

# The Fab Four: Trend, Carry, Volatility and Value

## Why We Think Combining Alternative Risk Premia is Necessary in Today's Economic Environment, And How to Go About It.

*Risk premia strategies (such as Trend, Carry, Volatility and Value) have faced various headwinds since the 2008 financial crisis. Key drivers of the decline in the levels of premia include historically low interest rates, greater levels of unpredictability in asset volatility and the increased tendency of assets to move together. However, the ability of a well-constructed strategy to extract a given level of premia has stayed broadly constant, and correlations between the risk premia types remain low. This latter attribute allows investors to combine the risk premia into one allocation to take advantage of the diversification between them, coupled with additional advantages of increased exposure (compared to separate allocations to each individual premium) while reduced trading costs coming from netting benefits.*

### Introduction

The market environment of the last decade with low interest rates, similar yield curves and increased correlation between traditional asset classes, has driven investors to look for alternative sources of returns outside of the normal allocations to stocks and bonds. One of the key sources of returns has been in the risk premia space.

### In our view, a risk premia strategy should:

- Accept a transfer of risk;
- Be compensated for that risk;
- Be proven to be persistent and pervasive and
- Be demonstrable in more than one asset class.

**Our Beatles reference in the title gives away the four premia we have faith in across a range of asset classes:**

**Trend:** the idea that the efficient markets hypothesis is broken, and some assets continue to move in line with their recent direction.

**Carry:** the idea that some assets exhibit income characteristics that are not fully captured by their forward markets.

**Volatility risk premium:** the idea that market participants need compensation for absorbing hedging risk.

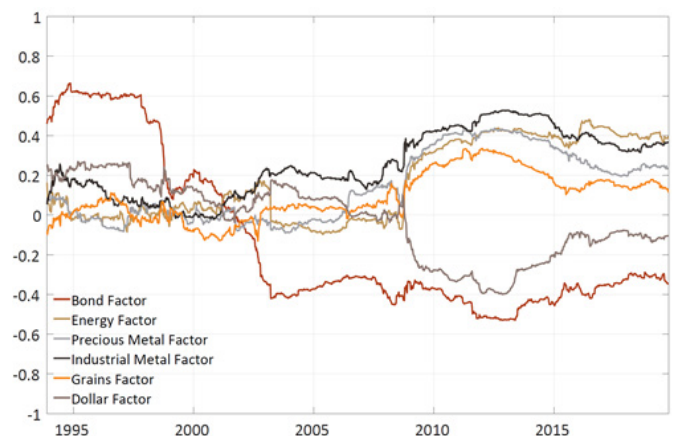
**Value:** the idea that some assets can be over-extended and thought of as "cheap" or "expensive".

### Where Are We, and How Did We Get Here?

Each of these premia have faced headwinds in terms of signal strength over the last decade; we might ask if there are aspects of the current macro environment that are driving this and whether we think these are here to stay.

Three observations are evident: first, interest rates are low, and likely to stay that way. Second, unpredictability has become more unpredictable; over the last quarter of a century we have seen more shocks (defined as 5-standard-deviation events) in equities and fixed income, but fewer in currencies and commodities. Third, as we see in Figure 1, there has been an increase in correlations among the major factors.

Figure 1: Correlations to equities among the major global factors.



### Where Does This Leave Us, and What Can Investors Do?

The economic environment has led to similar discount curves, increased interconnectedness of asset classes, and risk premia that are weaker and connected to the business cycle. Given the headwinds thus facing risk premia, how should investors think about allocating to the space?

First, don't panic. The good news is that the ability of a well-designed portfolio to extract returns from available premia (the "beta") has remained broadly constant over time. For a good manager, improvements in portfolio construction and expansion of asset universes have offset the alpha decay.

A further piece of good news, shown in Figure 2, is that while the correlations among the premia themselves have picked up in magnitude, the averages have been broadly stable and very

close to zero. Given these two facts, it is natural to combine the premia to take advantage of their natural diversification.

At Fulcrum, we have examined two approaches in the combination of risk premia: (i) a bottom-up allocation agnostic to the historical performance of the strategies and (ii) a top-down approach which acknowledges our practical experience in running risk premia strategies for over a decade. The bottom-up approach seeks to equalise the risk contribution of the different pieces of the portfolio. The alternative approach includes the information from the historical performance of the strategy and its breadth. The final step is to recognise that neither approach is definitive, and model average across them. This leads to an allocation that is transparent and robust over time.

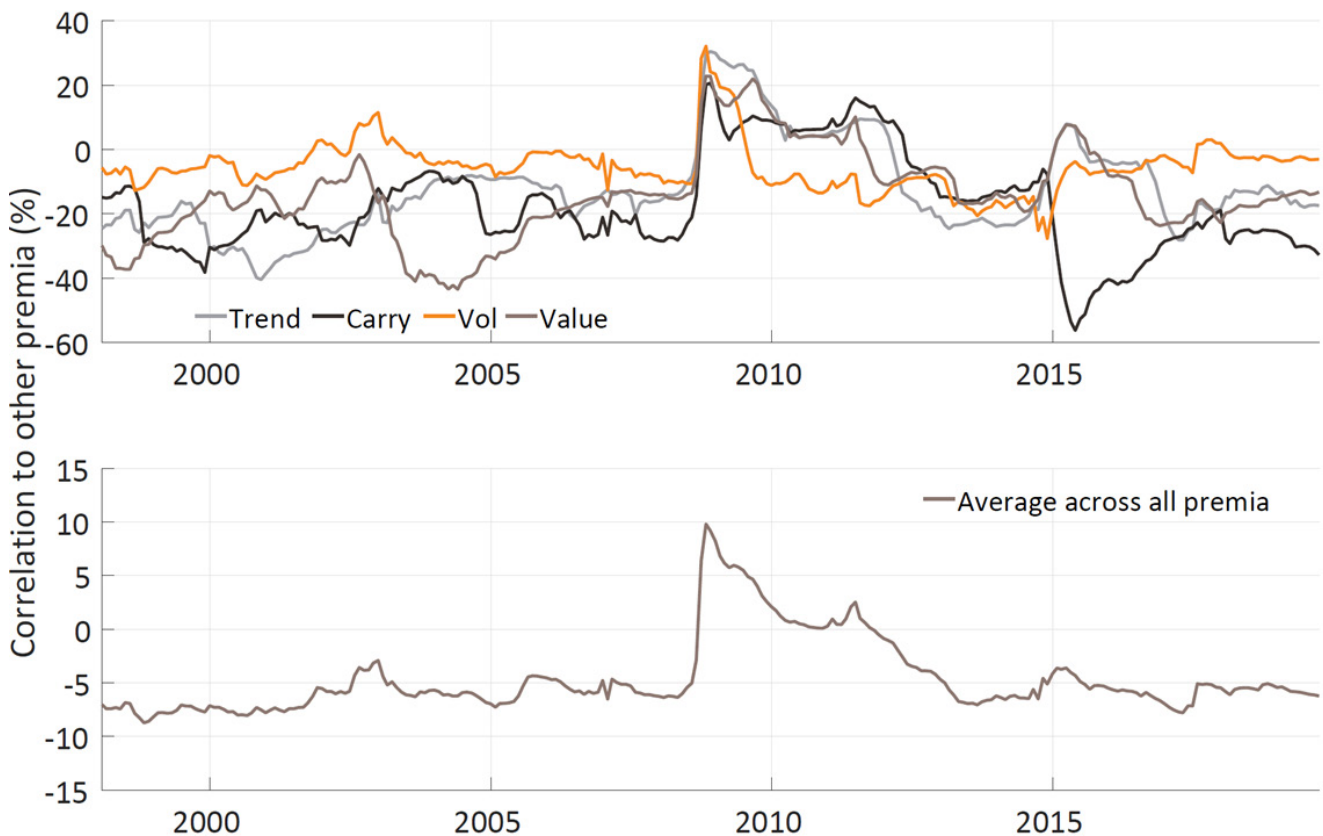
### Conclusions

What we have highlighted above is that classical risk premia strategies (Trend, Carry, Volatility and Value) face headwinds that are, at least in part, attributable to a macro environment that is unlikely to improve.

We believe that the right way to approach this challenge is to recognise that performance in each of the premia will fluctuate and that correlations among them remain low, and thus to combine them and use the diversifying nature of the strategies to the investors' advantage. Aside from improving performance, such an approach has the additional benefits of capital efficiency and gains from netting of trading costs. The final advantage is one of future-proofing; the commoditisation of risk premia strategies over time places a high degree of emphasis on the institutional qualities of the investment manager, and their ability to evolve "new" strategies as these migrate from the alpha space and into the risk premia one. We believe that the four major risk premia we have discussed here have already made that journey and look forward to incorporating new strategies in the same framework in the future.

**This is a summary note from a longer and more detailed article we recently wrote. Please contact us if you would like a copy of the original version, with more historical data and analysis in relation to the work on this topic.**

Figure 2: Correlation of each of the premia - Trend, Carry, Volatility and Value - to the other three (top) and the average of these across the four premia over time (bottom).





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