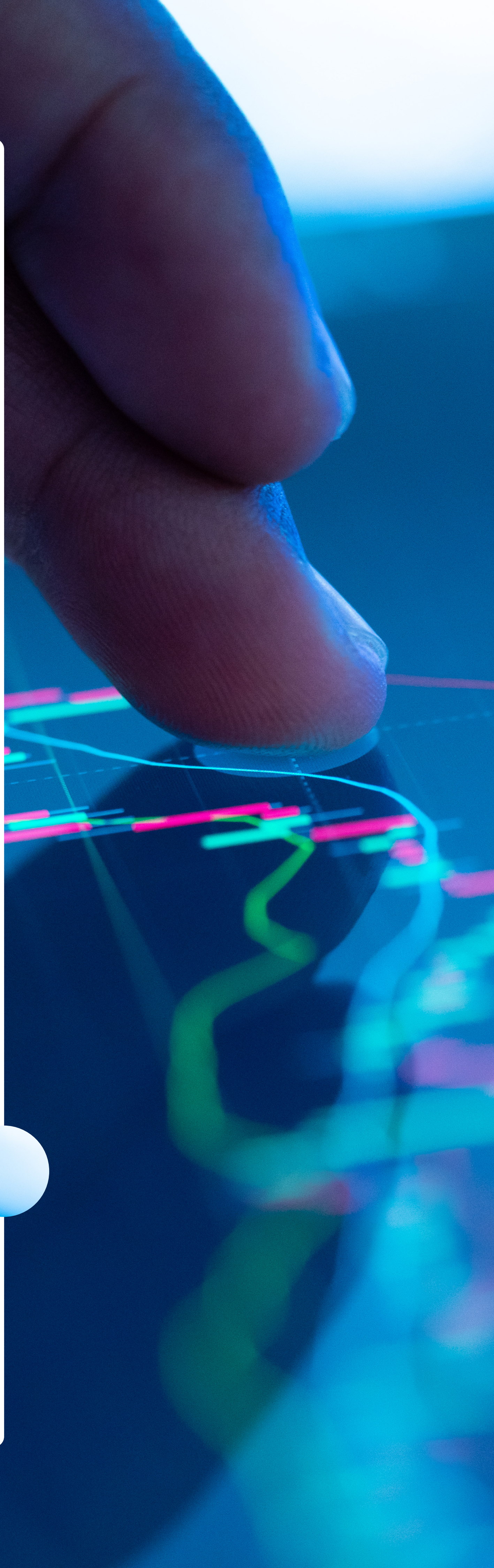
CANDRIAM
A NEW YORK LIFE INVESTMENTS COMPANY

«Absolute performance» management: is passive management alpha the new performance driver?

60 seconds with the Portfolio Manager



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This marketing communication is intended for non-professional investors.

Célia Fseil

Head of Equity Market Neutral

Célia Fseil, Head of Equity Market Neutral, the lead manager of long/short equity strategies[1], explains to what extent these can offer a consistent performance and a decorrelation to your equity investments within a diversified portfolio.

Why choose a long/short equity management strategy without directional bias?

In an uncertain global economic and political environment, equity markets are less buoyant. One of the usual responses to this change in environment is to increase the diversification and liquidity of underlying assets in portfolios. However, in recent periods of temporary stress, the markets have shown that both of these responses may be illusory. Asset classes that behave independently in periods considered normal often head in the same direction during market downturns. Thus, diversification is ineffective at a time when it would prove most useful (as shown by freeze on the commercial paper market in 2008).

Long/short equity strategies can help stabilise the overall performance of a portfolio when they are combined with other asset classes such as equities, bonds and commodities. Indeed, the decorrelation of these strategies from most traditional asset classes, even during downward movements, makes it possible to smooth the fluctuations of a portfolio and reduce its risks.

A long/short equity investment without directional bias - said to be market neutral - can thus help to diversify and stabilise a portfolio, while greatly improving its risk/return profile.

In which market environment do long-short equity strategies generate the best performances?

In all markets, Equity Market Neutral strategies are an allweather investments. When wellconstructed, equity market neutral portfolios are independent of most economic and financial market forces. Equity Market Neutral strategies are parti cularly interesting in an environment of rising shortterm rates and volatile equity markets.

Candriam offers a unique, and liquid, Equity Market Neutral strategy, offering investors daily purchases and sales. Our longstanding and tested investment process, established in 2003, can demonstrate its track record even in periods of market crisis.

60 SECONDS WITH THE FUND MANAGER

(1) Using disparities in the valuation of different equities (e.g. short selling of a share considered overvalued, with simultaneous purchase of a share presumed to be undervalued within the same sector).

How does it work?

It is based on transactions constructed via short and long positions systematically hedged against market risks. Thus, the positions are not sensitive to stock market movements, and performance is not linked to share prices.

These investment returns are generated entirely by the skill of the investment mana ger, or alpha. There is no contribution from the rise or fall of the stock markets. When positions are correctly hedged, exposure to the equity market should be minimized.

Alpha in a Passive World? Can you tell us a bit more as the new performance driver?

There has been a relentless rise in passive equity investments over the last decade, a trend which seems likely to continue.

At Candriam, this type of management offers active managers the opportunity to leverage two potential sources of alpha incorporated in our investment process: index arbitrage and price spread arbitrage between two correlated assets (relative value).

Passive and index managers, including passive ETFs, are obliged to rebalance their holdings when there is a change in the indices they follow. These changes may mean that the index adds a new name, or drops a stock out of the index calculation. This frequently causes some temporary share price and valuation misalignments in the equity markets when numerous passive funds buy or sell large amounts of a stock in a very short period of time. Our Index Arbitrage strategy positions itself to benefit from this rise in index-matching. This is the first engine of our performance.

With fewer assets under active manage ment, academic discussions have arisen over whether the market will become less efficient. Active managers try to outperform the market, or index, by finding inefficien cies – a valuation which is incorrect, or an unanticipated change at a company. For our Equity Market Neutral strategy, our second engine, or alpha source, is to identify these inefficiencies. According to some academics and market commenta tors, these inefficiencies may become more frequent as the amount of passive investing continues to grow. If so, this increases our opportunity set. An example includes “pair trading” between two stocks which typically move together. When most investors are passive, more inefficiencies on these “pairs” will occur.

Why Candriam?

Our first point of difference is that we com bine both a fundamental and a quantitative approach to identify opportunities and build our positions. Most Equity Market Neutral strategies rely on one approach, either fundamental or quantitative. This can lead to a very concentrated and poten tially riskier portfolio with very few names, or a portfolio of several hundred or even thousands of stocks. In this type of portfolio it might be difficult to have a global view of the implicit exposures (sector, factor,...).

Our other unique element is our twobucket portfolio construction. We combine two performance sources, index arbitrage arising from the tremendous growth in passive management, and the forgotten opportunities in relative value strategies. While both are ‘allweather’, index arbitrage can take advantage of short-term ineffi ciencies, while relative value can benefit from medium-term inefficiencies - another way in which we reduce risk and stabilise returns.

Risk management is crucial. Thus, we check that our portfolio is appropriately diversified in terms of geography, sector and capitalisation. Risk in traditional equity strategies primarily depends on equity markets. Conversely, risks weighing on long/short equity strategies depend on manager skill and desired risk exposure. By combining fundamental and quantitative analysis, we can limit risks within our portfolios.

At Candriam, we have been managing this type of strategy for nearly 20 years. The investment process has proved effective in periods of market turbulence, such as the financial crisis of 2007-2009 and the Covid crisis in 2020.

With this experience and continuity, Candriam has been able to create a strategy that meets the expectations of numerous investors.

The main risks of the strategy are:

• Risk of capital loss:

There is no guarantee for investors relating to the capital invested in the strategy in question, and investors may not receive back the full amount invested.

• Sustainability Risk:

The sustainability risk refers to any environmental, social or governance-related event or situation that might affect the performance and/or reputation of issuers invested in.

Sustainability risks may be subdivided into three categories:

• Environmental: environmental events may create physical risks for the companies invested in.

• Social: refers to the risk factors linked to human capital, the supply chain and the way companies manage their impact on society.

• Governance: these aspects are linked to governance structures.

The sustainability risk may be specific to the issuer, depending on its activities and practices, but may also be due to external factors. If an unforeseen event occurs in a specific issuer such as a strike or more generally an environmental disaster, the event could have a negative impact on the performance. In addition, issuers which adapt their activities and/or policies may be less exposed to the sustainability risk.

• Equity risk:

Some strategies may be exposed to equity market risk through direct investment (through transferable securities and/or derivative products). These investments, which generate long or short exposure, may entail a risk of substantial losses. A variation in the equity market in the reverse direction to the positions can lead to the risk of losses and may cause the performance to fall.

• Counterparty risk:

OTC derivative products and/or efficient portfolio management techniques may be used. These transactions may cause a counterparty risk, i.e. losses incurred in connection with commitments contracted with a defaulting counterparty.

• Derivative risk:

Financial derivatives are instruments whose value depends on (or is derived from) one or more underlying financial assets (equities, interest rates, bonds, currencies, etc.). The use of derivatives therefore involves the risk associated with the underlying instruments. They may be used for purposes of exposure or hedging against the underlying assets. Depending on the strategies employed, the use of derivative financial instruments can also entail leverage risks (amplifying downward market movements). In a hedging strategy, the derivative financial instruments may, under certain market conditions, not be perfectly correlated to the assets to be hedged. With options, an unfavourable fluctuation in the price of the underlying assets could cause the strategy to lose all of the premiums paid. OTC financial derivatives also entail a counterparty risk (though this may be attenuated by the assets received as collateral) and may involve a valuation risk or a liquidity risk (difficulty selling or closing open positions).

• Arbitrage risk:

Arbitrage is a technique which consists in benefiting from the differences in prices recorded (or anticipated) between markets and/or sectors and/or securities and/or currencies and/or instruments. If such arbitrage transactions perform unfavourably (a rise in sell transactions and/or fall in buy transactions), the performance may fall.

The risks listed are not exhaustive, and further details on risks are available in regulatory documents.