IDEAS Connect

# Harvesting risk premia in equity markets

Harvesting risk premia is a common strategy for fixed-income investors. Risk premia also exist in the equity markets. Investors can seek to earn equity risk premia by taking explicit exposure to factors. In part one of a two-part series, we look at the concept of the equity risk premium and the issues and options to consider when combining multiple risk premia/factors in an equity portfolio.

Most institutional investors have a large allocation to fixed-income investments. Within the fixed-income space, risk-premium investing is a common strategy. The yield spread between bonds and comparable "safe-haven" securities such as US Treasuries represents the premium (the additional return) that compensates the investor for the risk taken.

For instance, investors can earn the premium by adjusting the duration of their portfolios (a term premium) or by adding exposure to corporate bonds (a credit premium). The potential outperformance of portfolios managed in such a way can be naturally explained as compensation for incurring extra risks. Of course, in the short term, this additional compensation may take time to materialise, particularly with equities, since stock volatility is much higher than bonds.

As we will explain later, risk premia are the drivers behind the relative performance of most active equity managers. Implicitly, a large part of their active returns can be explained by these factor exposures. This is true even if institutional investors did not explicitly allocate to risk premia/factor-based strategies.

### The role of risk premia in explaining equity returns

The existence of risk premia is well-documented in academic literature (Exhibit 1). In the beginning, the Capital Asset Pricing Model (CAPM) and the concept of beta, first introduced in the 1960s, explained the pricing of securities using a single market factor. Subsequently, this concept has been revised and enhanced to incorporate other factors (stock-level characteristics) that help explain stock returns.

Equity factors carrying their own risk premia contribute a much larger portion of excess returns to a portfolio's performance. Exhibit 2 depicts the evolution of the source of excess returns.

**Exhibit 1: Risk premia as a source for excess returns – a brief history**

### Market beta

Decades ago, a portfolio's relative return was primarily attributed to the portfolio manager's skills. With the advent of the Capital Asset Pricing Model (CAPM), the same portfolio's active return was decomposed into a component that describes the portfolio's sensitivity to the movement of the broad market, called beta, and a component that cannot be explained by market movement, called alpha.

In essence, the CAPM theory clarified that part of a portfolio's relative performance is not solely a result of the portfolio manager's stock-picking skills (alpha) but also due to its exposure to the broad market (beta).

For example, if you buy defensive, low-beta stocks in a down market, you will outperform, independently of any stock-selection skill involved in deciding which defensive stocks to buy.

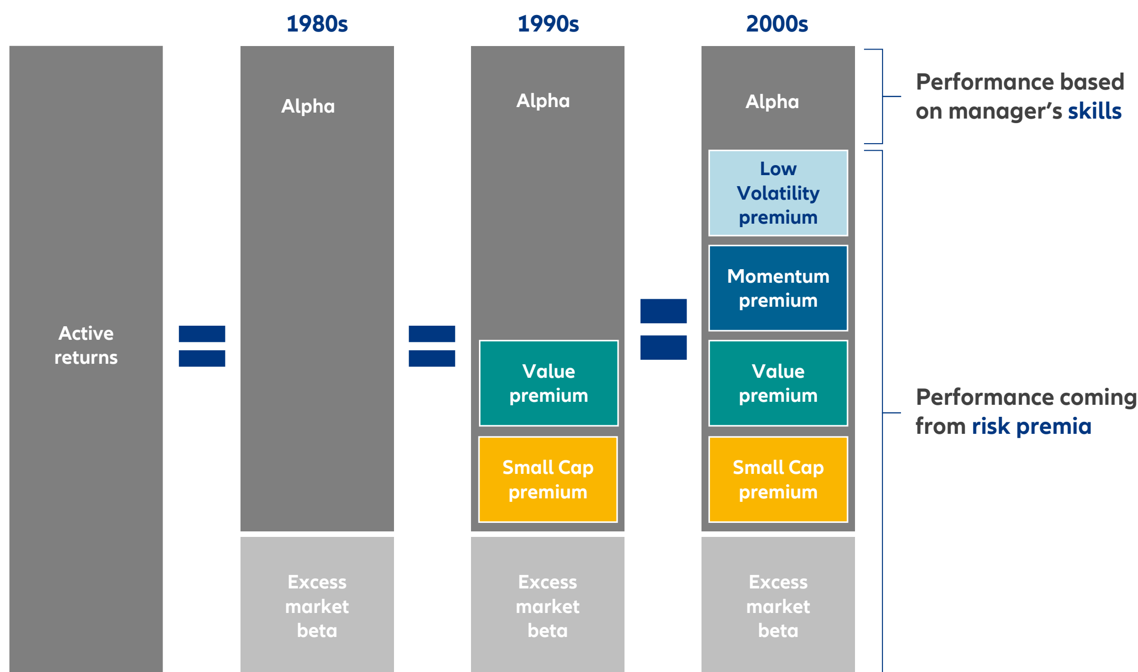
### Discovery of equity risk premia/factors

In the autumn of 2013, Eugene Fama received the Nobel Memorial Prize in Economics for his explanation of the empirical outperformance of small-cap companies (Size) and high book-to-market companies (Value) as risk premia. In his seminal paper with Kenneth French, Fama argues that there is more than one risk premium in equity markets.

Fama and French say sub-segments of the market carry their own risk premia above and beyond what the broad market offers. A portfolio has a market beta that measures its exposure to the broad market. Yet, several other betas measure their exposure to different risk premia.

Other researchers later refined and extended this concept of beta and risk premium within the equity market to include more risk premia/factors, such as growth, momentum, quality, revisions, etc.

**Exhibit 2: Where do excess returns come from?**




| | |
|---|---|
| Low Volatility: | Low beta or less significant price fluctuations |
| Momentum: | Recent upward trends or "in favour" |
| Value: | Relatively "cheap" or attractively valued |
| Small Cap: | Small in terms of stock market capitalisation |

Source: Allianz Global Investors, MSCI. For illustrative purpose only.

### Is there a smarter way to combine multiple risk premia?

Smart beta indices may be a good starting point when looking to exploit risk premia. However, we think institutional investors can do better than just buying and blending individual smart beta ETFs or indices.

Why? Smart beta indices are not designed with a view to a diversified combination with other smart beta indices but are designed as stand-alone products. Therefore, when capitalising on multiple risk premia in a portfolio, it is important for institutional investors to seek out some forms of diversification.

To illustrate this point, consider that "Value" and "Momentum" tend to have low to negative excess-return correlations. Therefore, it would be natural to assume that combining the two factors would produce greater relative return stability than implementing each individually. Intuitively, this makes sense: The beneficial market environment for the trend-following factor (i.e., Momentum) tends to favour the contrarian factor (i.e., Value).

Nonetheless, a portfolio diversifying across factors, even those with low correlations, can still suffer from large drawdowns in relative performance. How could this happen? There are two major reasons:

(1) **a potential loss of diversification occurs when many stocks overlap across different equity factors;** and

(2) **macroeconomic sensitivities, for example, interest rate sensitivity or oil price sensitivity** — what we call "unrewarded risk factors"— can overwhelm the factor's excess-return premium.

These two risks can be effectively managed through thoughtful portfolio construction. This is where the expertise of active portfolio managers comes into play, as they can change the composition of the individual risk-premium portfolios to mitigate these risks.

At Allianz Global Investors, we believe investors can potentially achieve **better outcomes (in terms of proper diversification and greater stability of relative performance) with an active, integrated portfolio** rather than just buying individual smart-beta strategies and combining them in a generic way. This sort of "naïve" combination may result in many unmanaged sector or factor biases and lead to insufficient diversification.

**Smart beta**
**– passive-like exposure to factors**

So-called "smart beta" investing is commonly used to refer to any equity portfolio or index that deviates from a conventional market-capitalisation approach to selecting and weighing underlying securities. It seeks to follow a systematic and rules-based methodology.

Smart beta strategies create passive-like long-only exposure to specific risk premia/factors, primarily through buying and holding exchange-traded funds (ETFs) such as Value, Growth, or multi-factor ETFs.

Given the popularity of smart beta strategies, there are many other terms that are used interchangeably in the marketplace to describe these strategies and their characteristics, including advanced beta, alternative beta, risk premia/factor investing and style investing.

### Other risk factors that are not rewarded with excess returns in the long run

It is important to note that macroeconomic exposures are non-rewarding risks in the sense that there is no risk premium attached to these kinds of risks for a buy-and-hold investor. There is no risk premium for taking on oil price risks or interest rate risks. Of course, there are periods when oil price risk pays off, and investors could try to benefit by trying to time those periods and making directional bets. However, we think that the timing of the oil price or the interest rate cycle is elusive.

When harvesting risk premia, investors are better off neutralising the implicit exposures to all of these non-rewarding risks. Certainly, the worst thing to do with these exposures to the non-rewarding risks, is to leave them unmanaged, like smart beta ETFs do, as this can create a lot of short-term volatility without any compensation for it.

To earn the risk premia in a much more stable way than a basket of smart beta indexes, active equity portfolio managers should therefore **isolate the long-term rewarding risks from the non-rewarding risks and control these non-rewarding risks.**

The second part of this two-part series introduces an active, integrated approach that not only incorporates the concepts discussed in this paper but also combines multiple risk premia into an explicit equity portfolio.

## Key takeaways

Harvesting risk premia is a common strategy within the fixed-income space. Research from leading academics supports the view that risk premia also exist in equity markets. Capturing equity risk premia (by taking explicit exposure to factors) is a way of earning additional compensation in the form of excess return over a broad, cap-weighted benchmark over time.

Smart beta indices may be a good start when looking to exploit risk premia, primarily through buying and holding ETFs. However, we think institutional investors can do better than just buying and blending individual smart beta ETFs or indices, which can lead to a potential loss of diversification when many stocks overlap across different indices or factors.

In addition, macroeconomic exposures, such as interest rate sensitivity or oil price sensitivity, can introduce unintended risks if left unmanaged at the stock level. An active, integrated solution for institutional investors may be much more desirable than a basket of smart beta ETFs. Part two of the two-part series shows an example of constructing an actively managed risk premia/factor-based equity portfolio.

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