Corporate Bond Factors – a new kid on the (factor) bloc?

Equity factors exhibited another challenging year during 2024 as only Low Risk in Europe and – surprisingly – Value within US outperformed market cap benchmarks, at least as "purified" risk factors are concerned. The overall trend of equity factors underperforming their market cap counterparts' dates to 2017 for many single factors as well as for multifactor concepts. Value and Size stand out as the factors exhibiting the largest drawdowns. **Long/Short has done materially better than Long Only relative (Smart Beta)**, but most investors don´t pay any attention as they typically hold their exposure in Long Only, even though most empirical research is based on Long/Short.

The major contributor to this disappointing outcome has been the ongoing concentration process in major equity benchmarks in all major regions, which brought us descriptions as FAANG, Magnificent 7 or GRANOLAS in Europe. And as **all active strategies** – and in this sense systematic risk factors are not different to alpha seeking strategies – **need dispersion to perform**, **a lack of "breath" shrinks the opportunity set and naturally lowers the expected return**.

Perhaps, the ultimate pressure on market concentration might have come to an end as the aggregate weight of the top ten names in Europe declined from more than 21% in January 2024 to just over 19% recently. Moreover, Value within the US might have turned the corner and might enjoy better times ahead but in Europe, the performance of Value seems to be still far away from a turnaround, let alone a stabilisation.

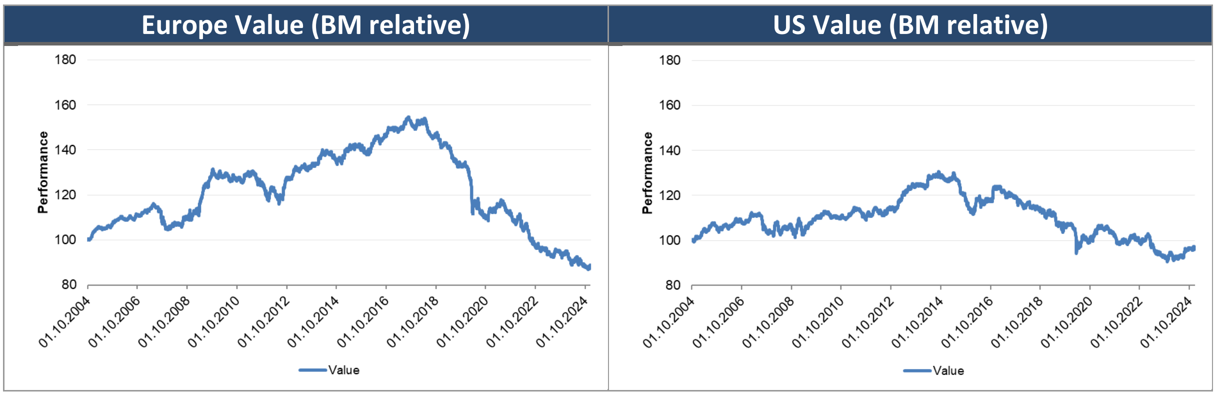


Exhibit1: iSTOXX Value Europe and USA relative to their MCAP benchmarks; Source: STOXX, Alpha Centauri calculations

Quite naturally, **long phases of underperformance or drawdowns are shaking investors beliefs as well as those from academic researchers to the very foundations**. Publications from IPE ("Have factor strategies had their day?"), Invesco ("Global Systematic Investment Study") and UBS ("Investment Returns Yearbook 2024") all released during November and December of 2024 are a confirmation of that.

But what is overlooked quite often is, that large losses or longer phases of drawdowns are quite normal in capital markets – many equity markets, i.e. Europe or Japan, or bond markets after the second world war or more recently since 2021 are examples. And factors are no exception as the table shows.

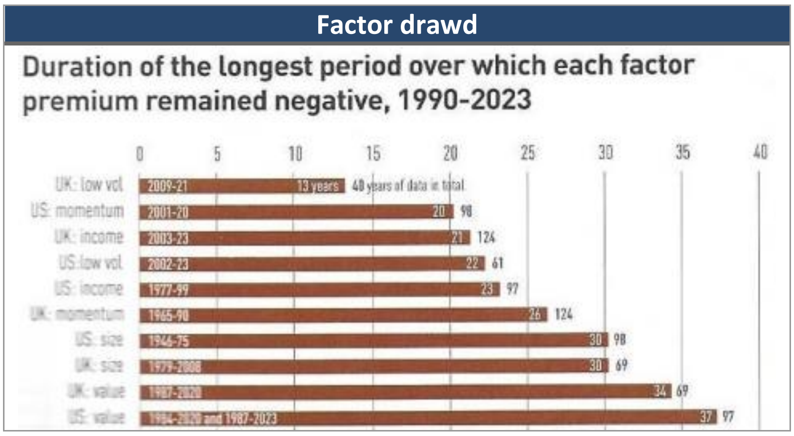


Exhibit2: Equity factor premia drawdowns; Source: Dimson, Marsh, Staunton in “UBS Investment Returns Yearbook 2024”

As the old saying goes, “nights are always darkest before the dawn” and perhaps we will see better times ahead for equity factors, but **the experience since 2017 naturally leads to the question, if there is something like a “common factor risk in risk factors”**? Because **even purified factors exhibited a quite high commonality in their behaviour** over that timeframe, **something which has been quite rare in history -** and the fact, that Long/Short did materially better than their Smart Beta counterparts imply questions like that.

Apart from equities, the three publications mentioned above show, that **investors are still looking for “undiscovered territory”** in risk premia space. Fixed income, especially **corporate bonds, are one of the areas in focus.** When looking at alternative risk factors across asset classes, corporate bonds stand out as the asset class with the smallest offering except some simple carry strategies (long high yield/short investment grade) or variance risk premia (implied vs. realized volatility).

Moreover, even the number of research publications is tiny compared to what we have seen in equity factors over the last 30 years let alone investment solutions. Despite its size, **uncovering factors in corporate bonds is much more difficult compared to equities because of stale pricing, illiquidity, optionality data quality and -history** to name a few.

The fact that corporate bonds and equities are both part of the liabilities of companies balance sheets, inspires researchers and investors alike to find similar factor exposures in the cross section of markets. But **it seems quite difficult to extract and verify them let alone to convert these findings into investment products.**

Prof. Marsh, Dimson and Staunton dedicated a longer chapter on corporate bond factors within the UBS Investment Returns Yearbook 2024 and separated publications along metrics used by researchers into three categories:

- **Bonds Only** with metrics which are unique for bonds like duration, ratings etc.
  Example: Factor Investing in the Corporate Bond Market, (Houweling/van Zundert; 2014)

- **Equity Only** which imply co-integration or spillovers from equities to bonds and which explain equity returns and risk in the cross section
  Example: Common Equity Factors in Corporate Bond Markets (Bektic et al.; 2017)

- **Crossover** where researchers used bond characteristics as well as equity metrics to extract factors from corporate bonds
  Example: Common factors in corporate bond returns (Israel/Palhares/Richardson; 2015)

Houweling/van Zundert tested on value, size, momentum and low risk and found statistically significant results on all factors, while the results of Bektic et al. using a Fama/French setup were disappointing. Israel/Palhares/Richardson tested on carry, low risk, momentum and value and discovered strong risk adjusted returns.

Apart from that, Marsh, Dimson and Staunton elaborated on studies dealing with **replication problems in corporate bonds** – something which sounds familiar to factor investors since the discussion came up with respect to equities a couple of years ago. One of the conclusions of these studies: **"Overall, robust evidence for common factor pricing in corporate bonds remains elusive".**

But as Marsh, Dimson and Staunton put it at the end of their article: **"Corporate bonds are a separate asset class and cannot be replicated by a combination of bonds and equities".** And from our point of view, this makes researching corporate bond factors and trying to put the results into investment solutions so interesting and perhaps - financially rewarding.

Factor performance:

As mentioned above, equity factors exhibited another disappointing year in 2024. In Europe, only Momentum outperformed during the 4th quarter, while value and size underperformed, leaving carry, low risk and quality roughly in line with the overall market. Different situation within US, where low risk outperformed, carry and momentum found themselves underperforming considerably and all other single factors quite flat.

Looking at full-year results, low risk outperformed in Europe while momentum was in line with benchmark. Carry posted a slightly negative results while value and size got crushed again underperforming by more than 2 times their ex-ante tracking error of 3%. US factors exhibited a similar outcome with respect to the fact, that only one factor -surprisingly value – outperformed while all others posted underperformance compared to market cap benchmark.

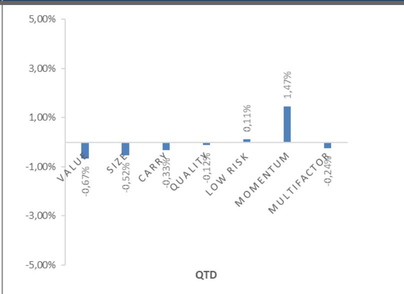
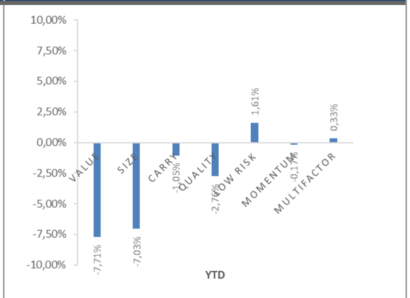
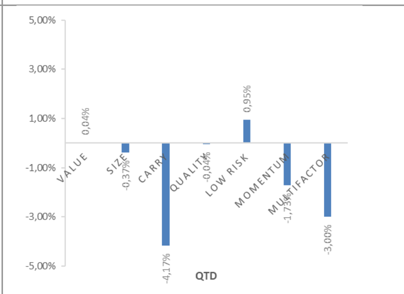
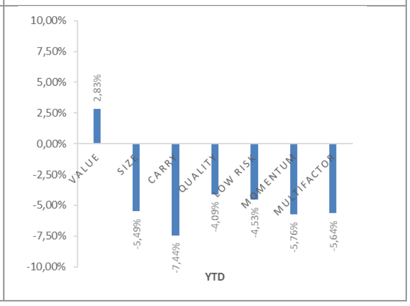
	Quarter to date	Year to date
Europe		
US		

Exhibit3: iSTOXX factors Europe and USA relative to their MCAP benchmarks; Source: STOXX, Alpha Centauri calculations

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