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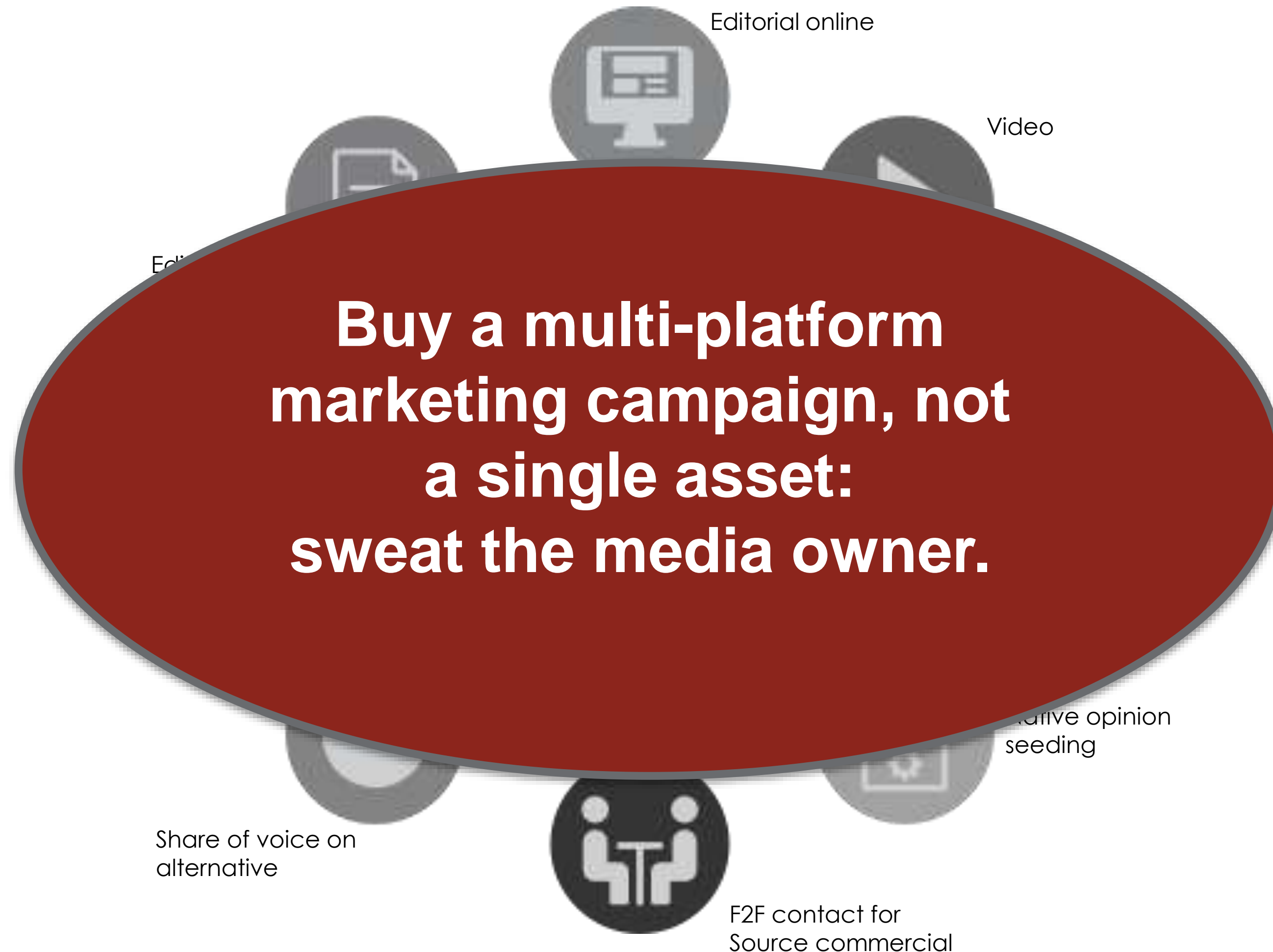

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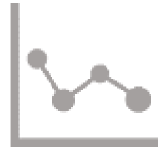

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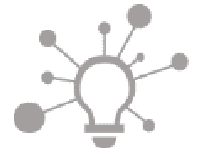

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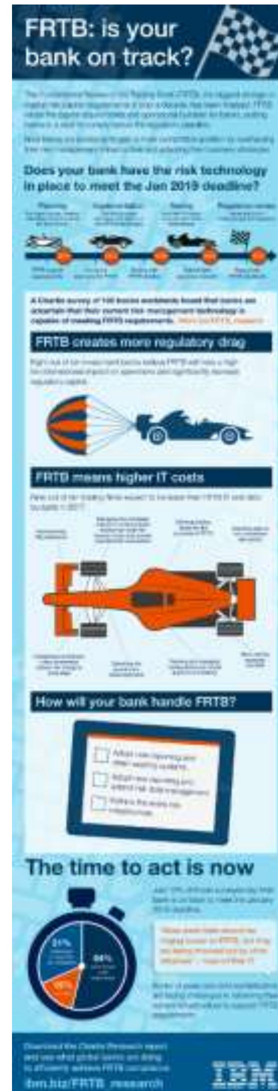
Quaternion

FRTB:
15%
35%
54%
66%
90%



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Practical applications of smart beta

A smart beta solution can represent a key tool for investors seeking to monitor risk and optimise their performance. Bruno Taillardat, global head of smart beta and factor investing at Amundi, discusses how investors can get the best from this investment strategy

Over the past few years, institutional investors have been getting to grips with the concept of smart beta. And, while some have allocated funds to one or more of these strategies, many remain unaware of its potential.

Smart beta products can offer solutions to specific issues, and investors may be surprised to find these strategies can be used in a range of scenarios to monitor risk and improve potential performance while keeping a lid on costs.

In this article, Amundi shares four examples of how smart beta can be used. It should be noted, however, that every client is different, and a well-resourced asset manager would be able to propose a solution according to their clients' specific requirements.

Bruno Taillardat, global head of smart beta and factor investing, Amundi

Case 1 – Improving portfolio returns while monitoring risk

Today's peculiar market conditions pose a dilemma for institutional investors. Nowadays, yields on fixed-income securities – whose profile is often less risky than equities – are very low, and while equity securities could potentially provide attractive returns, they are riskier because of higher volatility.

In this context, because of low expected returns and increasing asymmetrical risk in bond markets, a balanced investor may want to reallocate from fixed-income to equities while avoiding an increase in overall risk.

Certain smart beta strategies can allow investors to switch a bigger portion of their portfolio to equities, while keeping a lid on risk. Switching from a market cap-weighted index to a low-volatility smart beta product allows investors to improve the return profile of their portfolios, at the same time limiting the impact of portfolio volatility.

The Amundi Conservative Equities range, for example, aims to offer exposure to equity markets with a lower volatility while maintaining the same expected potential returns. Investors can thus increase their allocation to equity without changing their overall risk. The investment process is based on a robust portfolio construction, ensuring a good level of diversification, thereby providing lower risk and more resilience compared with the benchmark.

The management team implements a process based on a systematic multi-criteria analysis to select quality stocks by taking care of liquidity. A quantitative optimisation process is then applied, aiming to build a portfolio with low volatility by ensuring it is not strongly exposed to risk factors with highly asymmetrical behaviour – so avoiding 'crowded trades' and exposure to downside traction.

Our solution – when exposed to European equities, for example – has a proven track record of performance enhancement over the past seven years, outperforming its benchmark (the MSCI Europe index) in five out of seven observed years, with reduced maximum drawdowns versus benchmark drawdowns.

Case 2 – Integrating environmental, social and governance (ESG) factors into a smart beta portfolio

A leading Dutch charitable foundation wanted to restructure its entire equity portfolio to reflect its cultural ethos of social responsibility and good governance, as well as to access the superior returns of smart beta strategies.

However, the foundation's board was concerned that too great a focus on ESG factors would push the performance too far from its internal reference benchmark.

The investor was also concerned that including an ESG filter might narrow the investment universe too greatly, diluting the fund's 'smart' characteristics and reducing portfolio performance.

In the past, Amundi has achieved these different investment goals by employing a number of asset managers, each with specific mandates – some focused on ESG targets with others providing a smart beta approach.

This is not necessary, however – all these investment aims can be applied to the whole equity portfolio. Firstly, Amundi created a fund that accessed a number of different investment factors, then applied an ESG filter.

This filter reduced the investment universe by 40%. However, using risk-monitoring techniques such as minimising volatility and reducing correlation preserved the potential performance of this fund. This was a suitable outcome for the foundation, as all the funds could be consolidated with a single manager

Case 4 – Smart beta instead of traditional active managers

A Canadian client with a global equity portfolio was interested in using an active strategy, rather than a standard market cap-weighted index, to give the portfolio exposure to stocks with a high dividend yield, but wanted these

Tackling the liquidity challenge for insurers and pension funds

Nobby Clark and Piyo Zhang, directors at HSBC's Client Solutions Group, discuss sourcing and managing liquidity for insurance firms and pension funds amid difficulties presented by upcoming regulatory changes

New financial regulation is throwing up questions and challenges for market participants across the industry. A significant concern among clients – particularly UK-based insurance firms and pension funds – is how sourcing liquidity to meet complex margin payments might impact their underlying business as a whole.

Insurance and pension firms have historically not needed to worry much about, or factor in, the cost of sourcing collateral for margin payments in their asset allocation strategies, focusing instead on headline returns. Following post-crisis regulation, there has been a sea change in mentality on new liquidity-related issues.

Some have contemplated changing their business models to accommodate the new rules. Variation margin requirements under the European Market Infrastructure Regulation (Emir) for cleared derivatives are typically required in cash, which most insurance and pension funds do not typically carry. To meet these obligations, some firms hold part of their portfolios in cash – creating a drag on their overall fund performance.

HSBC, through strategic investments and its insights programme, *The dealing room of tomorrow*, has prepared itself to meet these challenges with intuitive solutions, and is ready to help clients meet their obligations without creating performance headaches.

"We have had some really good feedback from clients. Using internal tools and analytics, we can clarify the cost of liquidity and help clients challenge the way they might interact with other parts of their group," says Nobby Clark, managing director at HSBC's Client Solutions Group. "We see this as part of a long-term commitment to client interaction. The more we understand each others' constraints, the better we can make use of solutions to satisfy all of our regulatory requirements."

Addressing the matching adjustment requirement

The drivers of change have come in different forms. Firstly, Solvency II – a European Union directive primarily focused on capital obligations for insurance firms – contains directives such as the 'matching adjustment' rule, which requires firms to have fixed, predictable sterling-denominated cashflows to match their annuity liabilities in the UK.

While relatively straightforward – particularly if you already have sterling-denominated investments – the matching adjustment rule can become more complicated with funds that seek diversification and better risk-adjusted returns by investing abroad – an insurance firm buying a US dollar-denominated asset would be introducing a non-matching asset to its portfolio, for example. This can be solved by trading a cross-currency swap to recreate that fixed sterling cashflow, but results in collateral obligations for the insurer.

Nobby Clark, Managing Director, Client Solutions Group, HSBC

Piyo Zhang, Director, Client Solutions Group, HSBC

"As soon as you have implemented a cross-currency swap, and the market moves, we will need the insurance firm to post or receive collateral. In the past few years there has been a drive to standardise collateral terms, and in the bank's ideal world all clients would post and receive cash," says Clark.

This is different from Solvency I, where insurance companies could use instruments such as FX forwards to hedge, or even leave their investments unhedged if they were happy with the risk. Under Solvency II, however, they must put long-dated cross-currency swaps in place to get that cashflow into sterling and benefit from the matching adjustment rules.

"The concern for insurance companies is that, if the mark-to-market moves against them, they must have sufficient liquidity to post cash collateral against those cross-currency swaps. So, while they are satisfying their requirements for the matching adjustment rule, diversifying their revenue universe and improving their returns, there is a drag to the extent that they must now post cash as collateral for the derivatives they are hedging on overseas investments," says Clark.

As a solution to this problem, HSBC offers a 'siloed credit support annex' (CSA), or collateral agreement, which allows insurance companies to use the overseas asset that the insurance firm has purchased as collateral for the cross-currency swap – instead of worrying about posting cash as margin.

Another way HSBC can ease the burden on insurance companies is to set up a special-purpose vehicle (SPV), which could own a portfolio of the firm's overseas assets. This SPV would then enter into a cross-currency swap to exchange all the US dollar-denominated cashflows for sterling ones.

"The SPV differs from a bilateral contract in that our only recourse is to the assets within the SPV, as opposed to a bilateral contract where we would have recourse to the entity plus the collateral that offsets that exposure," says Clark. "One of the reasons we look at the portfolio approach is because we have been discussing ways in which clients could, under some circumstances, substitute the assets within the SPV and maintain the fixed sterling cashflows for their matching criteria."

"We have a structure that is ready and waiting to be capitalised on by insurance companies – if it's the solution they prefer," says Piyo Zhang, a director at HSBC's Client Solutions Group.

Central clearing for derivatives – The case for pension funds

Unlike insurance companies, pension funds were granted a temporary mandatory clearing exemption for over-the-counter derivatives in the final Emir regulation to address concerns with the sourcing of collateral. Central clearing requires the posting of initial and variation margin, with central counterparties demanding the latter in cash.

However, since September 1, pension funds have been required to post variation margin to bank counterparties for non-cleared derivatives, which the dealer community has often preferred to receive in cash. For FX forward transactions, counterparties will need to begin posting margin in January 2018 – the same time the second Markets in Financial Instruments Directive (Mifid II) comes into effect. Pension funds may face difficulties closing out the settlement of a hedge they have put in place on overseas assets.

Take, for example, a pension fund that invests in US dollar equities with a hedge ratio of 60% implementing its hedge ratio on a GBP/USD forward contract and rolling that contract for three months. It is exposed to the risk of GBP/USD depreciating, which has happened since the Brexit vote, and the net asset value (NAV) of the trade. In this example, the NAV will actually perform well because the fund will have hedged just 60% of the overseas investment, rather than 100%. The US dollar assets will therefore appreciate significantly in sterling terms and money will only be lost on the 60% hedge.

"The problem comes when that contract requires settling and the pension fund will have to pay out the settlement of the hedge it has put in place. This becomes a liquidity drag – or a cashflow drag – rather than just a margining requirement," says Clark. "In all the examples highlighted, there are stages where the liquidity becomes a burden through a requirement to post collateral, and to the extent to which the client can post cash, which can have an immediate liquidity impact. If gilts, then it is delayed, but when the contract comes into settlement, this cost can become crystallised."

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The authors

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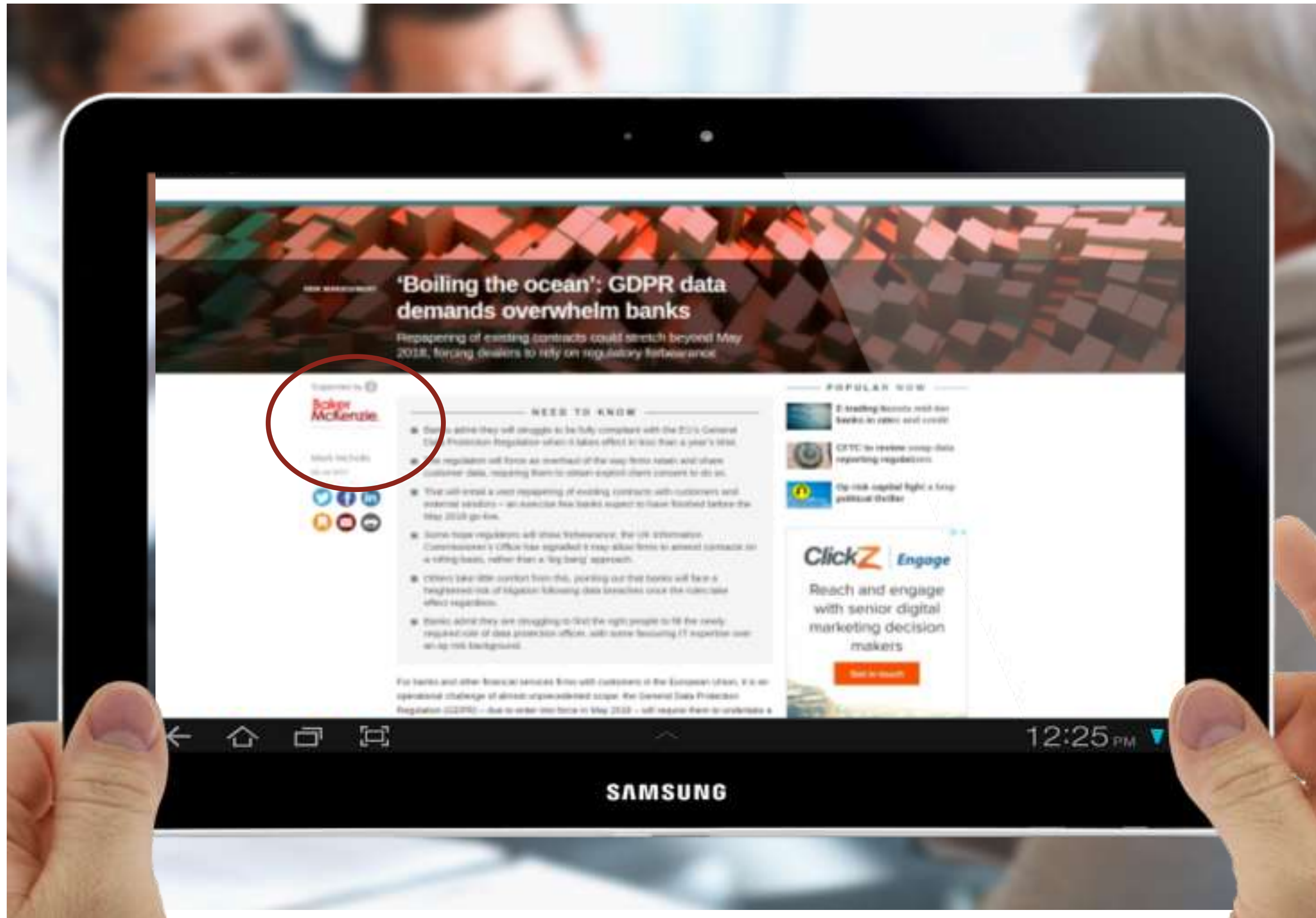

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FINANCIAL SERVICES
THE REFERENCE DATA UTILITY OPPORTUNITY

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Knowledge of how a utility could add value to capital markets firms is increasing, with widespread agreement on the fact that moving data to a fully operational industry-led reference data utility can be effective for reducing risk.

In today's market, many firms recognize the benefits of collaborating and backing an industry-led initiative to get the data right. Managing reference data in-house is no longer considered a competitive advantage.

This animated video is based on a whitepaper that analyses the results of a recent *WatersTechnology* survey and provides insights into the most important ways utilities could deliver value to an organisation. The paper further discusses how each capital markets firm now has the opportunity to move reference data to a utility and take enterprise data management to an industry level.

Download the white paper *Utilitizing Reference Data: What to Expect When Moving Data to a Fully Operational Utility* from Risk Library

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