltz (2013 – see figure 1).

Stock selection

Focusing only on stocks with the highest factor scores ignores the potential negative interaction effects with other risk factors. For instance, a stock with a low volatility score might have a low value score. A smart factor index might therefore have a positive exposure to a desired factor tilt but low or even negative exposures to other rewarded risk factors. Thus, investors would benefit from additional controls in the stock selection mechanism to account for such interaction effects. To address the issue of factor interactions, we follow the approach proposed by Amenc et al (2017), which differentiates from standard ‘bottom-up’ approaches. The authors document that the ‘top-down’ approach provides better performance per unit of factor exposure due to better diversification. They demonstrate a solution to increase factor intensity in the ‘top-down’ approach by eliminating stocks with low multifactor scores. They show that the absolute underperformance of a ‘factor losers’ portfolio is substantially larger than the outperformance of a ‘factor champions’ portfolio. Therefore, eliminating factor losers may be a more efficient way to increase factor intensity than focusing on factor champions, which is the milestone of ‘bottom-up’ approaches.

Scientific Beta uses a factor intensity (HFI) filter, which eliminates stocks with the lowest multi-factor scores. The score is based on the following factors: value, momentum, low volatility, high profitability and low investment. In figure 2a, we show the standard selection process that we use for our smart factor indices. We select 50% of stocks based on the factor score and excludes stocks, within the factor-based selection, with the lowest multi-factor score, leaving 30% of stocks compared to the starting investment universe.

The HFI filter is available on our defensive indices and is essential to maintain a good factor intensity. Indeed, when investing in a low volatility

![Smart Beta 2.0 framework](image)

**Figure 1. Smart Beta 2.0 framework**

- **Tilt to desired factor ('beta')**
- **Diversify undesired risks ('smart' weighting)**
- **Smart Beta**

**2a. Stock selection with HFI filter**

- **50% stock selection over the factor tilt**
- **50% of the 50% stock selection is excluded based on HFI filter**
- **HFI-filtered smart factor indices (60% remaining stocks)**

Spring 2019
The analysis is based on daily total returns in US dollars from 21 June 2002 (base date of S&P/ASX 200) to 31 December 2018. Yield on secondary US Treasury Bills (3M) is used as a proxy for the risk-free rate. The regression basis is the absence of return series of the cap-weighted index over the risk-free rate. The cap-weighted index is the S&P/ASX 200 Cap-Weighted. The other six factors are equal-weighted daily-rebalanced factors obtained from S&P/ASX. Beta- and are beta-adjusted every month with their realized CAPM beta. Coefficients significant at 5% p-value are highlighted in bold. The smart factors indices used are the S&P/ASX 200 Low-Volatility Diversified Multi-Strategy and the S&P/ASX 200 High-Yield Low-Volatility Diversified Multi-Strategy (4-Strategy).

The diversified weighting scheme is designed to combine four different weighting schemes as explained in figure 3, in order to diversify model risks. The diversified multi-strategy weighting scheme equally weights the following strategies: efficient maximum Sharpe ratio, maximum deconcentration, maximum decorrelation and diversified risk-weighted. Amenc et al. (2015) show that diversifying across different models improves the robustness of smart beta strategies, because the risk of choosing one specific weighting scheme is not rewarded.

Since each weighting scheme is different in terms of parameter estimation risk and optimality risk, investors can improve the diversification of model risks by combining several weighting schemes and avoid, for instance, the

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### 3. Multi-strategy diversification scheme

**Combination of weighting schemes**

- **Diversified multi-strategy**
- **Single diversification strategies**
  - Maximum deconcentration
  - Diversified risk-weighted
  - Maximum decorrelation
  - Efficient maximum Sharpe ratio
  - Diversified stock-specific risk

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**Scientific Beta defensive offering design**

Scientific Beta’s offering design is aimed at providing investors with a defensive profile – i.e., lower volatility compared to the cap-weighted index, as well as protection in bear markets. Moreover, we want to offer them choices that will fit with their various investment objectives. Indeed, some investors might be interested in having the lowest volatility and the highest protection in bear markets without any regard for tracking error. Others might want to have the smallest volatility while keeping a low tracking error, whereas some investors might want a good volatility reduction and protection in bear markets but with the highest possible risk-adjusted returns. Therefore, our defensive offering relies on three indices that will give different levels of exposure to the low volatility factor, and consequently different levels of defensiveness, factor intensity, risk-adjusted performance and relative risks, to fit investors’ preferences.

- **High Factor Intensity Low Volatility Diversified Multi-Strategy (4-Strategy)**
  - This is the flagship index of the offering (hereafter the ‘standard HFI index’). Its design is similar to our flagship multi-beta multi-strategy offering. Its construction follows the one described in figure 2a. It seeks an exposure to the low volatility factor through the selection of 50% of stocks of the universe with the lowest volatility. The use of the HFI filter, which allows the negative factor interaction between factors to be taken into account, removes 40% stocks with the lowest multi-factor scores (based on value, momentum, low volatility, high profitability and low investment scores), leading to a final selection of 30% of the size of the original universe. Finally, we apply the diversified multi-strategy weighting scheme described above to diversify away idiosyncratic risks. This index is aimed at investors seeking the highest risk-adjusted performance with a high factor intensity and a good reduction of volatility and protection in bear markets compared to the cap-weighted index.

- **High Factor Intensity Low Volatility Diversified Multi-Strategy (Sector Neutral)**
  - It is well known that smart factors are exposed to implicit risks (see Shirbini [2018] and in particular sector risks (see Aguet et al. [2018]) that can have important consequences on short-term performances. Therefore, the design of this index (called sector-neutral HFI index in the rest of the paper) is similar to our standard HFI index but with an additional sector-neutral objective, to control sector risks and reduce relative risks like tracking error. The index seeks an exposure to the low volatility factor through the selection, within each sector, of 50% of stocks with the lowest volatility. The use of the HFI filter, which allows us to take into account the negative factor interaction between factors, removes 40% stocks with the lowest multi-factor scores, leading to a final selection of 30% of the size of the original universe. Finally, we apply the diversified multi-strategy weighting scheme to diversify away idiosyncratic risks. The index is aimed at investors that care about tracking error or relative risks, while seeking a reduction of volatility and protection in bear markets relative to the cap-weighted index. Obviously, the sector neutrality objective has a cost, since it reduces the distance of the smart factor to the cap-weighted index. Indeed, the exposure to the low volatility factor and the overall factor intensity of the index will be weaker than without sector neutrality, which is the case of the standard HFI index. Nevertheless, its benefits reside in a lower tracking error, higher information ratio and low exposures to macroeconomic factors and in particular to interest rate risks.

- **Narrow High Factor Intensity Low Volatility Diversified Multi-Strategy (4-Strategy)**
  - The construction of this index (hereafter referred to as the high sensitivity of minimum volatility approaches to the estimation of risk parameters.
narrow HFI index) seeks a strong exposure to the low volatility factor through
the selection of 30% of stocks (narrow selection) of the universe with the
lowest volatility (see figure 2c). The use of the HFI filter, which allows the
negative factor interaction between factors to be taken into account, removes
one-third of stocks with the lowest multi-factor scores, leading to a final
selection of 20% of the size of the original universe. Finally, we apply the
diversified multi-strategy weighting scheme to diversify away idiosyncratic
risks. The factor risk range between 0.16, for the sector-neutral HFI index, and
a much higher Sharpe ratio, which is the main benefit of the HFI filter that we use in our construction process.

In Panel A (US universe), we observe that the factor intensities of our
indices range between 0.52 and 0.65, which is an improvement of 166% and
236% compared to the MSCI Minimum Volatility index. Exposures to the low
volatility factor range between 0.16, for the sector-neutral HFI index, and
0.41 for the narrow HFI index. In between, we find the standard HFI index
with an exposure of 0.29. The sector neutrality objective explains the low
standard HFI index offers a similar level of volatility reduction as the MSCI
Minimum Volatility index, but with a much higher Sharpe ratio, which is the
highest of our offering. The sector-neutral HFI index offers the weakest
volatility reduction and the smallest Sharpe ratio of our offering because its
objective is to control sector risks and therefore improve relative risks (we
will discuss this point in section four). Nonetheless, it offers only a slightly
lower volatility reduction than the MSCI Minimum Volatility index (~15% vs
~17% on the US universe and ~18% vs ~26% on the Developed universe) but
with a higher Sharpe ratio (~20% on US and +14% on Developed universe).
Finally, the narrow HFI index offers the highest volatility reduction and the
lowest level of extreme risks, which is its main objective. Moreover, it delivers
a slightly reduced Sharpe ratio from our standard HFI index.

High factor intensity and good factor deconcentration
The very good risk-adjusted performance of our defensive indices finds its
roots in factor intensity. Indeed, we observe in figure 5 that our indices have
much higher factor intensities than the MSCI Minimum Volatility index
while having a good exposure to the low volatility factor. This is the main
benefit of the HFI filter that we use in our construction process.

4. Absolute performance of SciBeta defensive offering and
MSCI Minimum Volatility on SciBeta USA and SciBeta
Developed universes

<table>
<thead>
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<tr>
<td>Panel A – SciBeta USA</td>
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<td>Annualised returns</td>
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<td>–21%</td>
<td>15%</td>
<td>–21%</td>
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<tr>
<td>Sharpe ratio</td>
<td>0.37</td>
<td>0.64</td>
<td>0.69</td>
<td>0.32</td>
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<tr>
<td>Sortino ratio</td>
<td>0.02</td>
<td>0.92</td>
<td>0.84</td>
<td>0.67</td>
</tr>
<tr>
<td>Maximum drawdown</td>
<td>45.6%</td>
<td>43.0%</td>
<td>44.3%</td>
<td>43.1%</td>
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<tr>
<td>Extreme 3Y rolling volatility</td>
<td>40.9%</td>
<td>31.9%</td>
<td>33.4%</td>
<td>30.2%</td>
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<tr>
<td>Panel B – SciBeta Developed</td>
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<td></td>
<td></td>
</tr>
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<td>Annualised returns</td>
<td>0.14</td>
<td>10.65%</td>
<td>14.81%</td>
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<tr>
<td>Annualised volatility</td>
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<td>13.6%</td>
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<td>Volatility reduction</td>
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<td>15%</td>
<td>–21%</td>
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<tr>
<td>Sharpe ratio</td>
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<td>31.9%</td>
<td>33.4%</td>
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The analysis is based on daily total returns in US dollars from 21 June 2002 (base data of SciBeta indices) to 31 December 2018. All statistics are annualised. Yield on Secondary US Treasury Bills (3M) is used as a proxy for the risk-free rate. The factor risk range between 0.16, for the sector-neutral HFI index, and a much higher Sharpe ratio, which is the main benefit of the HFI filter that we use in our construction process.
exposure of the sector-neutral index, which dilutes the low volatility exposure. Nevertheless, this index is still well exposed to other rewarded risk factors and therefore has a good factor intensity. We highlight that our indices have no negative exposures to any rewarded risk factors whereas the MSCI Minimum Volatility index has negative exposures that are statistically significant to momentum, high profitability and low investment, which translates into a poor factor intensity of only 0.19. Moreover, its low volatility exposure is only 36% lower than the sector-neutral HFI index but 20% lower than the narrow HFI index. The factor deconcentration, which is the effective number of factors to which the index is exposed, and the factor exposure quality are much higher for our indices than the MSCI index, which is the result of better exposures to rewarded risk factors. Finally, the level of market beta exposures reflect the defensiveness of our indices. The narrow HFI index, which has the highest level of volatility exposure also has the lowest market beta exposure (0.72), explaining why it has the highest level of volatility reduction (figure 4). Our sector-neutral index has the highest market beta exposure (0.86) and is therefore the least defensive index of our offering but its objective is to reduce relative risks compared to the cap-weighted index, so it was expected. Finally, our standard HFI index has a market beta exposure of 0.79, which is similar to the MSCI Minimum Volatility index.

We have similar conclusion on Panel B (Developed universe). Indeed, we observe that factor intensities of our indices range from 0.56 to 0.65, which is an improvement of 115% to 150% compared to the MSCI Minimum Volatility index. Exposures to the low volatility factor range between 0.22, for the sector-neutral HFI index, and 0.44 for the narrow HFI index. In between, we find the standard HFI index with an exposure of 0.32. We highlight that our indices have almost no negative exposures to any rewarded risk factors whereas the MSCI Minimum Volatility index has negative exposures that are statistically significant to value and momentum, which translates into a poor factor intensity of only 0.26. The factor deconcentration and the factor exposure quality are much higher for our indices than the MSCI index, which is the result of better exposures to rewarded risk factors. In terms of market beta exposures, the narrow HFI index has the lowest (0.72), which is similar to the MSCI Minimum Volatility index. Our sector-neutral index has the highest market beta (0.82) because of the sector neutrality objective. Finally, our standard HFI index has a market beta exposure of 0.77, which unlike the US universe is higher than the MSCI index.

High information ratio and robustness of outperformance
Our defensive offering has very good relative performance compared to the cap-weighted index as well as strong probability of outperformance as seen in figure 6. Indeed, we observe in Panel A (US universe) that our indices have information ratios ranging from 0.23, for our narrow HFI index, to 0.54 for our sector-neutral HFI index. These numbers are much higher than the MSCI Minimum Volatility index, which delivers an information ratio of only 0.14. The probabilities of outperformance for each horizon are also much better for our indices, which demonstrates the robustness of our construction process based on the Smart Beta 2.0 framework. The sector-neutral HFI index clearly exhibits the best relative statistics, since it is one of its objectives to reduce the exposures to the cap-weighted index. It exhibits the strongest probabilities of outperformance for the one-year and three-year horizon and the lowest maximum relative drawdown. The standard HFI index has a good information ratio, which is more than 305% higher than the MSCI index with even a smaller tracking error (~190) and weaker maximum relative drawdown (10.8% versus 17.3%). Finally, the narrow HFI index has the smallest information ratio and probabilities of outperformance and the highest relative risks of our offering, but its statistics are still better in comparison to the MSCI index.

We start the analysis with bull/bear market regimes conditional analysis (see figure 7). We first observe a clear asymmetry of relative returns compared to the cap-weighted index, since they are negative in bull markets and positive in bear markets while they are much higher in magnitude in bear markets. This is the typical characteristic of defensive strategies. The narrow HFI index provides, as expected, the strongest protection in bear markets, since its relative return stands at +13.97% on US and +14.06% on Developed, but it also provides the lowest relative return in bull markets (~9.59% and ~9.45% on US and Developed universes respectively). The standard HFI index offers also a good protection in bear markets, since its relative return stands at +10.79% on US, which is similar to the MSCI Minimum Volatility index (~10.4%) and +11.24% on Developed, which is slightly lower than the MSCI index (~14.09%). However, in bull markets, the index loses only ~5.26% relative to the cap-weighted index on US and ~5.81% on Developed, which is much better than the MSCI index (relative loss of ~8.33% and ~12.8% on US and Developed universes respectively).

Finally, the sector-neutral HFI index provides the lowest level of protection in bear markets with a relative returns standing at +7.23% on US and +8.54% on Developed. Note that the protection is still interesting since it is only 33% and 24% lower than the standard HFI index, on both. In bull markets, the index loses only ~2.43% compared to the cap-weighted index on US and ~3.9% on Developed.

As expected, the sector-neutral HFI index delivers the lowest protection in bear markets and is, as expected, less sensitive to market regimes, since it provides the smallest bull/bear spread relative return of all indices. At the opposite, the narrow HFI index offers the highest protection in bear markets and suffers important relative losses in bull markets. The standard HFI index
is a good compromise, since it provides good level of protection in bear markets, almost as high as the narrow HFI index and has more controlled relative losses in bull markets. Moreover, for the same level of protection in bear low volatility market regimes and exhibits very low conditional spread factor return regimes, since it delivers almost the same returns in both bull and bear low volatility factor regimes on US and +13.73% on Developed, which is similar to the MSCI index (+0.91% and –0.32% on US and Developed). The sector-neutral HFI index has a very low conditionality to the returns of the low volatility factor. We observe that, as volatility markets if suffers lower relative losses in low volatility markets than low volatility markets. Moreover, for the same level of protection in high volatility market regimes, almost as high as the narrow HFI index and suffers much smaller relative losses in high volatility markets. The standard HFI index provides a good level of protection in high volatility markets since its relative return stands at +7.95% on US and +13.73% on Developed. Nevertheless, we highlight that the MSCI Minimum Volatility index does even worse with a relative loss of –7.08% in low volatility markets on the US universe and –7.63% on Developed.

The standard HFI index offers the highest protection in high volatility markets since its relative return stands at +7.95% on US and +16.04% on Developed, which is similar to the MSCI index (+6.63% and +7.95% on US and Developed). In low volatility markets, it loses –2.16% compared to the cap-weighted index on US and –1.84% on Developed, which is much better than the MSCI index (relative loss of –7.08% and –7.63% on US and Developed universes respectively).

The sector-neutral HFI index has the lowest protection in high volatility markets with a relative return of +5.05% on US and +5.63% on Developed, which is only 23% lower than the standard HFI index on both universes and has the smallest relative loss in low volatility markets (–0.87% on US and –0.77% on Developed).

These results are similar to the bull/bear market return regimes analysis. The sector-neutral HFI index delivers the lowest protection in low volatility markets but its relative performance is less conditional to market volatility regimes. At the opposite, the narrow HFI index offers the strongest protection in high volatility markets and suffers important relative losses in low volatility markets. The standard HFI index is again a good compromise, since it provides good level of protection in high volatility market regimes, almost as high as the narrow HFI index and suffers much smaller relative losses in low volatility markets. Moreover, for the same level of protection in high volatility markets it suffers lower relative losses in low volatility markets than the MSCI index, due to its better factor intensity.

Finally, in figure 9, we show absolute performance of the different indices conditional on the returns of the low volatility factor. We observe that, as expected, the narrow HFI index has the highest return in bull low volatility factor regimes (+17.39% on US and +15.73% on US and Developed) and very low return compared to all other indices in bear low volatility factor regimes (–0.29% on US and +0.91% Developed). The bull/bear spread return is high, which means the index is highly conditional on the low volatility factor regimes. The standard HFI index has a return of +14.83% in bull low volatility factor regimes on US and +13.73% on Developed, which is similar to the MSCI Minimum Volatility index. However, it delivers a return of +5.16% in bear low volatility factor regimes on US and +5.33% on Developed, which is much better compared to the MSCI index (+1.63% and –0.32% on US and Developed). The sector-neutral HFI index has a very low conditionality to the factor return regimes, since it delivers almost the same returns in both bull and bear low volatility factor regimes and exhibits very low conditional spread returns (–0.27% on US and +1.58% on Developed). As expected, the sector-neutral HFI index has a low conditionality to the low volatility return regimes because of its sector neutrality objective that dilutes its exposures to the factor, unlike the narrow HFI index, which exhibits the highest conditionality. The standard HFI index is again a good compromise, since it provides good level of protection in bear markets, almost as high as the narrow HFI index and has more controlled relative losses in bull markets. Moreover, for the same level of protection in bear low volatility markets the index is highly conditional on the low volatility factor. The bull/bear spread return is high, which means the index is highly conditional on the low volatility factor regimes. The standard HFI index has a return of +14.83% in bull low volatility factor regimes on US and +13.73% on Developed, which is similar to the MSCI Minimum Volatility index. However, it delivers a return of +5.16% in bear low volatility factor regimes on US and +5.33% on Developed, which is much better compared to the MSCI index (+1.63% and –0.32% on US and Developed). The sector-neutral HFI index has a very low conditionality to the factor return regimes, since it delivers almost the same returns in both bull and bear low volatility factor regimes and exhibits very low conditional spread returns (–0.27% on US and +1.58% on Developed). As expected, the sector-neutral HFI index has a low conditionality to the low volatility return regimes because of its sector neutrality objective that dilutes its exposures to the factor, unlike the narrow HFI index, which exhibits the highest conditionality. The standard HFI index is again a good compromise, since it provides good level of protection in bear markets, almost as high as the narrow HFI index and has more controlled relative losses in bull markets. Moreover, for the same level of protection in bear low volatility regimes and exhibits very low conditional spread returns (-0.27% on US and +1.58% on Developed).
Since 2013, with the Smart Beta 2.0 framework, EDHEC-Risk Institute has created Scientific Beta multi-smart-factor indices that are well diversified and exposed to rewarded factors. These indices have a robust live track record with annualised outperformance of 1.42% and an improvement in Sharpe Ratio of 49.20% compared to their cap-weighted benchmark.¹

We believe that the academic consensus and concern for robustness that underlie the design of our smart beta indices are always demonstrated, not only in our long-term track records, but also in our live performances.

For more information, please visit www.scientificbeta.com or contact Mélanie Ruiz on +33 493 187 851 or by e-mail to melanie.ruiz@scientificbeta.com

¹ The average live outperformance and improvement in Sharpe Ratio across all Scientific Beta developed regions of Scientific Beta Multi-Beta Multi-Strategy (Equal Weight and Equal Risk Contribution) indices is 1.49% and 1.36% for the outperformance and 52.36% and 46.04% for the improvement in Sharpe Ratio. This live analysis is based on daily total returns in the period from December 20, 2013 (live date) to December 31, 2018 for all diversified multi-strategy indices that have more than 3 years of track record for all available developed world regions – USA, Eurozone, UK, Developed Europe, Developed Europe ex UK, Japan, Developed Asia Pacific ex Japan, Developed ex UK, Developed ex USA and Developed. The benchmark used is a cap-weighted portfolio of all stocks in the respective Scientific Beta universes.

Information containing any historical information, data or analysis should not be taken as an indication or guarantee of any future performance, analysis, forecast or prediction. Past performance does not guarantee future results.
We highlight that its exposure to the term spread factor is negative (−0.46 and −0.73 on US and Developed universes respectively), but is lower compared to the other indices of our offering and much reduced compared to the MSCI Minimum Volatility index. Defensive investors that are worried by a sudden increase in rates should favour this index.

The standard HFI index's only significant exposure is to the term spread (−1.48 and −1.29 on US and Developed universes respectively). We highlight that the narrow HFI index offers the same level of volatility reduction, but is lower compared to the other indices of our offering and much reduced compared to the MSCI Minimum Volatility index. Defensive investors that are worried by a sudden increase in rates should favour this index.

11. Recap of the key elements of our defensive offering

The analysis is based on daily total returns in US dollars from 21 June 2002 (base date of SciBeta indices) to 31 December 2018. All statistics are annualised and regressions are based on weekly total returns in US dollars. The yield differential of Secondary US Treasury Bills (3M) is used as a proxy for the T-bill factor. Term spread factor is the difference in yield differential of 10-year US Treasury bonds and yield differential of three-year US Treasury bonds. The market factor is the excess return series of the cap-weighted index over the risk-free rate. Credit spread factor is the difference in yield differential of BBB corporate bonds and AAA corporate bonds. Coefficients significant at 5% p-value are highlighted in bold. The smart factor indices used are the SciBeta USA High Factor Intensity Low Volatility Diversified Multi-Strategy (4-Strategy) and the SciBeta USA Narrow High Factor Intensity Low Volatility Diversified Multi-Strategy (4-Strategy). The cap-weighted indices are the SciBeta USA Cap-Weighted and the SciBeta Developed Cap-Weighted.

<table>
<thead>
<tr>
<th>Panel A – SciBeta USA</th>
<th>Standard HFI</th>
<th>Sector-neutral HFI</th>
<th>Narrow HFI</th>
<th>MSCI Minimum Volatility</th>
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<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
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<td>−1.00</td>
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<tr>
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<td>−0.87</td>
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<tr>
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<td>Panel B – SciBeta Developed</td>
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<td></td>
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<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
</tr>
<tr>
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<tr>
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<td>16.26</td>
<td>19.30</td>
<td>16.17</td>
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</table>

| Panel A – SciBeta Developed |
| Unexplained |
| Market beta |
| T-bill |
| Term spread |
| Credit spread |
| R-squared |

10. Macroeconomic sensitivity of SciBeta defensive offering and MSCI Minimum Volatility on SciBeta USA and SciBeta Developed universes

The analysis is based on daily total returns in US dollars from 21 June 2002 (base date of SciBeta indices) to 31 December 2018. All statistics are annualised and regressions are based on weekly total returns in US dollars. The yield differential of Secondary US Treasury Bills (3M) is used as a proxy for the T-bill factor. Term spread factor is the difference in yield differential of 10-year US Treasury bonds and yield differential of three-year US Treasury bonds. The market factor is the excess return series of the cap-weighted index over the risk-free rate. Credit spread factor is the difference in yield differential of BBB corporate bonds and AAA corporate bonds. Coefficients significant at 5% p-value are highlighted in bold. The smart factor indices used are the SciBeta USA High Factor Intensity Low Volatility Diversified Multi-Strategy (4-Strategy), SciBeta USA High Factor Intensity Low Volatility Diversified Multi-Strategy (4-Strategy) (Sector Neutral), SciBeta USA Narrow High Factor Intensity Low Volatility Diversified Multi-Strategy (4-Strategy), SciBeta Developed High Factor Intensity Low Volatility Diversified Multi-Strategy (4-Strategy) (Sector Neutral) and the SciBeta Developed Narrow High Factor Intensity Low Volatility Diversified Multi-Strategy (4-Strategy). The cap-weighted indices are the SciBeta USA Cap-Weighted and the SciBeta Developed Cap-Weighted.

| Panel A – SciBeta USA |
| Market beta |
| T-bill |
| Term spread |
| Credit spread |
| R-squared |

The design of Scientific Beta's defensive offering answers investors' needs for a reduction in volatility compared to the cap-weighted index and also offers capital protection in bear markets (see figure 11). This is achieved through the Smart Beta 2.0 construction framework, which first selects stocks with low volatility, then applies an HFI filter to remove the stocks with the lowest multi-factor scores and finally diversifies away idiosyncratic risks with a diversified weighting scheme. This approach delivers high factor intensity and good long-term risk-adjusted performance, because it harvests the low volatility factor, which is known to provide an additional source of performance compared to the cap-weighted index over the long-term, while maintaining positive exposures to other rewarded risk factors, thanks to the use of the HFI filter. Moreover, Scientific Beta's top-down approach gives investors the flexibility to select the solution that fits with their investment objectives by offering them three different versions of defensive indices.

The High Factor Intensity Low Volatility Diversified Multi-Strategy (4-Strategy) index offers a good exposure to the low volatility factor and hence a good level of volatility reduction and protection in bear markets (similar to the popular benchmark – the MSCI Minimum Volatility index), while providing the highest factor intensity as well as the best risk-adjusted performance of our offering. This index is recommended for defensive

| Panel A – SciBeta USA |
| Market beta |
| T-bill |
| Term spread |
| Credit spread |
| R-squared |

Defensive strategies tend to overweight defensive sectors, like utilities. This sector has an exposure to interest rate risks for two main reasons. First, the sector has lower risks than global equities, meaning that in a low interest rate period, as was the case over recent years (and is still the case), bond investors can have an interest in investing in utilities companies, since they provide higher yields than bonds through high dividend payouts. This is the so-called bond-like feature of the utilities sector. If bond yields increase, utilities stocks become less attractive and bond investors sell their investments. This negatively impacts stock prices and therefore returns. Second, utilities companies have high capital expenditures that cannot be solely financed by free cash flows and therefore require debt financing, which is cheaper than equity financing. In a rising rate environment, their interest payments will increase and have a negative impact on their earnings. The latter will have a negative impact on their prices and returns. For these reasons, we can expect negative exposures of defensive solutions to T-bill and term spread factors.

Defensive strategies should be positively related to risk aversion and therefore to credit spread, which is a measure of financial distress. Indeed, we should expect spreads between BAA and AAA bonds to increase when market volatility increases. For this reason, we can expect positive exposures of defensive solutions to credit spreads.

We see in figure 10 the different exposures of our defensive indices on the macroeconomic factors, from which we can draw the following conclusions. The sector-neutral HFI index has the lowest exposures to the various macroeconomic factors and especially to interest risk factors because of its sector neutrality objective, which implies weak relative exposures to defensive sectors, like utilities, that are negatively impacted by interest rate risks.
Inconsistent factor indices: What are the risks of index changes?

Noël Amenc, Associate Dean for Business Development, EDHEC Business School, CEO, Scientific Beta; Mikheil Esakia, Quantitative Research Analyst, Scientific Beta; Felix Goltz, Research Director, Scientific Beta, Head of Applied Research, EDHEC-Risk Institute; Marcel Sibbe, Junior Quantitative Equity Analyst, Scientific Beta

In investors with weak tracking error constraints who are seeking a solution that is not only defensive, but that is also properly exposed to other rewarded risk factors in order to obtain the highest risk-adjusted return.

The High Factor Intensity Low Volatility Diversified Multi-Strategy (4-Strategy) (Sector Neutral) index offers the lowest volatility reduction and protection in bear markets. Moreover, it delivers the smallest Sharpe ratio of our offering. Nonetheless, its additional objective is also to reduce tracking error through the sector neutrality objective. The objective is achieved, since the index delivers the lowest tracking error and the best information ratio of our offering. Moreover, it has low conditionalality to market and macroeconomic factors in particular to T-bills and term spread factors. This index is recommended for defensive investors with tracking error constraints wanting to avoid negative relative performance in bull market regimes or in rallies of some sectors and that are worried by rising interest rates.

The Narrow High Factor Intensity Low Volatility Diversified Multi-Strategy (4-Strategy) index has the highest exposure to the low volatility factor and therefore delivers the strongest volatility reduction and offers the best protection in bear markets. The index is therefore designed for investors who seek the most defensive solution. Obviously, this high exposure to the low volatility factor comes with a cost, in the form of lower exposures to other rewarded risk factors, higher conditionality to various regimes, meaning important relative losses in bull markets for instance, and high tracking error. Moreover, it has the strongest sensitivity to macroeconomic factors of our offering and in particular to T-bills and term spread factors. For Scientific Beta, this index should not be considered as a standalone solution, but rather as an overlay solution for investors willing to modify their portfolio’s market beta or low volatility exposure, while simultaneously avoiding a reduction in the factor intensity of their existing portfolio thanks to the HFI filter.

To conclude, Scientific Beta's defensive offering is motivated by a strong belief that investors are not identical and that their investment objectives and constraints are different. This is why we believe that our top-down approach, which is simple and transparent, is the best approach for our clients. Finally, we offer risk control options (such as the sector-neutrality objective) and concentrated selections (such as the narrow high factor intensity), which allows investors to explicitly define their preferences in terms of relative risks and level of defensiveness, which are often hidden by-products in defensive solutions offered by competitors. Whatever the defensive index chosen, the fact that they are part of the Scientific Beta smart factor indices ensures that they benefit from the same features as all the other indices we offer, namely the good diversification of unrewarded risks and the capacity to limit undesired risks. For investors, this is the guarantee that their choice will be the best possible.

References


changing an index methodology over time. For example, new rules may improve the ease of implementation. Just as methodologies for cap-weighted indices introduced a free-float adjustment to improve liquidity, smart beta index methodologies may change their rules to improve investability. Moreover, just as cap-weighted index rules may reconsider how to categorise countries into emerging and developed markets, smart beta index rules could be updated to improve the implementation of a given factor strategy.

However, it is important to note that the changes are consistent with investment objectives. For example, it would be surprising if a multi-factor index suddenly targets a different set of factors than it did in the past. Index providers should have a sound justification for why index methodology changes align with their investment philosophy.

Another crucial aspect when there is a change in index methodology is transparency in the transparency of European ETF providers. Goltz and Le Sourd (2018) find that one of the key challenges that investors face when analysing factor-based strategies is difficulty in accessing information, in particular for risks such as data-mining risks. Changes to index rules and the performance characteristics of older index offerings should be transparent to allow investors to evaluate a provider’s strategies.

This article analyses the implications of inconsistencies for investors, and illustrates problems with industry practice using examples from recent index changes.

**What do inconsistencies over time mean for investors?**

### Data-mining risks

The key issue arising from inconsistency over time of index methodologies is a data-mining risk. Frequent changes of index methodologies add an important layer of flexibility to providers, thus increasing the risk of data snooping. For example, one of the most common methodology changes in the industry is ‘enhancing’ factor definitions. Searching over many possible ‘enhanced factors’, it is easy to find a definition that shows stellar backtested performance purely by chance. Harvey and Liu (2016) refer to such factors as ‘lucky factors’. Besides finding the ‘best’ variable as a proxy, there are a number of adjustments that smart beta index providers use, such as sector and/or country relative scoring, transformation of a factor score distribution (logarithmic, normal, etc) or aggregating multiple variables into composite scores using arbitrary weights, to name only a few options. The more flexibility, the higher the selection bias.

When assessing the live performance of an index, it will always be possible to identify a better-performing factor definition for the relevant time period. If providers replace factor definitions because one of many backtested ‘enhancement’ options outperforms the live index performance, investors will not reap any benefits as the improvement will be spurious. Moreover, if providers follow such a data-mining approach, backtests of newly launched indices would indicate performance that is artificially inflated.

There is a more fundamental reason why frequent changes in factor definitions are problematic. Such changes would suggest that these factors are not the persistent drivers of returns that investors are looking for. Factors such as stock value and momentum are recognised as persistent factors precisely because they deliver premia that are justified economically, and factor premia have been documented empirically, including for the 30-year period after the initial results were made publicly available (see McLean and Pontiff [2016]). Factors that require frequent updating cannot be persistent factors and thus frequent updating is a sign of a lack of robustness.

Enhancing factor definitions is just one example of possible methodology changes. The data-mining critique applies not only to the definition of a particular factor, but also to the selection of factors. Simply choosing the factor combination with the ‘best’ in-sample performance will not lead to robust performance in the future. Selection and weighting of different factors should be well-justified, not purely backwards looking.

Another pitfall of index methodology inconsistencies is model-mining risk. In fact, even if the factor definition and factor selection remain fixed, multi-factor indices may rely on different portfolio construction models to combine factor exposures into an index. When deciding on portfolio construction, a multitude of options is available to providers. In particular, portfolio construction could be subject to arbitrary constraints. For example, one index provider reports how different levels of constraints were tested over the backtest and how the selected constraints produced the multi-factor index with the highest information ratio. Using a large number of ad-hoc constraints (sector/country weights, security weights, factor exposures, turnover) in portfolio construction exacerbates model risk. The risk is that one may pick the constrained model that works well in the backtests but does not produce robust performance out-of-sample. Again, frequent and unjustified changes to methodologies would allow providers to replace a model that has done poorly in a live track record with a model that has achieved better results in the backtest.

For investors, it is crucial to identify whether index changes are purely motivated by opportunities for backtest enhancement, or whether providers are actually offering an improvement to an existing index. Andrew W. Lo argues that by defining data-mining risk, investors can use an analytical framework to limit the number of possibilities in the search process. Indeed, one of the fundamental principles to avoid data-mining risk is to limit the range of possible options a provider could implement as index changes. With less flexibility to the provider, there will be less risk of data mining. To put a constraint on the amount of flexibility providers have, investors can require that any methodology change remains consistent with the investment principles of the existing offerings. Indeed, if changes are conducted within an explicit methodological framework and with reference to a clear investment philosophy, there is little room for data mining. Requiring a consistent framework and investment philosophy is one of the best weapons against spurious performance records. Such a framework is nothing but the realisation of investment discipline.

### Conflict with long-term investing

Beyond data-mining risks, inconsistency over time is a general problem when making decisions about long-term investments. The majority of institutional investors, such as pension funds, have a long-term investment horizon, implied by the nature of their liabilities. Maintaining a long-term horizon is among the most frequently referred to investment principles of pension funds and sovereign wealth funds.

Short-term and ad-hoc adjustments of investment methodologies are at odds with effective long-term investing. Instead, long-term investing requires deciding on investment principles and staying the course in the long term. Recommendations for governance principles of pension funds argue that “investment beliefs can help investors steer a consistent course, regardless of today’s investment fads” (Lydenberg [2011]). Appropriate index strategies should reflect this focus on consistent principles and not change methodologies according to the latest fad. Moreover, there is evidence that when investors change their exposures frequently over time, these efforts typically have adverse results (see Frazzini and Lamont [2008]). Compared to staying the course, such frequent changes compromise investment results.

More specifically, it appears that erratic factor index methodologies are at odds with the foundations of factor investing. For example, consider the position of an investor who blindly follows frequent changes to a provider’s factor definitions and factor menu. If investors really believe that the factors they are using to invest change very frequently over time, controlling their current exposure to such factors is close to useless as a support for investment decisions, as these should rely on factors that will still be relevant drivers of performance in the future. Indeed, the academic evidence on factor investing suggests that factors are rewarded over the long term. Index methodologies that frequently change factor definitions, or that change the set of factors at different points in time, are inconsistent with the principles of factor investing.

### Which inconsistencies exist in the industry?

This section discusses in detail the three most common changes in the methodology of factor indexes, namely factor selection, factor definition and investment principles. The following subsections also provide examples of recent index changes.

#### Changing factor selection

Extensive empirical research over the past decades has discovered hundreds of ‘rewarded’ factors, also known as the ‘factor zoo’. However, only a few of these factors have survived academic scrutiny. The set of factors that appears in consensus models of expected return is not only relatively small, but also very stable over time. For example, Fama and French proposed a three-factor model in 1993 and extended the set of factors to five in 2015. In a span of more than two decades, two factors were added to the menu while maintaining the factor definitions of the initial factors. Moreover, the new factors follow the same ad-hoc analysis as the old factors. The change is not more frequent simply because newly proposed empirical asset pricing factors need to pass a high hurdle before they are accepted as consensus factors. While there are hundreds of factors in the ‘factor zoo’, only a handful have been confirmed by independent replication, post-publication evidence and
rigorous theoretical models. A high hurdle for acceptance of factors implies that the relevant set is relatively stable over time.

1 If one sets a low hurdle on accepting new factors, we would expect to see a much faster pace of change. The flipside would be that such a low hurdle will increase the risk of accepting spurious factors that have not undergone a sufficient amount of scrutiny. New sets of factors could appear frequently depending on ‘factor fads’. Likewise, well-established factors could be abandoned prematurely, without sufficient validation and replication of results.

2 When considering the factor selection in multi-factor flagship products, we observe a fast pace of change over time. For example, in 2013, MSCI launched a series of Quality Mix indices, representing a flagship multi-factor offering. The index targeted balanced exposures to value, low volatility and quality factors. However, MSCI decided to exclude the low volatility factor from its flagship Diversified Multi-Factor series in 2015, the launch of the MSCI Diversified Multi-Factor series. The new index targets value, quality, size and momentum factors. Although the exclusion of the low volatility factor does not appear to be guided by the consideration that it is not a true rewarded factor. A relevant question is whether the exclusion of this factor in the new multi-factor index (Diversified Multiple-Factor index series, or DMF), allowed the information ratio to be improved in the backtest as of the launch date. One may ask what would have happened to the backtested performance of the DMF indices if MSCI had instead included the low volatility factor in the computation of the composite score used in the DMF optimiser. In fact, MSCI reports the results for various selections of factors in the publication introducing the DMF. There we learn that including the low volatility factor would have caused a deterioration of the information ratio from 1.14 to 0.86 for the world index over the 16-year backtest period. Naturally, selecting rewarded factors on the basis of their performance over a backtest period is backward-looking and can prove counter-productive out-of-sample. We will return to the question of performance since launch of the index below.

Inconsistencies regarding factor selection might exist not only with the previously released product offerings, but also with the previous research findings. For example, the launch of the RAFI multi-factor index series was backed up by a research publication, which explicitly emphasised the robustness of factors it included, such as quality and size (see, eg, Arnott, Beck and Kalesnik [2016]). However, an earlier publication (see Beck et al [2016]) concluded that the quality and size factors are not robust. More specifically, we can compare the following two statements (emphasis added):

- From September 2016: “We found that two of the more popular factors – quality and size – lack robust empirical evidence to support them.”

- From January 2017: “RAFI Multi-Factor is designed to offer the following benefits: Combines theoretically sound and empirically robust single-factor strategies – value, low volatility, quality, momentum and size…”

Ultimately, such examples show that provider views on what a robust factor may change dynamically over time, sometimes within very short time periods. Such short-term variations in fundamental beliefs about factors appears to be inconsistent with the idea that factor indices should represent strategic choices for long-term investing.

Indeed, one provider states about its factor investing framework that: “Performance or factor positions may be added, modified or removed, […] to ensure it accurately reflects a set of robust factors and factor groups at a given point in time”. The irony of labelling spurious factors as “robust at a given point in time” reflects to what extent robustness is neglected in current industry practices.

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</tbody>
</table>

The problem with inconsistency over time in the factor set is that such changes have a tremendous impact on backtest performance. We provide a stylised example to illustrate the impact of selecting different sets of factors. First, let us consider the historical performance of portfolios that allocate equal weights to at least three factors out of six. Figure 1 shows the distribution of Sharpe ratios of 42 possible portfolios that can be formed with different factor selections. The results indicate that the risk-adjusted performance of multi-factor indices varied between 0.51 and 0.73 over the 40-year period, a range of 0.22 between the highest and lowest Sharpe ratio. If we look at the 10-year sub-periods (a more typical length for a backtest period), the performance range – ie, the difference between the highest and lowest Sharpe ratios – may be as high as 0.42. This example suggests that selecting factors differently in a new index offers sufficient flexibility to show large improvements in backtested performance relative to an existing index.

The performance differences become even more pronounced when considering relative performance. The second panel of figure 1 reports the information ratios of stylised portfolios. Over the full sample, the information ratios range from 0.11 to 0.81. The dispersion is even higher when looking at shorter periods of 10 years. Overall, the analysis indicates that factor selection in multi-factor indices has a dramatic impact on the performance, both in absolute and relative terms, especially when looking at short backtest periods. Thus far, we have only analysed in-sample performance of portfolios that tilt towards different sets of factors. It is more relevant to analyse what happens when one periodically selects a factor combination with the most attractive backtest. In the following exercise, we pick factor combinations based on the returns over the past five and 10 years of data. Again, we limit the minimum number of factors to three. After formation, the selected multi-factor index is held for different horizons (HP).

The analysis in figure 2 shows that the factor-picking strategies underperform the six-factor equally weighted allocation. More importantly, we find that all of the factor-picking strategies experience degradation in terms of out-of-sample performance. Out-of-sample degradation is the difference in the annualised ‘value-add’ of picking factors between the holding period and the annualised performance of active strategies. The strategies are synthetic portfolios that correspond to the sum of market returns and equal-weighted returns of different long-short factors. The factor selection is done on the basis of historical performance (calibration period). The combination of factors that has the highest return over the calibration period is held for different time periods (HP in year).

The out-of-sample degradation of returns is the difference between relative returns of the strategies during the holding and calibration periods. The reported numbers are the average of those differences across all holding periods in the sample. The returns are relative to the six-factor equally weighted portfolio. The performance measures are computed over the period 1 July 1980–31 December 2017.

<table>
<thead>
<tr>
<th>Selecting past winner</th>
<th>EW</th>
<th>H = 1</th>
<th>H = 2</th>
<th>H = 3</th>
<th>H = 4</th>
<th>H = 5</th>
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</tr>
</thead>
<tbody>
<tr>
<td>Sharpe ratio</td>
<td>0.68</td>
<td>0.68</td>
<td>0.66</td>
<td>0.63</td>
<td>0.57</td>
<td>0.59</td>
<td>0.61</td>
<td>0.63</td>
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<tr>
<td>Information ratio</td>
<td>0.54</td>
<td>0.44</td>
<td>0.35</td>
<td>0.33</td>
<td>0.31</td>
<td>0.32</td>
<td>0.33</td>
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The table reports the performance of active strategies. The strategies are synthetic portfolios that correspond to the sum of market returns and equal-weighted returns of different long-short factors. The factor selection is done on the basis of historical performance (calibration period). The combination of factors that has the highest return over the calibration period is held for different time periods (HP in year).

The out-of-sample degradation of returns is the difference between relative returns of the strategies during the holding and calibration periods. The reported numbers are the average of those differences across all holding periods in the sample. The returns are relative to the six-factor equally weighted portfolio. The performance measures are computed over the period 1 July 1980–31 December 2017.

![Distribution of performance numbers for different factor selections](https://www.researchaffiliates.com/en_us/strategies/rafi/rafi-multi-factor.html)

![Distribution of information ratios](https://www.researchaffiliates.com/en_us/strategies/rafi/rafi-multi-factor.html)
the calibration period.\textsuperscript{11} For example, selecting factor combinations each year based on the previous five years will result in degradation of annualised relative returns by 3% out-of-sample. The degradation is consistent across different factor picking strategies, regardless of the calibration and holding parameters.

The analysis clearly suggests that factor picking inflates backtest results. We also emphasise that we constructed a relatively well-behaved exercise, with an allowed amount of picking across a fixed set of six factors. In practice, index providers could generate much more flexibility by extending the set of factors or flexibly defining weights given to each factor.\textsuperscript{12} Given the large amount of flexibility and the pronounced risk of overstated backtest performance, investors should analyse closely what the justification for changes in factor selection is.

Changing factor definitions
As mentioned above, not only the set of factors, but also the factor definitions underlying the empirical and theoretical evidence on factor investing are very stable over time. Again, there is a stark contrast when it comes to factor definitions used by index providers. In fact, providers tend to update factor definitions frequently. We can provide two straightforward illustrations of changes in factor definitions for different indices with a value investing orientation.

A first example is the value factor definition used by MSCI, a provider of indices and analytics tools. Figure 3 shows the evolution of factor definitions across time for the value factor used by MSCI.\textsuperscript{13} Interestingly, modifications in the value factor definition concern not only the variables that form the composite value score, but also how they are combined, and which adjustments are carried out (such as sector-relative scoring). The resulting value factor definition is a specific choice among a large number of possible variations.

When it comes to the selected variables, we can see that the only consistent variable is the price-to-book ratio, which is indeed the standard characteristic used to capture the value factor in academic research. The other variables change dynamically over time. For example, ‘enterprise value-to-cash flow’ is introduced in 2014, but then disappears from the definition favoured in 2018. One may ask what the value of such transient variables is. When it comes to adjustments, we observe the same erratic behaviour. For example, the factor ‘adjustment for leverage to avoid overweighting highly-leveraged firms’ was introduced as an ‘enhancement’ in 2014 but is absent from the definition favoured in 2018. One could ask why the so-called ‘enhancement’ did not carry through to the definition developed later.

A second illustration of a change in definition of variables is index methodologies for fundamentally-weighted indices.\textsuperscript{14} In 2005, FTSE launched the FTSE RAFI index series. This weighted stocks based on stock-level composite scores made up of companies’ sales, cash flows, book value and dividends. In 2011, another series of fundamentally-weighted indices was launched, which is now known as the Russell RAFI indices. While there are no differences in index objective or conceptual underpinnings between the two index series, the accounting variables to measure the firms’ fundamental values are different. More specifically, the Russell RAFI index series relies on sales, cash flows and dividends. Unlike the FTSE RAFI index, it excludes the book value. Furthermore, the new index adjusts sales by financial leverage, and adds buybacks to the dividends. It is worth noting that the earlier index, which was released in 2005, a few years before the global financial crisis, did not adjust any of the fundamentals for leverage, while the index that was launched in 2011, after the global financial crisis, did include an adjustment for leverage to avoid overweighting highly-leveraged firms. This suggests that the view on how to define basic firm fundamentals has evolved dynamically

\textsuperscript{11}The reported numbers are average across all the holding periods in our sample, and the returns used are relative to the six-factor portfolio to measure the ‘value’ added by actively picking factors.

\textsuperscript{12}In this study, the portfolios were based on equally-weighted factor definitions. This study examines the impact of changing the factor definitions used by index providers on alternative value definitions and this portfolio is held for another five years.

\textsuperscript{13}The methodology of MSCI Enhanced Value (2014) can be found here: https://www.msci.com/ecp/methodology/sectors/MSCI.4c57ed52.1e90a823.5.e10a387f22258b72307ac مهم موضوعات مصرف بالجملة: مبادئ الصناعة المالية، وتشير إلى الجوانب المختلفة للاستراتيجية المالية، وتشير إلى أهمية استخدام القيمة المصرفية في الاستراتيجية المالية. يتضمن الجوانب المختلفة للاستراتيجية المالية، وتشير إلى أهمية استخدام القيمة المصرفية في الاستراتيجية المالية. يتضمن الجوانب المختلفة للاستراتيجية المالية، وتشير إلى أهمية استخدام القيمة المصرفية في الاستراتيجية المالية. يتضمن الجوانب المختلفة للاستراتيجية المالية، وتشير إلى أهمية استخدام القيمة المصرفية في الاستراتيجية المالية. يتضمن الجوانب المختلفة للاستراتيجية المالية، وتشير إلى أهمية استخدام القيمة المصرفية في الاستراتيجية المالية. يتضمن الجوانب المختلفة للاستراتيجية المالية، وتشير إلى أهمية استخدام القيمة المصرفية في الاستراتيجية المالية. يتضمن الجوانب المختلفة للاستراتيجية المالية، وتشير إلى أهمية استخدام القيمة المصرفية في الاستراتيجية المالية. يتضمن الجوانب المختلفة للاستراتيجية المالية، وتشير إلى أهمية استخدام القيمة المصرفية في الاستراتيجية المالية. يتضمن الجوانب المختلفة للاستراتيجية المالية، وتشير إلى أهمية استخدام القيمة المصرفية في الاستراتيجية المالية. يتضمن الجوانب المختلفة للاستراتيجية المالية، وتشير إلى أهمية استخدام القيمة المصرفية في الاستراتيجية المالية. يتضمن الجوانب المختلفة للاستراتيجية المالية، وتشير إلى أهمية استخدام القيمة المصرفية في الاستراتيجية المالية. يتضمن الجوانب المختلفة للاستراتيجية المالية، وتشير إلى أهمية استخدام القيمة المصرفية في الاستراتيجية المالية. يتضمن الجوانب المختلفة للاستراتيجية المالية، وتشير إلى أهمية استخدام القيمة المصرفية في الاستراتيجية المالية. يتضمن الجوانب المختلفة للاستراتيجية المالية، وتشير إلى أهمية استخدام القيمة المصرفية في الاستراتيجية المالية. يتضمن الجوانب المختلفة للاستراتيجية المالية، وتشير إلى أهمية استخدام القيمة المصرفية في الاستراتيجية المالية. يتضمن الجوانب المختلفة للاستراتيجية المالية، وتشير إلى أهمية استخدام القيمة المصرفية في الاستراتيجية المالية. يتضمن الجوانب المختلفة للاستراتيجية المالية، وتشير إلى أهمية استخدام القيمة المصرفية في الاستراتيجية المالية. يتضمن الجوانب المختلفة للاستراتيجية المالية، وتشير إلى أهمية استخدام القيمة المصرفية في الاستراتيجية المالية. يتضمن الجوانب المختلفة للاستراتيجية المالية، وتشير إلى أهمية استخدام القيمة المصرفية في الاستراتيجية المالية. يتضمن الجوانب المختلفة للاستراتيجية المالية، وتشير إلى أهمية استخدام القيمة المصرفية في الاستراتيجية المالية. يتضمن الجوانب المختلفة L
may be a reason for concern. However, what is most striking about this illustration is that the out-of-sample period turns out to be about 4.5% below the in-sample performance. Thus, a reported backtest for such a strategy would have over-reported performance by a substantial amount. Indeed, the key risk of fishing for enhanced factor definitions in a backtest is that backtest performance numbers will be inflates relative to what investors can reasonably expect going forward.

We can ask how such a stylised example is for evaluating the risk of overstated backtests that arises in practice. We would argue that data-mining risks in practice are even greater in that stylised example. In fact, our example is based on picking a single factor definition. In factor definitions used in the industry, we commonly see combinations of multiple variables. Novy-Marx (2015) argues that the use of composite variables in designing and testing factor-based strategies increases the data-mining risks exponentially, due to a “particular pernicious form of data-snooping bias”\(^{15}\) in composite variable definitions.

Changing portfolio construction principles

Our illustrations above show that index methodologies may display severe inconsistencies over time in terms of factor selection choices and factor definitions. However, it turns out that the latter two are not the only sources of inconsistency. The portfolio construction principles of smart beta products also change dynamically over time.

One of the most evident examples in recent years is the increased popularity of so-called ‘bottom-up’ approaches in multi-factor investing. The bottom-up approach builds a multi-factor portfolio in a single pass by choosing and/or weighting securities by a composite measure of multi-factor exposures, as opposed to a more traditional top-down approach that assembles multi-factor portfolios by combining distinct sleeves for each factor.

While both approaches aim to capture premia associated with multiple factors, there are significant differences between the two. In particular, bottom-up and top-down portfolio construction rely on a different set of investment beliefs and investment objectives, as shown in Amenc et al. (2017, 2018). Bottom-up approaches try to increase the overall factor exposure, accounting for fine-grain differences in composite exposures. The underlying index methodology is often an assumption that there is a determinist link between factor exposures and stock returns. In contrast, top-down approaches prioritise portfolio diversification over precision in engineering factor exposures. The underlying investment belief is that expected returns at the stock level are highly noisy and the relation between factor exposures and returns can only be expected to hold in a broad sense.

Of course, investors may expect that the fundamental investment beliefs about factor investing of a given provider do not change frequently over time. As we pointed out above, investment beliefs are necessary for long-term investing, to ground investment decisions in sound principles and avoid being exposed to investment fads. An abrupt change in positioning with respect to bottom-up or top-down portfolio construction thus appears to be inconsistent with sound long-term investing.

However, index providers have displayed a large degree of flexibility in implementing beliefs concerning bottom-up versus top-down portfolio construction. One example is the adoption of a bottom-up portfolio construction by index provider MSCI, which, on the occasion of the release of a new series of Diversified Multiple Factor indices, promoted, with its research publications, an approach that was strictly opposed to the top-down approach that the same research teams had supported as part of the launch of the Quality Mix indices.

A fundamental question for investors is how different the performance of index offerings can be when using flexibility on factor selection, factor definitions and portfolio construction to come up with new index methodologies. We analyse this question with the following illustration.

What is the impact of index changes on performance?

We have shown above that frequent changes to different dimensions of factor indices are quite common in the industry. We also provided stylised examples to show potential consequences for investors. These illustrations isolated the effect on performance from a specific part of the methodology, such as factor selection. We now show an example of changes in index methodology across multiple dimensions.

More specifically, we consider the multi-factor offerings of index provider MSCI, and their evolution in 2015.\(^{16}\) The MSCI Quality Mix index was the flagship multi-factor index offering prior to 2015. The series targeted the value, low volatility and quality factors by blending the single-factor indices in a top-down manner. The new flagship offering, the Diversified Multiple Factor (DMF) index series, targets the value, momentum and size factors. We consider such a stylised example common in practice due to the flexibility in index construction.

We now show an example of changes in index methodology across multiple dimensions.

It is interesting to analyse how these differences in index construction translate into differences in terms of factor exposures. Figure 5 shows the factor exposures of the two strategies. It is obvious from the analysis that the factor exposures of the indices are extremely different. The MSCI Quality Mix (QMX) index is highly exposed to the profitability and low volatility factors, while DMF loads more heavily on the size, value and momentum factors. Changes in factor selection, factor definitions, and in the portfolio construction methodology indeed translate into very different outcomes.

In addition to factor exposures, it is interesting to consider differences in performance. In particular, one might ask whether the performance of the new index appeared significantly better than that of the old index as of the launch date of the new index. Indeed, we find that the new index (DMF) came with a backtest that showed substantially higher returns than the old index, as of the launch date of the new index. At the launch date of the new index, its relative returns over the cap-weighted index were 2.7% in the backtest, for the time period since launch of the old index. At that time, the old index (QMX) posted a 0.7% relative return since its launch. In terms of information ratio, the new index more than doubles the performance compared to the old index. After the launch of the new index however, the hierarchy between the two indices changed. The new index (DMF) has barely been able to beat the benchmark since its release in 2015, while the old index (QMX) outperformed the cap-weighted MSCI World by 1.3%. The old index produced an information ratio of 0.63 compared to an information ratio of 0.01 for the new index (DMF). Figure 6 provides an overview of these results.

5. Factor exposures of MSCI multi-factor offerings

We provide an overview of the factor exposures of the two index offerings, based on weekly returns in US dollars, from 21 June 2002 to 31 December 2018. Factor exposures are estimated using a seven-factor model, which includes the market, size, value, momentum, volatility, profitability and investment factors. The market factor is the return of MSCI World minus the return of three-month US Treasury bills. The remaining are long/short factors that equal-weight the stocks within the highest and the lowest 30% of stocks ranked by the given criterion.

6. Backtest vs live performance: MSCI flagship offerings

We provide an overview of the backtest vs live performance of MSCI flagship offerings, based on weekly returns in US dollars, from 21 June 2002 to 31 December 2018. Factor exposures are estimated using a seven-factor model, which includes the market, size, value, momentum, volatility, profitability and investment factors. The market factor is the return of MSCI World minus the return of three-month US Treasury bills. The remaining are long/short factors that equal-weight the stocks within the highest and the lowest 30% of stocks ranked by the given criterion.

\(^{15}\) Examples of such strategies cited by Novy-Marx (2015) are the MSCI Quality index, which draws on a composite of three variables, and Research Affiliates’ Fundamental indices, which rely on composite measures of fundamental firms size.

\(^{16}\) For the methodology of the two multi-factor offerings, please refer to the previous footnote.
While we understand the motivation for index providers to launch a new series of indices, when these indices differ from their past ones, their investment beliefs do not appear to lead to good performance, these new investment beliefs, often formed from concerns over in-sample performance, do not necessarily hold up against out-of-sample robustness tests.

Indeed, choices made by product providers are often guided by backtested performance. For example, one of the index providers explicitly mentions that “for follow the track record of the indices, as they can do with managers when they are interested in the ability to generate outperformance, which is also the promise of smart beta indices. It should be recognised that the level of transparency between index providers is fairly variable. For example, in the case of the indices considered in the illustration in the previous section, there is transparency in the sense that MSCI has kept publishing the performance of its old flagship offering (QFX) after launching the new multi-factor indices (DMF) in 2015, and presents these two indices as being part of its standard multi-factor index offering. We can regret the confusion of the concepts and the competition of which are the comparison with the performance of competitors, best index governance practice should also be in line with the presentation of asset manager performance promoted as part of the GIPS standards. These standards would lead to the construction of composites that are representative of all the indices produced by index providers, including those that have been discontinued, and as such would increase the transparency of representative of all the indices produced by index providers, including those that have been discontinued, and as such would increase the transparency of.

Managing index changes: how to achieve transparency for investors

While frequent changes to index methodologies do entail risks, it also seems inevitable that methodologies change as markets and the investment industry evolve, and research comes up with new approaches that offer better ways to achieve investment objectives. We have argued above that it is important that those changes are consistent with investment principles. Investors should require a sound rationale for an index change to make sure that a new index is justified by reasons other than an embellished backtest. Moreover, changes in index methodology, index offerings should be transparent to allow investors to assess both the reasons for and the implications of methodological changes. In particular, investors should have access to the performance of previous offerings. For example, if a product provider updates the rules of an existing index, the performance record of the index before the change will be effective will still be available. This is common practice, for example when a new country is added to the universe of a cap-weighted index. Another possibility is to launch a new index while maintaining the production of the previous offering(s), hence allowing investors to make comparisons between older and newer indices.

In both cases, the question of information on these changes is important. It is the only thing that enables investors to understand the changes made and to follow the track records of the indices, as they can do with managers when they are interested in the ability to generate outperformance, which is also the promise of smart beta indices. It should be recognised that the level of transparency between index providers is fairly variable. For example, in the case of the indices considered in the illustration in the previous section, there is transparency in the sense that MSCI has kept publishing the performance of its old flagship offering (QMX) after launching the new multi-factor indices (DMF) in 2015, and presents these two indices as being part of its standard multi-factor index offering. We can regret the confusion of the concepts and the competition (inconsistency) between the investment beliefs of research teams from the same company, but at least it is easy for the investor to find the information. Providers prefer to persuade investors to evaluate investment potential on the basis of indices, and to avoid the risk of relying on spurious performance records. Therefore, providers of factor products should be transparent about the methodological changes they make.

While providers will naturally change index methodologies as markets evolve and research progresses, there are important requirements to safe-guard investors from facing unlimited data-mining risks.

Going beyond the examples mentioned, the question of the governance of index changes should be a subject of concern not only for index providers but also, and especially, for investors. Regardless of the reasons for discontinuation of indices, disappearing indices are unfavourable from a transparency perspective. In fact, when index methodologies disappear or are hidden, investors are no longer able to assess the quality of the index offerings through time. It is straightforward to preserve transparency by maintaining old and new index series in parallel in as visible a manner as possible. When index changes are announced, investors should get clear information on the details of these changes without requiring investors to do the detective work of comparing different versions of ground rules documents. Providers should also be transparent about the motivations behind index changes.

While frequent and unjustified changes in index methodologies and offerings heighten data-mining risks, a lack of transparency about these changes effectively prevents investors from analysing such risks. While all indices require transparent construction rules at any given point in time, transparency also has to apply to changes in these rules over time.

More globally, we might think that with success of smart beta index offerings, the promise of which is fairly similar to that of an active asset manager, namely beating the cap-weighted benchmark, and the demand of competition of which are the comparison with the performance of competitors, best index governance practice should also be in line with the presentation of asset manager performance promoted as part of the GIPS standards. These standards would lead to the construction of composites that are representative of all the indices produced by index providers, including those that have been discontinued, and as such would increase the transparency of representative of all the indices produced by index providers, including those that have been discontinued, and as such would increase the transparency of.

Conclusion

Providers of smart beta strategies frequently change index rules. These changes often create inconsistencies between different products released at different times. Such changes may affect factor definitions, factor selection, and portfolio construction principles. By giving concrete examples, we show that methodological changes are quite common in the industry and sometimes happen across multiple dimensions at the same time.

The main problem with inconsistencies across time is a data-mining risk. While providers will naturally change index methodologies as markets evolve and research progresses, there are important requirements to safeguard investors from facing unlimited data-mining risks.

First, a lack of transparency about index changes makes it more difficult for the market to trust the arguments, and exacerbates the risk of relying on spurious performance records. Therefore, providers of factor products should be transparent about the methodological changes they make.

Second, providers can put stringent requirements on index changes by remaining consistent with their investment principles. Indeed, if the urge to ‘innovate’ means deviating from investment principles, index investors will risk being disappointed with results. Maintaining investment discipline by adhering to a set of long-term principles may be the best safeguard against negative surprises with factor indices. Investors may be well advised to rely on providers that do not follow the latest factor fad by continuously changing their index methodologies. As Warren Buffett once said, “the stock market has a very efficient way of transferring wealth from the impatient to the patient”.

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References


A major crisis is threatening the sustainability of pension systems across the globe.

The first pillar of pension systems, which is made up of public social security benefits and aims at providing a universal core of pension coverage to address basic consumption needs in retirement, is strongly impacted by rising demographic imbalances. Life expectancy at age 65 in OECD countries is expected to grow by 4.2 years for women and 4.6 years for men between 2020 and 2065. As a result, the number of individuals aged 65 and over per 100 individuals aged between 20 and 64, which rose from 13.9 in 1950 to 27.9 in 2015, is expected to grow to 58.6 by 2075.¹

In parallel, the second pillar of pension systems, which is expected to provide additional replacement income for retirees via public or private occupational pensions, is weakening. In particular, private pension funds have been strongly impacted by the shift in accounting standards towards the valuation of pension liabilities at market rates instead of fixed discount rates, which have resulted in increased volatility for the value of liabilities. The impact of this new constraint has been reinforced by stricter solvency requirements following the 2000–03 pension fund crisis. As a result of these changes in accounting and prudential regulations, a large number of corporations have closed their defined benefit pension schemes to new members and increasingly to further accrual of benefits, so as to reduce the impact of pension liability risk on their balance sheets and income statements. Overall, a massive shift from defined benefit pension schemes to defined contribution pension schemes is taking place across the world, implying a transfer of retirement risks from corporations to individuals.

As an almost universal rule, public and private pension schemes deliver replacement income lower than labour income, and the gap is sometimes severe. According to OECD, an individual with average earnings in the US can expect to receive merely 49.1% of labour income from mandatory pension arrangements when retiring, and the replacement rate falls to 29.0% in the UK. With the need to supplement public and private retirement benefits via voluntary contributions, the so-called third pillar of pension systems, individuals are becoming more and more responsible for their own retirement savings and investment decisions. This global trend poses substantial challenges to individuals, who often lack the expertise required to make such complex financial decisions.

Currently available products fall short of providing a satisfactory answer to the needs of individuals preparing for retirement. In response to these concerns, a number of so-called retirement products have been proposed by insurance companies and asset management firms. Asset management products offer a wide range of investment options, but none of these options really addresses retirement needs because they neither allow investors to secure a given level of replacement income, nor explicitly account for the costs of high surrender charges, which can amount to several percentage points of the invested capital. This rigidity is a major shortcoming in the presence of life uncertainties such as marriage and children, changing jobs, health issues, changing locations to lower or higher cost cities or countries, decisions about retirement dates, etc. It also explains why annuities, while offering the security that investment products lack, are in low demand overall.²

To sum up, individuals are currently left with an unsatisfactory dilemma between on the one hand insurance products that provide security but lack flexibility, and on the other hand investment products that provide flexibility but no security with respect to the level of future replacement income.

Retirement bond: The safe asset in retirement investment solutions

Fortunately, existing financial engineering techniques can be used to design new

¹ Figures cited here are from the OECD report, Pensions at a Glance 2007.
² Other explanations of the ‘annuity puzzle’ are related to the fact that annuities involve counterparty risk and high levels of fees, and also that they do not contribute to bequest objectives.
forms of “flexicure” investment solutions that can offer individuals both security and flexibility when approaching retirement investment decisions, thus providing a way out of the impasse of a choice between annuities and target date funds. In a recent paper (Martellini, Milhau and Mulvey [2019]), we analyse investment decisions for individuals saving for retirement in the goal-based investing framework, which is the counterpart of the liability-driven investing framework used in institutional money management (see also Degaest et al [2014]), and we argue that a straightforward and quasi-reversible approach is not an option. The annuity products are not fully locked, and any assets are not fully paid by the bond is constant or preferably cost of living-adjusted. Their payments are deferred to the retirement date, and (2) interest payment and capital amortisation are spread over time in such a way that the annual income paid by the bond is constant or preferably cost of living-adjusted. Their price can easily be obtained by summing future cash flows discounted at market zero-coupon rates, and they can be replicated by standard factor-market techniques like duration hedging and duration-convexity hedging, or by cash flow-matching methods that rely on the stripping of coupon-paying bonds and/or interest rate derivatives. These methods are routinely deployed in asset-liability management for the construction of liability-hedging portfolios.

These dedicated duration-matched bond portfolios are very different from the typical off-the-shelf short duration bond portfolio used by default as the ‘safe’ component in target-date-fund strategies. The latter portfolio is actually unsafe with respect to retirees’ needs because its duration does not match the duration of the targeted cash flow schedule. As a result, it does not properly replicate the performance of the retirement bond, and there is no guarantee that it will deliver the desired cash flows in retirement. Because the cash flows of the retirement bond are normalised to $1 per year, the purchasing power of savings in terms of replacement income is given by the nominal value of savings divided by the retirement bond price.

Given an inception date for accumulation, the funding ratio is defined as the ratio of the current purchasing power to its initial value, so it is equal to the relative performance of wealth with respect to the retirement bond. Figure 2 shows how an annuity with a cost-of-living adjustment can be decomposed as the sum of a retirement bond, or retirement bond-replicating portfolio, which covers the first 20 years in retirement, and a deferred late life annuity that takes care of the late retirement period. The blue bars represent the 20 cash flows of the retirement bond and the red ones are the cash flows (in uncertain number) of the deferred annuity that starts right after the retirement bond has matured.

Retirement bonds do not exist as off-the-shelf fixed-income products, but a series of recent articles in the financial and general press has made a case for their issuance by governments and other public or semi-public institutions. Merton and Muralidhar (2017) coin the term ‘SelfIES’ (Standard of Living indexed, Forward-starting, Income-only Securities – see also Muralidhar [2015]; Muralidhar, Ohashi and Shin [2016], Martellini, Merton and Muralidhar [2018], and Kobor and Muralidhar [2018]). These bonds would enjoy the following two main characteristics: (1) payments are deferred to the retirement date, and (2) interest payment and capital amortisation are spread over time in such a way that the annual income paid by the bond is constant or preferably cost of living-adjusted. Their price can easily be obtained by summing future cash flows discounted at market zero-coupon rates, and they can be replicated by standard factor-market techniques like duration hedging and duration-convexity hedging, or by cash flow-matching methods that rely on the stripping of coupon-paying bonds and/or interest rate derivatives. These methods are routinely deployed in asset-liability management for the construction of liability-hedging portfolios.

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Improved forms of target date funds as meaningful retirement solutions

The retirement bond portfolio is intended as a liquid portfolio that delivers stable and predictable replacement income. Each dollar invested in this portfolio allows the individual to secure a fixed number of dollars every year in retirement. On the other hand, and precisely because of this security, investing in the retirement bond portfolio cannot generate upside in terms of replacement income. To increase the achievable level of replacement income without relying only on additional contributions, an investor has to take some risk and invest in assets that are expected to outperform the retirement bond in the long run. A well-diversified equity fund would be a good example of such a ‘performance-seeking portfolio’. Let us consider as a starting point a target date fund that lets the equity allocation gradually decrease from 60% in 1998 down to 20% in 2018, and which explicitly uses an “improved” version by replacing the bond portfolio with the retirement bond that starts paying off at the investor’s retirement date. The equity component and the glide path remain unchanged. Unlike the standard target date fund, the improved target date fund explicitly takes into account the nature of the goal (which is to produce replacement income) as well as the investor’s retirement date and decumulation period.

In what follows, we show that the use of the retirement bond in place of the standard bond portfolio leads to substantial improvements in terms of replacement income. To give a first sense of these benefits, figure 3 shows the simulated funding ratios obtained with the standard and improved target date funds.
3. Change in the purchasing power of wealth in terms of replacement income with respect to 1998 level, 1998–2018

Both target date funds start with a 60% allocation to equities in 1998 and let it gradually decrease to 20% in 2018. The second building block is a standard bond portfolio (the Barclays US Treasury index) in the standard fund, and the retirement bond in the improved fund.

In this particular sample period, the improved target date fund outperformed its standard counterpart because the retirement bond itself outperformed the bond index. Indeed, the retirement bond benefited more from the decrease in interest rates because of its longer duration. Across a large number of scenarios, the retirement bond portfolio is actually expected to outperform on average the bond index provided there is a positive premium associated with interest rate risk.

Another consequence of the substitution of the standard bond portfolio with the proper goal-hedging portfolio is that the purchasing power of wealth in terms of replacement income displays less variability over time. Numerically, the volatility of annual changes in the funding ratio decreases from 19.09% to 13.54%. The explanation is straightforward because a perfect goal-hedging portfolio has by definition zero tracking error with respect to the retirement bond. Similar results are obtained by replacing the standard bond portfolio with the retirement bond in a balanced fund, which maintains a fixed-mix allocation to the equity and the bond building blocks (see Martellini, Milhau and Mulvey [2019]).

Probabilities of reaching ‘aspirational’ levels of replacement income

To evaluate the adequacy of an investment solution for an individual, absolute performance is of little relevance. Performance is only useful to the extent that it serves goal achievement, so a better metric is the ex-ante probability of reaching an aspirational goal, defined as a target level of replacement income that the individual was unable to finance at the beginning of accumulation.

Figure 4 shows the probabilities of reaching the target income level with both the standard and the improved target date funds introduced above. These probabilities are estimated with a Monte-Carlo model for the returns of the performance-seeking portfolio – modelled as a broad equity index – as well as the return of the standard bond portfolio and of the retirement bond. The horizontal axis represents the percentage of the target income level that can be financed with initial savings. When it is less than 100%, the target income level is a genuine ‘aspirational’ goal because it cannot be financed with initial savings.

For all values of the initial funding ratio, the improved fund generates higher success probabilities measured in terms of probabilities to reach full funding. The benefit of using the improved target date fund is relatively small for severely under-funded individuals, but becomes substantial for initial funding levels starting at 80% and above.

It should be emphasised at this stage that even the improved target fund can experience substantial short-term losses in terms of funding ratio. To address this concern, Martellini, Milhau and Mulvey (2019) introduce a class of risk-controlled portfolio strategies, which adapts standard portfolio insurance techniques to the management of relative risk with respect to the retirement bond, and show that they are effective at capping the size of losses within a given time frame (eg, one year) to a pre-specified threshold.

4. Probabilities of reaching aspirational goal by retirement date

Individuals should not have to choose between security and flexibility when approaching retirement investment decisions

In this article, we propose to apply the principles of goal-based investing to the design of a new generation of ‘flexicure’ retirement investment strategies, which aim at offering the best-of-both-worlds between insurance products and asset management products. These strategies can be used to help individuals and households secure minimum levels of replacement income while generating upside exposure through liquid and reversible investment products. In implementation, recent advances in financial engineering and digital technologies make it possible to apply goal-based investing principles to a much broader population of investors than the few traditional clients who can afford customised mandates or private banking services. This environment creates an opportunity to provide genuine investment solutions, as opposed to off-the-shelf products, to individuals preparing for retirement.

The pension crisis will not be solved by financial engineering alone. Part of the solution lies in the hands of individuals themselves, who need to start contributing more and earlier so as to more efficiently complement the benefits expected from the first two pillars of pension systems. However, the investment industry does face an ever greater responsibility to provide suitable retirement solutions, especially to individuals who are unfamiliar with basic financial concepts and are therefore not in a position to make educated investment decisions.

In a recent joint initiative, EDHEC-Risk Institute and the department of Operations Research and Financial Engineering (ORFE) at Princeton University have teamed up to design a series of indices called the EDHEC-Princeton Retirement Goal-Based Investing index series, which are published on EDHEC–Risk Institute and Princeton ORFE websites (see https://risk.edhec.edu/indexes-investment-solutions for more details). It is our hope and ambition that this initiative, as well as related work, can facilitate the introduction of second-generation flexicure target date funds that will be used as part of the solution to the global pension crisis. After all, similar techniques are routinely used in liability-driven investment solutions designed for the benefit of institutional investors, and transporting them to individual money management would be a worthwhile and long-awaited endeavour.
Better Defensive

Scientific Beta’s defensive offering benefits from good diversification of unrewarded risks and, with its High Factor Intensity (HFI) filter, exhibits higher factor intensity than traditional low volatility strategies. As such, it benefits from a much better excess return capacity over the long term.

Compared to popular Minimum or Low Volatility indices, Scientific Beta’s Low Volatility HFI Diversified Multi-Strategy (4-Strategy) index delivers much higher Sharpe ratios and information ratios as well as lower exposures to macroeconomic risks.

From the Scientific Beta index’s base date of June 28, 2002, to December 28, 2018, the Low Volatility HFI Diversified Multi-Strategy (4-Strategy) index delivers a Sharpe ratio improvement compared to the cap-weighted index of 74% for the US universe (versus 33% for the MSCI Minimum Volatility index) and 96% for the Developed universe (versus 56% for the MSCI Minimum Volatility index).*

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*The analysis is based on daily total returns in USD from 28-Jun-2002 (base date of SciBeta indices) to 28-Dec-2018. All statistics are annualised. The smart factor indices used are the SciBeta USA High Factor Intensity Low Volatility Diversified Multi-Strategy (4-Strategy) index, the SciBeta Developed High Factor Intensity Low Volatility Diversified Multi-Strategy (4-Strategy) index, the MSCI USA Minimum Volatility (USD) index and the MSCI World Minimum Volatility (USD) index. The cap-weighted indices are the SciBeta USA Cap-Weighted and the SciBeta Developed Cap-Weighted.

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Main results from the EDHEC European ETF and Smart Beta and Factor Investing Survey 2018

Véronique Le Sourd, Senior Research Engineer, EDHEC-Risk Institute

EDHEC-Risk Institute conducted its 11th survey of European investment professionals on the usage and perceptions of exchange-traded funds (ETFs) at the beginning of 2018. 1 This annual survey, introduced in 2006, and initially entirely devoted to ETFs, now also dedicates a large group of questions to investors’ general use and opinion of smart beta and factor investing strategies, with a special focus on fixed income.

Our results are based on the responses of 163 European decision-makers (37% belong to executive management and 33% are portfolio managers). The survey respondents were from 25 countries, with 17% from the UK, 69% from other EU member states, 13% from Switzerland and 1% from other countries outside the EU. Institutional investment managers made up the majority of respondents in the study (72%), and participating organisations together have assets under management of at least €1.1tn.

In the present article, we sum up the main results of the survey. We first turn to key results concerning ETF usage and selection, and then address results relating to the use of smart beta and factor investing strategies. We conclude with investor perspectives for future developments.

How do investors select and use ETFs?

It appears that, while ETFs indeed offer numerous possibilities to move beyond traditional passive investing, the principal use of ETFs for traditional asset classes remains long-term investing in broad market indices. Some 61% of respondents use ETFs for buy-and-hold investments, while only 45% of them use ETFs for tactical bets. Looking at trends on ETF usage in our successive surveys, it appears that the use of ETFs for buy-and-hold investments has remained quite stable at over 60% since 2012. Moreover, despite the intense product development for a multitude of sub-segments of the markets (sectors, styles etc.), gaining broad market exposure remains the main focus of ETF users (71% of respondents), to be compared with 45% who use ETFs to obtain specific sub-segment exposure (sector, style). While some variations were observed for those figures over the period from 2009 to 2018, the values obtained in 2018 are equal to the long-term mean.

Consistent with this desire to use ETFs for passive exposure to broad market indices, respondents show little appetite for seeing discretionary active strategies delivered in an ETF wrapper. In fact, with 15% of respondents mentioning it, actively-managed strategies are one of the least desired categories when we asked about their wishes for future product development in the ETF space. It can also be noted that investors are largely satisfied by ETFs in traditional asset classes, but more reserved about ETFs for alternative asset classes. While 97% and 92% of respondents are satisfied with their use of ETFs to invest in equities and government bonds, respectively, only 17% are satisfied with their use of ETFs for hedge funds.

When selecting an ETF provider, two criteria dominate investors’ preoccupations. The first one is costs, and the second one is the quality of replication. They are related to hurdles associated with an ability to offer products with low cost and high replication quality.

Innovation appears to be of less importance. Finally, complementing the active offering of the provider appears to be important for only 5% of respondents (see figure 1).

1. What criteria do you consider when selecting an ETF provider?

Given that the key decision criteria are more product-specific and are actually ‘hard’ measurable criteria, while ‘soft’ criteria that may be more provider-specific have less importance, competition for offering the best products can be expected to remain strong in the ETF market. This implies that it will be difficult to build barriers of entry for existing providers unless they are related to hurdles associated with an ability to offer products with low cost and high replication quality.

Future growth drivers for ETFs

The European ETF market has seen tremendous growth over the past decade or so. While such growth can be observed ex post from market data, our survey allows us to assess the drivers of such growth and the intentions of future ETF adoption by respondents. A remarkable finding from our survey is that a high percentage of investors (50%) still plan to increase their use of ETFs in the future, despite the already high maturity of this market and high current adoption rates. We thus observe a remarkably persistent tendency for future growth. First, a clear finding is that lowering investment cost is the primary driver behind investors’ future adoption of ETFs for 86% of respondents in 2018. However, investors are not only planning to increase their ETF allocation to replace active managers (70% of respondents in 2018), but are also seeking to replace other passive investing products through ETFs (45% of respondents in 2018).

Motivations and growth prospects for smart beta and factor investing strategies

Smart beta and factor investing strategies have continuously been in the spotlight in recent years and the increasing investor interest is obvious. Our

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1 Goltz, F., and V Le Sourd (2018). The EDHEC European ETF and Smart Beta and Factor Investing Survey 2018. EDHEC-Risk publication produced with the support of the Amundi ETF, Indexing and Smart Beta research chair.
survey allows some light to be shed on the drivers behind this interest and the actual usage of smart beta and factor investing strategies among investors. A first important result is that the quest for outperformance is the main driver of interest in smart beta and factor investing. In fact, 73% of respondents agree that smart beta and factor investing indices offers significant potential for outperformance, and indicate that the most important motivation behind adopting such strategies is to improve performance, far ahead of other such as ‘Address regulatory constraints’ or ‘Manage risk’. However, despite this strong motivation to use smart beta and factor investing strategies to seek performance improvements, the actual implementation of such strategies is still at an early stage, according to information from our respondents on their current and future usage. In fact, while 46% of respondents currently invest in smart beta and factor investing strategies, another 28% do not but are considering adopting such strategies in the future. Moreover, among those respondents who have made investments in smart beta and factor investing strategies, these investments typically make up only a small fraction of portfolio holdings. 83% of respondents invest less than 20% of their total investments in smart beta and factor investing strategies and only 11% of respondents invest more than 40% of their total investments in these strategies. This low intensity of usage of factor indexing ultimately means that investors – even if they have adopted factor investing – do not fully capture the benefits as of today. It is perhaps surprising that almost a decade after the influential report on Norway’s Sovereign Wealth Fund (see Ang, Goetzmann and Schafer [2009]), which emphasised the benefits of factor investing for investors, adoption of such an approach remains partial at best. However, the growth trend in adoption of such strategies is intact. When asked about their use of smart beta and factor-based investment products in terms of assets over the near future, 48% of respondents indicate an increase of more than 10% while only 3% indicate a decrease.

**Investor expectations for further development of ETF products**

Our survey allows us to define a bit more clearly the type of niche markets where investors would like to see further ETF product development. As shown in figure 2, the top concerns for respondents are the further development of ethical/socially responsible investing (SRI) ETFs, with 34%, as well as emerging market equity ETFs and emerging market bond ETFs, with 32% and 31%, respectively. Additionally, for ETFs related to advanced forms of equity indices – those based on smart beta and on multi-factor indices – 27% and 25% of respondents, respectively, wished for further developments in these two areas. Moreover, if we aggregate the responses concerning smart beta indices, single-factor indices and multi-factor indices, we note that 42% of the respondents want further developments in at least one of these categories. This shows that the development of ETFs based on advanced forms of equity indices is now by far the highest priority for respondents. Alternatively, if we use our survey results to look at trends over time concerning the demand for ETFs based on emerging market equity, we see that a strong decline began in 2012, when 49% of respondents were demanding additional developments in this area – a percentage that had been relatively stable since 2006. Now that it lies at 32% in 2018, it seems that a share of respondents have shifted their demands from developments in emerging market equities to new forms of indices.

Regarding the further demand for ETFs based on smart beta indices, which shows the strong interest of respondents in alternative indices, the result is interesting as there have been a considerable number of smart beta and factor investing ETF product launches. The fact that more than a quarter of investors still see room for further product development may be explained by the fact that product launches have focused on relatively few popular strategies thus accounting for a small number of risk premia, such as the value premium and defensive equity strategies. We also note that additional demand for ETFs based on smart bond indices is not so far behind, with 23% of respondents mentioning it. This should be put in perspective with the high interest of respondents in smart beta and factor investing for fixed income (see figure 3).

**How do investors implement smart beta and factor investing strategies?**

Our survey allows for several insights into how investors implement their smart beta and factor investing strategies and their exposure to desired factors. In terms of the actual product wrapper used for smart beta and factor investing exposure, respondents favour passive funds that replicate smart beta and factor investing indices (63% of respondents) but also use active solutions – ie, approaches including a significant amount of discretion – albeit to a lesser extent (49% of respondents).

Respondents were asked to compare passive replication of smart beta and factor investing indices to discretionary smart beta and factor investing strategies on a range of criteria. It appears that both of them obtain the same score for the possibility to create alignment with investment beliefs. Discretionary strategies are preferred for the reactivity/dynamism they offer, in terms of ease of use as building blocks in portfolio allocation – undoubtedly due to the fact that most indices available today are rather standardised – and ease in changing portfolio allocation over time. Replication of smart beta and factor investing strategies is essentially preferred for the following criteria: mitigating possible conflict of interest provider vs investor, the availability of information for assessing strategies, the broadness of the available solutions, the ease to change allocation over time and costs. While passive replication of indices is seen as more useful for achieving investment goals, the differences in perception across the two approaches are most notable in specific areas.

Our survey also allows us to differentiate between the types of uses respondents make of their factor exposure. It appears that the most frequent use respondents have for factor-based exposures is a strategic use to harvest long-term premia (score of 3.31 on a scale from 0, no use, to 5, highly frequent use). However, the least frequent approach in use today is a tactical use based on macroeconomic regimes (score of 1.98). These results suggest that the implementation of a factor-based strategy rarely aims at factor return timing and much more frequently targets the extraction of long-term premia.

**Position of investors in smart beta and factor investing strategies for fixed income**

This year, we introduce a special focus on smart beta and factor investing for fixed income. The results of our survey show that 17% of the whole sample of respondents already use smart beta and factor investing for fixed income. Some 80% of this sub-sample of respondents invest less than 20% of their total investment in smart beta and factor investing for fixed income.

**3. Opinion of respondents about statements concerning smart beta and factor investing for fixed income**

This exhibit indicates the percentage of respondents who would like to see further development in the future for different ETF products. Respondents were able to choose more than one product.

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**3. Opinion of respondents about statements concerning smart beta and factor investing for fixed income**

This exhibit indicates the percentage of respondents who would like to see further development in the future for different ETF products. Respondents were able to choose more than one product.
It appears that respondents show significant interest in smart beta and factor investing for fixed-income (score of agreement of 3.13 on a scale from 0, strongly disagree, to 5, strongly agree). However, there is a significant gap between the interest in this investment and the forecast of an increase in it (score of agreement of 3.34). There are straightforward explanations for this gap. First, the average score of agreement with the statement that smart beta and factor investing approaches developed for equity investing are transposable to fixed-income is only of 2.16; second, respondents do not consider there to be enough research in the area of smart beta and factor investing for fixed income (average score of 1.65 – see figure 3). Overall, it thus appears that investors are doubtful that research on factor investing in fixed income is sufficiently mature at this stage. Given the strong interest in such strategies indicated by investors, furthering research in fixed-income factor investing is a promising venture for the industry.

Do investors have the necessary information to evaluate smart beta and factor investing strategies? The results of our survey suggest that the transparency of smart beta and factor investing strategies is a key component of their appeal. Some 90% of our respondents declare that smart beta and factor investing indices require full transparency on methodology and risk analytics. However, they also cited a lack of transparency as the second most important hurdle to increasing smart beta and factor investing investments. To analyse the question of transparency and lack thereof in detail, we asked respondents about the information they consider important to assess smart beta and factor investing. At the same time, respondents were asked whether they considered this information to be easily available. Their responses thus allowed us to assess the gap between required information and ease of access to this information (see figure 4).

It is interesting to see the spread between the importance of and the accessibility of this information. It appears that the highest spread is observed for information respondents considered as crucial. For example, data-mining risk and information about transparency on portfolio holdings over a backtest period are two crucial pieces of information for respondents, with scores of 3.63 and 3.85 (on a scale from 0, not important, to 5, crucial), respectively. Data-mining risk is also the piece of information that appears to be the most difficult to obtain for respondents, with a score of 2.21 (on a scale from 0, difficult to obtain, to 5, easy to obtain), while information about transparency on portfolio holdings over a backtest period is among the three most difficult pieces of information to obtain, with a score of 2.49. Liquidity and capacity, which is the most important piece of information for respondents, with a score of 4.06, is also information relatively difficult to obtain, with a score of 2.92. Even relatively basic information such as the index construction methodology is not judged to be easily available (score of 3.25) relative to its importance (score of 4.01). On the contrary, information about recent performance and risk over the past 10 years is among the least important for respondents with a score of 3.36, but it is also one of the most easily available, exhibiting one of the highest scores (3.22) across the board in terms of availability.

The fact that information that is regarded as important is not considered to be easily available clearly calls into question the information provision practices of smart beta and factor investing providers. In fact, the only area in which no pronounced gap exists between the importance and the ease of accessibility scores is for recent performance numbers. Performance and risk information is judged to be moderately easily available and moderately important. All other areas show pronounced gaps between these two metrics. Two of the three items that are judged to be the least easily available are holdings over the backtest period and data-mining risks. Interestingly, both these items rank much higher on the importance score for investors than, for example, recent performance. Moreover, there is a pronounced gap of 0.87 between importance of information items and their ease of accessibility, as shown by the means of their respective scores (3.70 and 2.83, respectively). Overall, though the gap has narrowed compared to last year, these results suggest that there is still room for further improvement, as investors still do not believe that information considered important for assessing smart beta and factor investing strategies is made available to them with sufficient ease.

**Investor requirements about smart beta and factor investing strategies**

From the results of our survey, it appears that respondents are primarily concerned with the documentation of the factor premium in extensive empirical literature (with a score of 3.74, on a scale from 0, not important, to 5, absolutely crucial), closely followed by the existence of a rational risk premium (with a score of 3.73), and then by ease of implementation and low turnover and transaction costs (with a score of 3.68) – see figure 5 for details. The existence of a rational explanation for factor risk premia is of principal importance to investors as it is probably suggests that the premium will be persistent. Indeed, if the literature interprets the factor premia as compensation for risk, the existence of the factor premia could also be explained by investors making systematic errors due to behavioural biases such as over- or under-reactions to news on a stock. However, whether such behavioural biases can persistently affect asset prices in the presence of some smart investors who do not suffer from these biases is a point of contention. In fact, even if the average investor makes systematic errors due to behavioural biases, it is still possible that some rational investors who are not subject to such biases might exploit any small opportunity resulting from the irrationality of the average investor. The trading activity of such smart investors may then make the return opportunities disappear. Therefore, behavioural explanations of persistent factor premia often introduce so-called ‘limits to arbitrage’, which prevent smart investors from fully exploiting the opportunities arising from the irrational behaviour of other investors.

**Expectations on future development for smart beta and factor investing products**

Finally, respondents were asked about the smart beta and factor investing solutions they think required further product development from providers.
Our survey results indicate that respondents desire further development in the area of fixed income, as well as in alternative asset classes, thus it is not surprising as smart beta and factor investing strategies were initially developed for equity investment (see figure 6). On a scale from 0 (no further developments required) to 5 (further developments required with strong priority), fixed-income smart beta and factor investing strategy solutions obtain a score of 3.54. This result should be considered in parallel with those displayed in figure 3, showing an increase in interest in these products but still with a limited share restricted to it. Integration of ESG in smart beta and factor investing, and strategies in alternative asset classes (currencies, commodities, etc), closely follow with scores of 3.12 and 3.01, respectively. The three other proposals – long/short equity strategies, solutions addressing specific investor objectives and products offering exposure to novel factors – obtained scores in a comparable range (2.68, 2.67 and 2.55, respectively). So, there is still a lack of products when it comes to asset classes other than equity, and this lack is particularly critical for the fixed-income asset class, which is largely used by investors. It is likely that the development of new products corresponding to these demands may lead to an even wider adoption of smart beta and factor investing solutions.

Conclusion
Responses to our survey provide interesting insights on benefits and challenges with smart beta and factor investing strategies. In fact, we find that adoption of such approaches is still partial despite a decade of discussion in the industry, with the vast majority of adopters investing less than 20% of their portfolio in such approaches. It was therefore interesting to better understand the challenges investors face when analysing such strategies. Our survey points to the important shortcomings of current smart beta offerings, which may explain the slow adoption by industry participants. For example, investors perceive a lack of transparency and difficulty in accessing information on such strategies, in particular on risk categories such as data-mining risks. In the case of fixed-income long/short strategies, investors express doubts over the maturity of research results at this stage. Investors also see a need for further developments of long/short equity strategies based on factors, strategies that address client-specific risk objectives, and strategies that integrate environmental, social and governance (ESG) considerations. Smart beta researchers and product providers doubtlessly have to work on improving their solutions for smart beta and factor investing strategies to make it into the mainstream.

The research from which this article was drawn was produced as part of the Amundi ETF, Indexing and Smart Beta Investment Strategies research chair at EDHEC-Risk Institute.

Reference

**Factor investing in sovereign bond markets:**
A time-series analysis of the level factor

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Most excess return studies in Treasuries have concentrated to date on the profitability of unconditional ‘carry’ strategies – ie, strategies where the investment on a N-maturity (zero-coupon) bond is held for a holding period (typically of one year) and is funded by the sale of a short bond expiring at the end of the investment period.1 These strategies are designed to capture in the long run the level/duration risk premium (indeed, if the expectation hypothesis were true, no excess returns should be reaped) and they have been profitable over long samples, as figure 1 shows for data spanning the 1971–2017 period. The most commonly adduced explanation for this profitability is the existence of a positive risk premium associated with bearing ‘duration’ risk (Fama and Bliss [1987], Campbell and Shiller [1991]). A finer analysis shows that the carry strategies have been profitable during recessions, unprofitable during expansions, and particularly unprofitable in the second half of the recorded expansions, suggesting that the market price of risk must be time-varying and depend on state variables linked to the business cycle, starting with the slope of the yield curve.

1 The returns are given by:

\[ x_{t-T} = p_t^{N \times (1-y)} - p_t^{1\times (1-y)} - (r_t - r_t^{1\times (1+y')})(N-1) + (y' - y) \]

where \( p_t^{N\times (1-y)} \) denotes the time-t log price of a N-maturity bond, and \( y' \) its yield.

1. Zero-coupon carry strategies: main statistics

<table>
<thead>
<tr>
<th>Maturity</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>10</th>
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</thead>
<tbody>
<tr>
<td>Average</td>
<td>0.05%</td>
<td>0.06%</td>
<td>0.12%</td>
<td>0.13%</td>
<td>0.19%</td>
<td>0.21%</td>
<td>0.22%</td>
<td>0.24%</td>
<td>0.26%</td>
</tr>
<tr>
<td>Standard deviation</td>
<td>1.73%</td>
<td>3.15%</td>
<td>4.38%</td>
<td>5.51%</td>
<td>6.58%</td>
<td>7.61%</td>
<td>8.64%</td>
<td>9.60%</td>
<td>10.58%</td>
</tr>
<tr>
<td>Sharpe ratio</td>
<td>0.30</td>
<td>0.30</td>
<td>0.30</td>
<td>0.28</td>
<td>0.29</td>
<td>0.29</td>
<td>0.27</td>
<td>0.26</td>
<td>0.25</td>
</tr>
</tbody>
</table>

This figure reports the average returns, standard deviations and Sharpe ratios from the carry strategies (one-year investment period) for US Treasuries from 1971 to 2017. Zero-coupon bond prices are from Gürkaynak et al (2007).

More recent work in the mid-2000s (Cochrane and Piazzesi [2005], Ludvigson and Ng [2009], Cieslak and Povala [2015]) has suggested that the return-predicting factor(s) – ie, quantities that are supposed to explain the observed excess returns – may be more complex than originally envisaged, but after the 1990s the existence of a positive duration risk premium has rarely been put in doubt.
It must be stressed, however, that virtually all the studies that have appeared in the academic literature have made use of ‘virtual’ discount bonds obtained by best fit to actual Treasury prices. Unfortunately, this translation from actual prices of coupon-bearing bonds to virtual prices of discount bonds is not unproblematic, since some of the distinguishing features of the new-generation return-predicting factors (such as the ‘tent’ shape) can disappear when slightly different construction methods are used to build the discount bond. It is also not obvious whether the high degree of predictability found using discount bonds by Cochrane and Piazzesi (2005), Ludvigson and Ng (2009), Cieslak and Povala (2015) and others survives when actual CUSIP-level data are used. To the best of our knowledge, no studies of the profitability of the new and old risk factors using CUSIP-level data have appeared in the literature. This article attempts to fill this gap.

Unconditional long/short carry strategies with CUSIP bonds

In what follows we propose a detailed empirical study of implementable unconditional and conditional carry strategies in the US Treasury market so as to assess whether the level factor remains conditionally and unconditionally rewarded when strategies are implemented using actually traded bonds rather than ‘virtual’ discount bonds.²

Our universe is made up of 1,720 coupon bonds over the period 27 December 1973 to 29 June 2018.³ We split, at each end-of-month date, all the available bonds into four maturity buckets:

- Bonds with maturities ranging from one to three years (bucket 1);
- Three to five years (bucket 2);
- Five to 10 years (bucket 3); and
- Higher than 10 years (bucket 4).

Since the time-to-maturity of every bond decreases over time and new bonds are regularly issued, the number of bonds in each bucket and the composition of each bucket vary over time. We define, for each bucket, an equally-weighted portfolio of all bonds in the bucket and perform monthly rebalancing back to this equally-weighted target.⁴ We further assume that each coupon paid by a given bond is reinvested in the same bond.

Figure 2 reports the main descriptive statistics for the four aforementioned portfolios. The median duration of the maturity bucket portfolios (taken over all dates) are 1.7, 3.4, 5.5 and 10.9 years. We note that average and median values are close for maturity, duration and number of bonds, suggesting that the underlying distributions are relatively symmetric. The minimum and median number of bonds in the four portfolios are respectively 13, 4, 9, 13 for the minimum value and 47, 32, 33.5, 32 for the median value, ensuring a sufficiently large number of bonds in each bucket. The annualised mean return and annualised volatility of the four portfolios respectively are 5.9%, 6.6%, 7.0%, 8.4% and 2.8%, 4.6%, 6.4%, 9.7% which indicates that bonds with higher maturity are riskier but better compensated. Sharpe ratios, which respectively are 0.44, 0.43, 0.37 and 0.39, suggest that the reward per unit of risk is higher for shorter maturity.

We first examine at CUSIP level the profitability of unconditional and conditional long-short carry strategies. For the period under analysis (27 December 1973 to 29 June 2018) we engage in an unconditional carry strategy using the four bucket portfolios as building blocks, so as to avoid inconsistencies related to the use of single bonds. More precisely, we compute at the end of each month a one-year investment horizon buy-and-hold zero-cost long/short carry strategy, where the long leg is a given maturity bucket and the short leg is an equally-weighted portfolio of the three bonds in the one to three-year maturity bucket with the lowest maturities. We made this choice for the short leg in order to have a duration as close as possible to the investment horizon (and hence to have the lowest possible duration risk for the funding leg). We consider the three to five-year, five to 10-year and 10-year-plus maturity bucket portfolios, and therefore three possible cases, for the long leg construction. For each of the three carry strategies considered, we obtain over the period 523 annual excess returns with no overlap.

The results are shown in figure 3, which displays the mean excess return, the volatility, the Sharpe ratio, the minimum excess return and the maximum excess return for the three zero-cost long/short carry strategies. The results we obtain are consistent with those obtained with fictitious zero-coupon bonds in that all the strategies display a performance level that is positive and statistically different from zero, with mean excess returns ranging from 1.2% to 3.1%. We observe that both the mean excess return and the volatility increase with the maturity of bucket portfolio chosen for the long leg of the strategy, a result which is again consistent with the findings obtained with zero-coupon bonds. On the other hand, we do not find the monotonic relationship between the Sharpe ratio and the duration of the long leg strategy that was obtained in the US zero-coupon bond universe.

Overall, these results suggest that an unconditional carry strategy is positively rewarded at the CUSIP level, which is consistent with the existence of a positive bond risk premium associated with an exposure to changes in the level of interest rates.

Bond returns predictability and level risk factor

Next, we study from a conditional perspective the level risk factor and define three signals that have been recognised in the academic literature for their ability to predict the variation of bond returns. The factor construction is implemented in practice as described below.

The slope return predicting factor at time \( t \) is simply defined as the difference between the 15-year zero-coupon yield and the two-year zero-coupon rate.⁵ For the Cochrane-Piazzesi return predicting factor, the procedure is the following:

- For \( n = 2...15 \), we first compute the \( n \)-year zero-coupon bond excess returns as:

\[
\text{zero}_{n,t}^{\text{excess}} = \left( P_{n,t} - P_{n,t-N} \right) - p_n - y_t = (x_t - y_{n-1,t}) (N - 1) + (y_{t,t})
\]

where \((y_{t,t})_{t=1,2,..,12,15}\) refers to the one-year forward rates \( \text{years from date} \ t \).

- We run 14 regressions of excess returns time series on the five forward rates time series

\[
\text{zero}_{n,t}^{\text{excess}} = \gamma_n x_t + \epsilon_t
\]

This figure contains the main descriptive statistics of the four following maturity buckets: one to three years, three to five years, five to 10 years and higher than 10 years. Each maturity bucket refers to an equally-weighted monthly rebalanced portfolio of all the bonds that have a time-to-maturity matching the bucket. CUSIPs, when paid, are assumed to be reinvested in the same bond. These numbers are computed with monthly returns over the backtesting period 27 December 1973 to 29 June 2018. The risk-free rate is the three-month T-bill rate.

3. Statistics for maturity buckets

<table>
<thead>
<tr>
<th>Bucket</th>
<th>1–2Y</th>
<th>3–5Y</th>
<th>5–10Y</th>
<th>10+</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mean excess return</td>
<td>1.2%</td>
<td>1.6%</td>
<td>1.1%</td>
<td></td>
</tr>
<tr>
<td>Volatility</td>
<td>3.4%</td>
<td>5.4%</td>
<td>9.1%</td>
<td></td>
</tr>
<tr>
<td>Sharpe ratio</td>
<td>0.3%</td>
<td>0.29</td>
<td>0.34</td>
<td></td>
</tr>
<tr>
<td>Minimum excess return</td>
<td>–9.1%</td>
<td>–14.0%</td>
<td>–17.6%</td>
<td></td>
</tr>
<tr>
<td>Maximum excess return</td>
<td>18.9%</td>
<td>19.1%</td>
<td>35.7%</td>
<td></td>
</tr>
</tbody>
</table>

Newey-West t-test 4.13 3.57 4.08

<table>
<thead>
<tr>
<th>Bucket</th>
<th>1–2Y</th>
<th>3–5Y</th>
<th>5–10Y</th>
<th>10+</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mean number of bonds</td>
<td>56.7</td>
<td>32.6</td>
<td>35.5</td>
<td>32.8</td>
</tr>
<tr>
<td>Minimum number of bonds</td>
<td>16.0</td>
<td>4.6</td>
<td>9.8</td>
<td>10.8</td>
</tr>
<tr>
<td>Maximum number of bonds</td>
<td>104.0</td>
<td>61.0</td>
<td>71.0</td>
<td>41.0</td>
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</table>

<table>
<thead>
<tr>
<th>Bucket</th>
<th>1–2Y</th>
<th>3–5Y</th>
<th>5–10Y</th>
<th>10+</th>
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<tbody>
<tr>
<td>Minimum duration</td>
<td>1.5</td>
<td>2.9</td>
<td>4.4</td>
<td>6.7</td>
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<tr>
<td>Maximum duration</td>
<td>2.0</td>
<td>3.3</td>
<td>6.8</td>
<td>10.9</td>
</tr>
<tr>
<td>Minimum maturity</td>
<td>1.9</td>
<td>3.2</td>
<td>7.2</td>
<td>19.2</td>
</tr>
<tr>
<td>Maximum maturity</td>
<td>3.4</td>
<td>4.0</td>
<td>7.2</td>
<td>19.5</td>
</tr>
<tr>
<td>Monthly maximum excess return</td>
<td>8.2%</td>
<td>11.2%</td>
<td>13.4%</td>
<td>15.4%</td>
</tr>
<tr>
<td>Annualised volatility</td>
<td>2.8%</td>
<td>4.6%</td>
<td>6.4%</td>
<td>9.7%</td>
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<tr>
<td>Annualised mean total return</td>
<td>5.9%</td>
<td>6.6%</td>
<td>8.4%</td>
<td>8.4%</td>
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2. Statistics for long/short dollar-neutral carry strategies

<table>
<thead>
<tr>
<th>Bucket</th>
<th>1–2Y</th>
<th>3–5Y</th>
<th>5–10Y</th>
<th>10+</th>
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<tbody>
<tr>
<td>Mean excess return</td>
<td>1.2%</td>
<td>1.6%</td>
<td>1.1%</td>
<td></td>
</tr>
<tr>
<td>Volatility</td>
<td>3.4%</td>
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<td>0.29</td>
<td>0.34</td>
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<td>35.7%</td>
<td></td>
</tr>
</tbody>
</table>

Newey-West t-test 4.13 3.57 4.08

- For the Cochrane-Piazzesi return predicting factor, the procedure is the following:

- We define the vector \( x_t \) as

\[ x_t = \left[ x_{2,t}; x_{3,t}; x_{5,t}; x_{10,t}; x_{15,t} \right] \]

where \((y_{t,t})_{t=1,2,..,12,15}\) refers to the one-year forward rates \( \text{years from date} \ t \).

- We run 14 regressions of excess returns time series on the five forward rates time series

\[ \text{zero}_{t,n}^{\text{excess}} = \gamma_n x_t + \epsilon_t \]

This figure displays the mean excess return, volatility, Sharpe ratios, minimum excess return and maximum excess return of the long/short dollar-neutral carry strategies over the backtesting period 27 December 1973 to 29 June 2018. The backtesting period contains 523 monthly overlapping one-year investment periods. We also report the Newey-West t-test for the mean excess return on the last row.

We thank ICEB for providing us with the dataset used for our empirical analysis.

3 All those bonds are non-callable and non-puttable.

4 This rebalancing frequency choice is meant to maintain the portfolio well diversified and keep its duration as stable as possible at time goes by.

5 We take into account maturities up to 15 years in the computation of the signals since the maturity bucket portfolio with the highest duration is made of bonds with duration up to 16.5 years.

6 The superscript ‘T’ means ‘transpose’.
and obtain the 14 corresponding individual maturity-dependent return-predicting factor time series $\gamma^X_{x, n} = 2 \ldots 15$.

- The Cochrane-Piazzesi (CP in short) signal at time $t$ is finally obtained by averaging the individual maturity-dependent return-predicting factors across maturities.

The procedure to compute the Cieslak-Povala return predicting factor is the following:

For $n = 2 \ldots 15$, we first compute the $n$-year zero-coupon bond excess returns. Then we run 14 regressions of excess returns time series on the five cycles time series and obtain the 14 corresponding individual maturity-dependent return-predicting factor time series $\gamma^X_{x, n} = 2 \ldots 15$.

- The Cieslak-Povala (CP in short) signal at time $t$ is finally obtained by averaging the individual maturity-dependent return-predicting factors across maturities.

For a given signal and a given zero-cost carry strategy, we split the 523 monthly overlapping excess returns into three different subsets labelled as ‘low’, ‘medium’ and ‘high’ regimes. More precisely, we observe the value of the signal at date $t$ and assign the corresponding excess return between date $t$ and $t+1$ (in years) to the low regime subset if the signal at date $t$ is in the first tercile, to the medium subset if it belongs to the second tercile and to the high regime subset otherwise.

Figure 4 details the main statistics for the returns of the three zero-cost carry strategies, both unconditionally (for comparison) and under the different signal regimes. It is clear from the results in this table that all the signals are strongly informative. For instance, the long/short 10-year-plus carry strategy displays unconditional mean excess return of 3.1% and a Sharpe ratio of 0.34. This should be contrasted with the average performance of this strategy in high slope, high CP and high CIP regimes, which returns as high as 6.7%, 7.3% and 9.9% and corresponding Sharpe ratios of 0.68, 0.85 and 1.33 (respectively). Conversely, the carry strategies conditioned on low slope, low CP and low CIP regimes displays strongly lower mean return and Sharpe ratios than the corresponding unconditional quantities (the Sharpe ratio, in particular, moves from approximately 0.30 for three maturity buckets when measured unconditionally, to values as low as –0.64 (for the CiP signal). Overall, these results suggest that it is possible, through the use of relevant signals such as Cieslak-Povala, to predict when investors are more or less compensated for bearing duration risk.

These CUSIP-level strategies, however, require the shorting of bonds, and, therefore, cannot be implemented by investors with long-only constraints. We therefore investigate in the next section how one can design implementable long-only carry portfolios that take advantage of the (conditionally) rewarded level/duration risk factor.

### Long-only carry portfolios

The long/short approach described above would be difficult to implement in practice because it requires the shorting of some bonds. We therefore now present a long-only framework to check whether the benefits of conditional carry strategies are robust with respect to the presence of realistic no short sales constraints.

To do so, we first define a benchmark portfolio as a linear combination of the four equally-weighted maturity bucket portfolios of US government coupon bonds presented in the previous section: one to three-year (referred to as BB1), three to five-year (BB2), five to 10-year (BB3) and 10-year-plus (BB4). The benchmark portfolio is initially equally-weighted and rebalanced once a year. Figure 5 illustrates the rationale behind the implementation of our unconditional and conditional carry portfolios: at each rebalancing date each carry portfolio strategy, whether unconditional or conditional, is defined as the addition of the benchmark portfolio and a zero-cost long/short overlay strategy. The overlay strategies are designed to take a long duration risk exposure (via overlay(+)) or a short duration risk exposure (via overlay(−)), as a function of the signals generated by the return predictive factors. The amplitude of the duration bet is controlled via the parameter $X$, for which we test five possible values: 5%, 10%, 15%, 20% and 25%.

We define the unconditional carry portfolio as the addition of the benchmark and the long-duration overlay at each yearly rebalancing date. This portfolio has by construction a longer duration exposure than the benchmark. To fix ideas, if we set $X = 25\%$, then the unconditional carry portfolio is equivalent to a 100% investment into the BB4 maturity bucket portfolio at all dates. For a given signal, we then build a conditional carry portfolio as follows: on each yearly rebalancing date we observe in what historical tercile the signal is, and then:

- If the signal is in the low (historical) tercile, the conditional carry portfolio is given by the benchmark plus the short-duration overlay;
- If the signal is in the medium tercile the conditional portfolio coincides with the benchmark; and
- If the signal is in the high tercile, the conditional carry portfolio is given by the benchmark plus the long-duration overlay.

Figure 6 summarises the main statistics for the benchmark, the unconditional carry portfolio and the conditional carry portfolio for the signals based on the three return-predicting factors (slope, Cochrane-Piazzesi and Cieslak-Povala).

We obtain that all unconditional carry portfolios have a higher annualised mean return than the benchmark (up to 8.4% for versus 7.0%), which again is

#### 5. Decomposition of the unconditional and conditional carry portfolios

![5. Decomposition of the unconditional and conditional carry portfolios](image)

This figure explains the rationale behind the construction of the unconditional and conditional carry portfolios as the addition, at each rebalancing date, of the benchmark and an overlay.
6. Conditional long-only carry portfolios

<table>
<thead>
<tr>
<th></th>
<th>Benchmark</th>
<th>Carry portfolios</th>
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<tbody>
<tr>
<td></td>
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</tr>
<tr>
<td></td>
<td>X = 5%</td>
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<td>X = 15%</td>
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<tr>
<td></td>
<td>X = 25%</td>
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</tr>
<tr>
<td>Annualised mean total return</td>
<td>7.1%</td>
<td>7.0%</td>
</tr>
<tr>
<td>Annualised volatility</td>
<td>5.6%</td>
<td>5.5%</td>
</tr>
<tr>
<td>Sharpe ratio</td>
<td>0.41</td>
<td>0.41</td>
</tr>
<tr>
<td>Tracking error</td>
<td>0.0%</td>
<td>0.0%</td>
</tr>
<tr>
<td>Information ratio</td>
<td>0.80</td>
<td>0.81</td>
</tr>
<tr>
<td>Average duration</td>
<td>5.43</td>
<td>5.51</td>
</tr>
<tr>
<td>Maximum drawdown</td>
<td>10.9%</td>
<td>12.5%</td>
</tr>
<tr>
<td>Hit ratio</td>
<td>58%</td>
<td>54%</td>
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<td>54%</td>
</tr>
</tbody>
</table>

This figure reports, for different values of X, the conditional long-only carry portfolio statistics: annualised mean total return, annualised volatility, Sharpe ratio, tracking error, information ratio, average duration, absolute duration difference with respect to the benchmark, maximum drawdown, one-way annualised turnover and hit ratio. The hit ratio is computed as the ratio of the number of months where the carry strategy has outperformed the benchmark over the total number of monthly observations. The benchmark and unconditional carry portfolio statistics are also reported.

consistent with the proof-of-concept results showing that the duration risk is rewarded. As expected given their higher duration (average duration up to 10.84 versus 5.43 years), these unconditional long-only carry portfolio strategies appear to be riskier than their benchmark, with a higher volatility (up to 9.7% versus 5.6%), and a higher maximum drawdown level (up to 18.5% versus 10.3%). These carry portfolio strategies also generate high tracking errors (ranging from 2.8% to 4.6% for X ranging from 15% to 25%) and slightly lower Sharpe ratios (ranging from 0.39 to 0.41) than the benchmark value (0.41). While these unconditional carry portfolio strategies therefore appear to be attractive from an absolute performance point of view, the overall risk, the difference of duration with respect to the benchmark and the resulting tracking error of the unconditional carry portfolio remain substantial.

Moving to the conditional carry strategies based on the three signals detailed above and comparing them to the unconditional long-only carry strategies, we find that they display an overall lower risk (lower volatility and lower maximum drawdown), a lower average duration absolute difference with respect to the benchmark and also a lower tracking error. The slope-based and CP-based conditional carry strategies have better Sharpe ratios (up to 0.47 for the slope-based ones and up to 0.55 for the CP-based ones) even if their average performances are a bit lower than the unconditional carry strategies. On the other hand, the Cielsak-Povala conditional carry strategies outperforms the unconditional carry strategies on all levels: for X = 25%, we obtain higher average annualised performance (9.0% versus 8.4%), lower volatility (5.8% versus 9.7%), higher Sharpe ratio (0.75 versus 0.39), lower tracking error (0.0% versus 4.6%), higher information ratio (0.68 versus 0.31), average duration close to the benchmark average duration (5.02 versus 10.84), lower average absolute duration difference with respect to the benchmark (2.87 versus 5.41), substantially lower maximum drawdown levels (8.6% versus 18.5%) and better hit ratio (74% versus 55%). This may be due to the fact that the set of conditional CIP-based carry portfolio take advantage of both the long-term positive reward of the duration risk factor and the bond return predictability.

Conclusions

Carry strategies with CUSIP bonds are profitable, even when a long-only constraint is added. The use of return-predicting factors such as Cielsak-Povala allows to significantly enhance the risk-adjusted performance of the conditional carry strategy.

Maeso, Martellini and Rebonato (2018) analyse in more detail the conditional CIP-based carry strategies and also demonstrate that (1) a CUSIP-level, long-only CIP-based conditional strategy effectively limits the negative impact (with respect to the benchmark) of an increasing interest rate scenario and that (2) the same CUSIP-level, long-only CIP-based conditional strategy outperforms the benchmark in all equity market scenarios, and particularly so in the case of a bear equity scenario, which makes them even more appealing in a multi-asset context.

The research from which this article was drawn was produced as part of the Amundi ETF, Indexing and Smart Beta Investment Strategies research chair at EDHEC-Risk Institute.

References

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Which factors explain unlisted infrastructure asset prices?

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Unlisted infrastructure prices have increased considerably over the past decade. Was it a bubble or a normal phenomenon?

In new research from the EDHEC Infrastructure Institute (EDHECInfra) we show that systematic risk factors can largely explain the evolution of average prices but also that valuations have shifted to a higher level. We show that unlisted infrastructure equity prices do not exist in a vacuum but are driven by factors that can be found across asset classes.

Six factors are found to explain the market prices of unlisted infrastructure investments over the past 15 years: size, leverage, profits, term spread, value and growth. To these usual suspects, one can add sector and geographic effects. The result is an unbiased view of the evolution of prices (price-to-sales and price-to-earnings ratios).

We also find that on top of standard risk factors associated with most firms, sector-specific factors explain the level of prices and their recent evolution. For instance, renewable energy projects are found to have much higher price-to-sales ratios than average infrastructure companies, while social infrastructure has lower than average price-to-sales and roads valuations trend up and down with the economic cycle.

Our analysis documents the contribution of these factors to the evolution of average prices over the past 15 years. Their effect is found to have been mostly persistent over this period – ie, individual risk premia have been stable albeit, in some cases, time-varying. These effects are thus likely to continue driving prices in the future.

At the aggregate level, we document a degree of covariance between unlisted infrastructure prices and equivalent measures in public equity markets. At the sector level, patterns emerge with higher correlation with public markets in certain sectors more exposed to the economic cycle (eg, roads) and others experiencing peaks followed by a decrease in prices, as in the power sector.

A second phenomenon documented in this paper is a shift to a generally higher price regime of the unlisted asset class during the 2008–15 period. During those years, the effect of certain risk factors on prices became less powerful, notably leverage, as average prices increase seemingly independently of their risk profile. During that period, the nature of investors active in the unlisted infrastructure market has also shifted: a period of price discovery (which has sometimes been called a bubble) led to lower required returns as the risk preferences of the average buyer of private infrastructure companies evolved. This period appears to end after 2015, when prices stabilise.

Infrastructure businesses are expected to deliver steady and predictable cash flows and to the extent that this is the case they should be expensive. Hence, after 10 years of price increases a price consensus may have been reached.

Unlisted infrastructure prices will, in all likelihood, continue to be driven by common factors in the future, while the evolution of investor preferences will also determine the general level of prices and of the fair value of the unlisted infrastructure asset class. Our results show that despite the evolution of investor preferences, systematic risk factors mostly continued to explain prices over that period, indicating that valuations remained, on average, rational and fair.

Approach: from biased transaction prices to unbiased factor prices

One of the most important requirements of the IFRS 13 framework is to calibrate valuations to observable market prices. Private infrastructure is an illiquid market and assets do not trade often. As a result, observable transac-

\[ \text{Price-to-sales ratio} \]

1. Mean price-to-sales ratio

Correlation unlisted infra/S&P500: 44.42%

We use statistical filtering techniques (Kalman filter) to capture the changing impact of these factors on prices over time as investor preferences and market conditions change. These factor effects are unbiased and statistically robust.

This allows us to compute thousands of ‘shadow prices’ for those unlisted infrastructure companies that did not trade over the past 15 years. With this approach, we can document the price dynamics of the unlisted infrastructure market for the underlying population and not just for a biased sample of available transaction data.

We use a price-to-sales (PSR) ratio as a valuation measure, which reflects the willingness of an investor to pay for future risky revenue growth and dividends, adjusted for risk. We find that PSRs are well behaved statistically and present multiple advantages over price-to-book and price-to-earnings ratios, not the least that they always have a positive sign. A higher PSR indicates buyers are willing to pay more per dollar of average historical revenues, suggesting that these revenues are either expected to grow or considered more predictable. PSRs are also the standard metric used in

international capital markets and may be compared directly with the equivalent ratio for public equity indices.

The six risk factors that explain unlisted infrastructure prices

- **Size**: Previous research shows that small-cap stocks tend to outperform large-cap stocks because they have a higher exposure to systematic risk factors, undergo longer periods of distress in bad times, pose higher credit risk or are less liquid. In the case of infrastructure, larger assets are found to have lower prices – i.e., higher returns. Effectively, size is a proxy of liquidity: larger infrastructure projects are more illiquid, complex to develop and the object of information asymmetries between buyers and sellers.

- **Leverage (credit risk)**: As for other firms, credit risk has an impact on equity investors in infrastructure, who take the risk of being ‘wiped out’ in the event of default. Infrastructure companies that have higher leverage – proxied by the ratio of total liabilities to total assets – thus have, on average, lower prices.

- **Profits**: Also in line with theory, profitability impacts prices directly and positively. We find that the effect – proxied by the profit margin – is time varying and more important during bad times (the years following the financial crisis).

- **Term spread**: the value of infrastructure investments, with their high upfront capital costs, is determined by their long-term cash flows. They are therefore sensitive to interest (discount) rate changes. The term spread – the difference between long-term and short-term interest rates – is found to have a negative impact on prices, also as theory predicts. In an international context, differences in term spread can also signal differences in country risk, especially when short-term rates are at the zero-lower bound, which is the case during most of the relevant period of observation.

- **Value**: a value effect exists if companies are ‘cheap’ from one perspective or another. We look at infrastructure companies that report negative book values during their first 10 years as a proxy of the ‘value’ period in their life-cycle. We find that the greenfield stage corresponds to a different level of prices than during the rest of the firm’s life-cycle.

- **Growth**: Infrastructure companies have limited growth opportunities as by nature they are designed to deliver individual investment projects with fixed revenues. Still, merchant infrastructure projects and corporates have opportunities to grow. For these companies, higher expected growth relatively increases prices. We also find that, in line with theory, realised revenue growth tends to have a positive effect on valuations.

**Stylised facts: the dynamics of unlisted infrastructure prices**

- **Price-to-sales ratios of infrastructure companies are significantly higher than in public markets**, irrespective of market conditions. This reflects the ability of infrastructure companies to transform income into dividends, as highlighted in previous studies, pay-out ratios (dividend pay-outs over revenues) tend to be four to five times higher in mature unlisted infrastructure companies than in listed companies of equivalent size, leverage and profitability.

- **Price-to-earnings ratios** tend to be much more volatile than in public markets. Indeed, pay-outs may be higher as share of revenues but they are also more variable as a result of the significant financial and operational leverage that characterises infrastructure companies. Their large but mostly fixed production costs make any excess revenue a source of pure profit, but since any decline in revenues is not easily matched with a decline in production costs, profits can decline very fast as well.

For the most part, the factors driving unlisted infrastructure secondary market prices make sense: size, leverage, value or profitability have the signs predicted by theory and their effects are persistent, albeit variable, across time. This is significant to define an ex ante factor model of returns for the purpose of asset valuation.

**Price formation and discovery is slow**: the factor effects documented above can take several years to change from one level to another, as transactions and investor preferences are processed by market mechanisms. This is partly the reflection of unlisted infrastructure status as a ‘new’ asset class, so that numerous transactions were necessary over many years for ‘fair’ prices – representing the willingness to pay of numerous buyers and sellers at one point in time – to emerge. Prices do not react immediately to short-term variations in financial conditions: the swings in price-to-earnings are due to the fact that prices stayed on a steady increasing path for most of the period, while earnings swung up and down, especially in the merchant sector. This can be both a function of the slow processing of price information in a high illiquid market, as well as the reflection of the belief by buyers that most of the value of infrastructure companies is embodied in a long-term business model, which can be considered impervious to short-term volatility.

**Valuations are not out of line with fair value**: because price movements can be explained by systematic factors and the remaining variability of transaction prices appears to be idiosyncratic, prices can be said to have mostly evolved to reflect the preferences of market participants taking major risk factors into account. In other, words, pricing has remained rational and informed. The fact that prices have increased a lot over the past decade cannot simply be attributed to a ‘wall of cash’ effect in a market where many participants were chasing few available opportunities.

The research from which this article was drawn was produced as part of the EDHEC/Long-Term Infrastructure Investors’ Association (LTIIA) Research Chair on Infrastructure Equity Benchmarking.

Reference

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Which factors explain private infrastructure credit spreads (and discount rates) and how do they evolve over time? Are infrastructure project finance spreads and infrastructure corporate spreads driven by common factors?

In new research supported by Natixis as part of the EDHEC/Natixis research chair on Infrastructure Debt Benchmarking, the EDHEC Infrastructure Institute (EDHECinfra) examines the drivers and evolution of credit spreads in private infrastructure debt.

We show that common risk factors partly explain both infrastructure and corporate debt spreads. However, the pricing of these factors differs, sometimes considerably, between the two types of private debt instruments.

We also find that private infrastructure debt has been ‘fairly’ priced even after the 2008 credit crisis. That is because spread levels are well explained by the evolution of systematic risk factor premia and, taking these into account, current spreads are only about 20 basis points above their pre-2008 level. In other words, taking into account the level of risk (factor loadings) in the investible universe and the price of risk (risk factor premia) over the past 20 years, we only find a small increase in the average level of credit spreads, whereas absolute spread levels are twice as high today as they were before 2008.

A better approach to estimating market credit spreads

The main difficulty facing econometric research on the pricing of infrastructure debt is the paucity and biases of observable data. Secondary transactions are very rare and usually not instrument-level sales. Still, large number of primary transactions (at the time of origination) can be observed. Nevertheless, this data is biased: origination follows procurement and industrial trends – eg, it tends to cluster in time and space when and where governments procure new infrastructure using a privately-financed model. Simply observing origination credit spreads over time does not take into account the underlying market for private infrastructure debt to which investors are exposed.

Primary spread data is also auto-correlated – ie, what best explains the spread for a given infrastructure borrower is not its characteristics, but the spread of the previous transaction.

To address these issues and estimate the effect of individual risk factors on spreads we do two things. Firstly we estimate the evolution over time of the risk factor premia and determine their unbiased effects on spreads over time. Secondly we use the EDHECinfra universe, a representative sample of existing infrastructure borrowers – as opposed to the biased sample of new borrowers in the primary market – to apply the risk premia estimated in the first step to the ‘factor loadings’ (the characteristics) of this better sample, thus computing a current market spread for each one, at each point in time.

Using a factor model in combination with a representative sample of investible assets can correct the bias and paucity of available data: as long as such factors can be documented in a robust and unbiased manner, they can...
be used to assess the fair value of private debt investments over time, whether they are traded or not.

What factors explain infrastructure credit spreads?

Our results show how the aftermath of the 2008 crisis changed and sometimes removed well-established relationships between certain factors and the cost of corporate and infrastructure debt: the impact of base rates on loan pricing disappeared, structural differences between markets vanished and certain sectors like roads experienced a continued increase in the price of long-term private financing.

Our results are statistically robust and explain the data well. We show that infrastructure and corporate credit spreads are determined by a combination of common factors that can be grouped into four categories:

1. **Market trend**: the largest effect driving credit spreads in both infrastructure and corporate debt is a time-varying trend factor which captures the state of the credit market over time. This effect is not explained by loan or borrower characteristics. In the case of infrastructure debt, this effect is roughly constant but exhibits ‘regime shifts’, especially 2008 (up) and 2014 (down). In the case of corporate debt, it is an upward trend also exhibiting jumps in 2008 and 2012. We find a 20bps increase of infrastructure spreads compared to pre-crisis levels, down from 75bps at the height of the credit crisis, indicating a degree of mean-reversion.

2. **Credit risk**: only explains part of the level of credit spreads. We find that infrastructure borrowers that are exposed to Merchant Risk are required to pay a time-varying premium from 20–40% above the market average at the time. Size has no effect on average corporate spreads but is a driver of lower risk premium in infrastructure debt. In effect, larger loans can be interpreted as a signal of lower credit risk in infrastructure finance. Industrial groups can be considered a partial proxy for credit risk but are mostly not significant, except for social infrastructure and, among corporate borrowers, infrastructure corporates, which have come to benefit from a substantial discount relative to average market spreads in recent years.

3. **Liquidity**: other drivers of spreads are proxies of the cost of liquidity for creditors. Maturity: while it is difficult to capture in static models, maturity is found to be a significant and time-varying driver of spreads for corporate debt, with higher premium charged during period of lower bank liquidity (2008–16), whereas infrastructure debt has a constant maturity premium. While the effect of size is primarily a matter of credit risk, we note that in periods of limited creditor liquidity (2008), even infrastructure debt becomes more expensive as a function of size. However, this effect is not strong enough to create a size premium. Re-financings, which are not a significant driver of spreads in normal times, are shown to be more expensive in times of credit market stress, especially for infrastructure debt.

4. **Cost of funds**: the benchmark against which floating rate debt is priced has been a factor explaining the level of credit spreads. Base rates are inversely related to spread, ie higher rates imply lower spreads, but this effect is shown to have all but vanished since 2008. Since then, the level of credit spreads and that of base interest rates has become completely uncorrelated. Market segments: taking base rates into account, some markets are cheaper than others as a result of the well-known segmentation of credit markets. This is the case when comparing Libor-vs-Euribor-priced loans but also the different geographic areas in which different lenders operate. Again, since 2008, these differences have tended to disappear.

Towards fair value in private infrastructure debt

Our assessment of the impact of certain risk factors in the formation of aggregate credit spreads is relevant for at least three reasons:

1. While observable spreads are biased due to the segmentation and low liquidity of the private credit market, unbiased factor prices (premiums) can be estimated from observable spreads, and used to determine the factor-implied spreads for any instrument at any time;

2. The time-varying nature of individual risk premia implies that re-pricing individual instruments over time can be material and is required if such investments are to be evaluated on a fair value basis;

3. A multi-factor model of spreads, ie discount rates, allows more robust valuation taking into account the effect of systematic risk factors. One of the most important requirements of the IFRS 13 framework is to calibrate valuations to observable market prices, thus ensuring that estimated spreads represent current investor preferences at the measurement time. While fair value is not always required for debt instruments, which are booked at their face value unless they become impaired, the requirement to evaluate assets on a like-for-like basis will only grow as the private debt asset class becomes a more significant part of investors’ portfolios.

The research from which this article was drawn was produced as part of the as part of the EDHEC/Natixis Research Chair on Infrastructure Debt Benchmarking.

Reference
