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Investment viewpoint

Getting ready for factor rotations

1798 Alternatives • Alternative Risk Premia

October 2021

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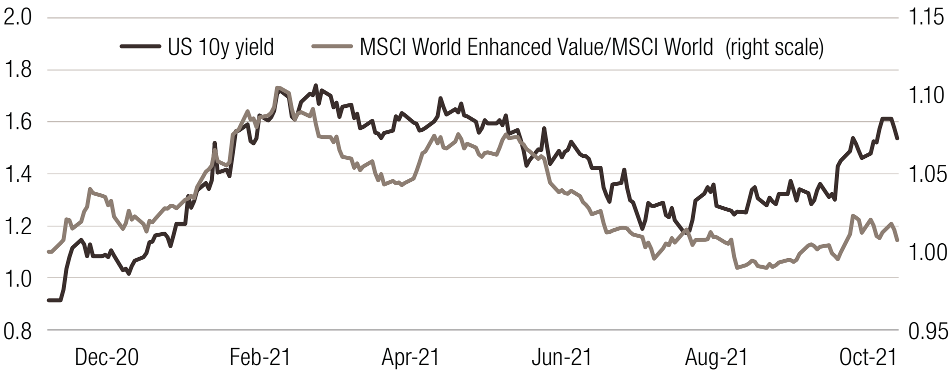
The beginning of this year has been marked by a strong rotation from Growth to Value as mounted inflationary expectations pushed rates higher. Growth companies that are expected to generate cash flows further in the future tend to underperform in the environment of rising interest rates due to increasing discounting factor. Following the sell-off in rates, the Fed managed to calm markets down, insisting that inflationary pressures were transitory and related to reopening of the economy. Since then, Value gradually lost its advance over Growth (see Exhibit 1).

Recently, the speculation that the inflation is not a short-term phenomenon has been mounting again on the back of persistently high inflation figures and, more importantly, the evidence that the largest component of the inflation is now not related to reopening components. The inflationary expectations pushed long-run yields up again and we saw signs of the beginning of a new Value-Growth rotation.

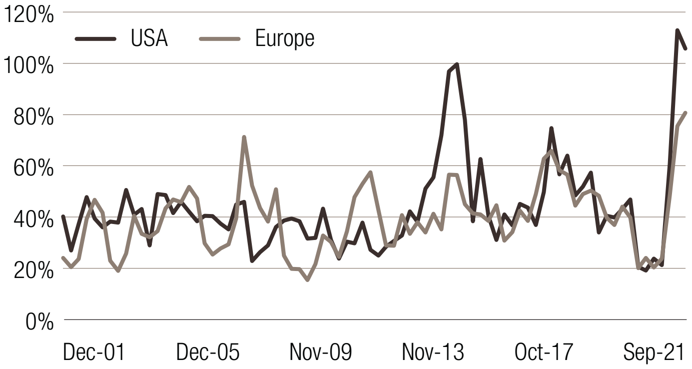
Clearly, the inflation theme has been dominating this year's debate, therefore, a prudent positioning in Value – Growth will be the key factor of success going forward. This thesis is reinforced by the observation that the recent volatility of the Value factor is close and even exceeds the volatility of the Beta factor (see Exhibit 2). In simple terms, getting the style exposure right is now as much important as getting the market direction right.

EX. 1 GROWTH-VALUE ROTATION IN 2021



Source: Bloomberg.

EX. 2 VALUE TO BETA VOLATILITY RATIO: VALUE IS NOW AS RISKY AS BETA



Source: LOIM. Ratio of the volatility of Value factor to volatility of Beta factor. Factor volatilities are estimated based on holdings of long-short portfolios replicating proprietary Beta and Value factors built on a GICS1 sector-neutral basis and each "purified" from other four factors (Value, Quality, Momentum, Beta, and Size).

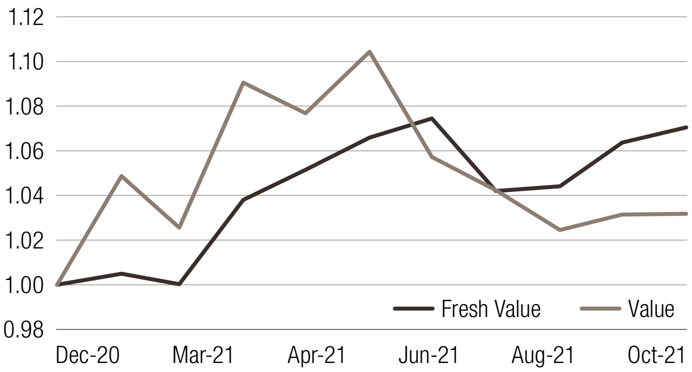
In our factor-based portfolio we gain the exposure to Value through a proprietary Fresh Value factor.[1] This variation of the value factor is derived from the traditional one by neutralising the past exposure to Value. In a nutshell, we target value stocks that became "cheap" only recently while avoiding stocks that stay "cheap" too long (value traps). Historically, the Fresh Value factor allowed capturing value premium in a much smoother way, avoiding violent movements typical for the traditional value investing.

The Fresh Value factor did its job this year too. While the original Value factor experienced wild fluctuations, Fresh Value was able to exhibit a much smoother performance resulting in a healthy return across all the regions. Going forward, Fresh Value may miss a sharp come-back to Value, however, it will capture the long-run rotation in the full extent.

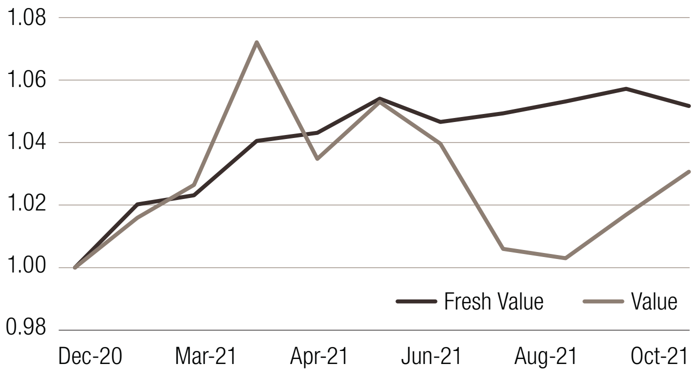
At this moment it is very difficult to make credible predictions about future style performances. We expect the inflationary pressures to persist, which should work in favour of Value. Nevertheless, we do not rule out alternative scenarios that might hurt Value. One of the worst case scenarios is the stagnation of the economy when high inflation is coupled with negative growth. Value stocks are known to perform badly during recessions as they have physical capital in place as opposed to growth companies that are still in the phase of investment. Whatever comes next, we are confident that our style positioning through the Fresh Value factor will allow us to capture future Growth-Value rotations while limiting downside risk of value stocks getting hit again.

EX. 3 FRESH VALUE GEST ITS JOB DONE

USA



EUROPE



Source: LOIM. Performance of long-short portfolios replicating proprietary Fresh Value and Value factors built on a GICS1 sector-neutral basis and each "purified" from other four factors (Value, Quality, Momentum, Beta, and Size).

1 Please, see our publication «Let's make Value great again» available at https://am.lombardodier.com/home/asset-classes/alternatives/alternative-risk-premia/alternative-risk-premia-research.html

IMPORTANT INFORMATION