

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

**60 seconds with the  
fund manager**



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Marketing communication



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**Emmanuel Terraz, Global Head of Absolute Return & Quantitative Equity – Head of Equity Market Neutral, the lead manager of long/short equity strategies<sup>(1)</sup>, 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 particularly 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 long-standing 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 manager, 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 management, academic discussions have arisen over whether

the market will become less efficient. Active managers try to outperform the market, or index, by finding inefficiencies – 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 commentators, 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 combine 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 potentially 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 two-bucket 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 inefficiencies, 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**
- **Sustainability Risk**
- **ESG Investment Risk**
- **Equity risk**
- **Interest rate risk**
- **Credit risk**
- **Currency risk**
- **Liquidity risk**
- **Derivative risk**
- **Counterparty Risk**
- **Arbitrage risk**
- **Volatility risk**
- **Emerging market risk**
- **External factors risk**

ESG Investment Risk: The non-financial objectives presented in this document are based upon the realization of assumptions made by Candriam. These assumptions are made according to Candriam's ESG rating models, the implementation of which necessitates access to various quantitative as well as qualitative data, depending on the sector and the exact activities of a given company. The availability, the quality and the reliability of these data can vary, and therefore can affect Candriam's ESG ratings. For more information on ESG investment risk, please refer to the Transparency Codes, or the prospectus if a fund.



**Find out more about our funds  
and their risk profiles:**

**[www.candriam.com](http://www.candriam.com)**

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