FIRST QUADRANT

MARKET INSIGHT

The Upside of Equity Beta Management

November 2018

"Red October" served as a jarring reminder that exposure to equity beta must be managed to meet most investment objectives. A simple way to manage risk might be to reduce exposure when prices fall below a certain level. But selling into a falling market is costly, and if the market rebounds, you have locked in losses. Furthermore, in addition to this realized cost, you paid a hidden opportunity cost: Had you placed a bet that prices would recover, you would have actually realized gains. To provide liquidity as prices plunge and news headlines question whether the bull market has ended, however, you need to have strong conviction that markets will again revert. In our process, we firmly believe that the best way to understand what is driving prices is to understand which investment objectives are driving prices.

Hedgers and profit-seeking equity traders are often aligned in their bets, even though these groups have distinct investment objectives. These differing objectives, however, can translate into divergent reactions to risk events. Investors with hedging objectives tend to manage risk fairly consistently, even over long periods, while investors with absolute return objectives can be more influenced by their views on the market environment. When profit-seekers perceive the ambient environment to be supportive, for example, they may be inclined to brush off potential sources of risk; if they have considerable uncertainty about the state of the environment, on the other hand, they might decide to sell assets to protect past profits.[1] Moreover, if the market is moving quickly, investors might be tempted to mimic others' behaviors, lest they "miss out" on a profitable new opportunity, or incur further losses during a downturn.

When risk reaction becomes heavily influenced (by exuberance or capital preservation), prices can become significantly divorced from their underlying fundamentals. Our equity beta management process identifies and capitalizes on these dislocations, expressing model-driven views on how much the reaction to risk is the result of fundamental indicators versus exuberance/capital preservation through futures positions. Our process typically views the price of risk to be relatively close to its appropriate value, given underlying fundamentals. But when equity markets experience notable swings, our strategy is more likely to take a strong view on whether the price movement reflects a fundamentals-based correction to the market outlook, or simply a shift in investor preferences.

During a market selloff, if our research infers that capital preservation objectives have contributed to the drop in prices, our strategy will

Past performance is no guarantee of future results. Potential for profit is accompanied by possibility of loss.

adopt a contrarian stance and provide liquidity. This is precisely the scenario that unfolded during October. As the market started to sell, our process identified an excessively steep fall in prices relative to fundamental indicators, and attributed a portion of the price movement to capital preservation objectives. Consequently, as the broad equity market slid, we increased our equity beta exposure – a pretty bold move given that stocks were experiencing their steepest losses since February! Nevertheless, we felt confident in the trade, even as the selloff showed few signs of abating. We have conviction in the robustness of our research. So when this beta-management model identifies large opportunities, we expect its recommendations to add significant value and, moreover, exhibit a strong positive right skew. And this was, indeed, what occurred.

The market had oversold, and toward the end of October, prices experienced a turnaround. Importantly, while prices crept closer to levels that reflected fundamental views, our process gradually moderated the excess in exposure to equity beta that it had developed. Altogether, our tactical management of portfolio beta exposure resulted in a strong positive contribution during the month of October and into the first two weeks of November. Investors who had held onto their assets breathed a sigh of relief as they recovered a portion of losses – but our process not only preserved its (already-strong) year-to-date performance, but added to it during this period.

Endnotes

[1] It is worth noting that passive strategies can emulate this human behavior, as well, through techniques such as "stop-loss" rules.

For index definitions and trademark language used in this publication, please visit https://www.firstquadrant.com/index-definitions for further information.

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