THE WEEKLY BRIEF

By LYXOR CROSS ASSET RESEARCH

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OUR THOUGHTS ON THE RALLY IN MOMENTUM STOCKS

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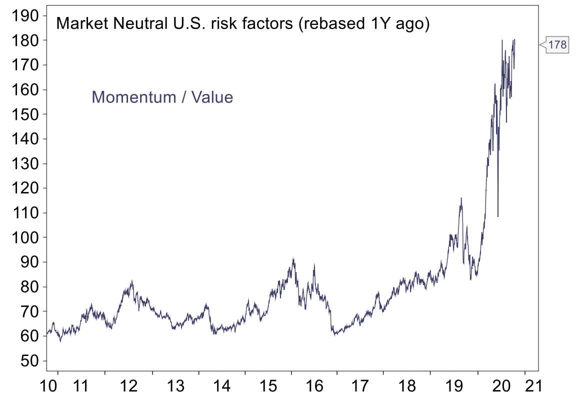
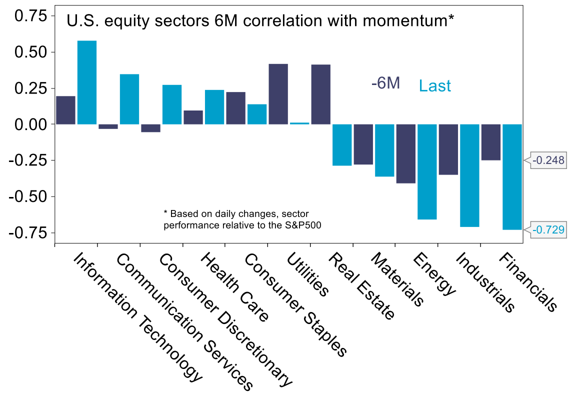
Momentum is a strategy which buys stocks trending higher and sells stocks on a downtrend within an index. It is systematic and has no considerations for earnings, valuation, or other fundamental metrics such as dividends. Historically, it has delivered strong returns, causing headaches for advocates of the Efficient Markets Hypothesis ("EMH"). Its persistence breaks one fundamental rule of the EMH: if past stock prices help predict future returns, they do not fully reflect all available information. Research on the causes of Momentum persistence was popularized by Hong and Stein in 1999 ("A Unified Theory of Underreaction, Momentum Trading, and Overreaction in Asset Markets").

In recent months, the Momentum risk factor has delivered strong returns, particularly in the U.S. (+7.7% in Q3-2020). It is currently long sectors such as IT, Consumer Discretionary, and a number of defensive sectors (i.e. Communication Services, Consumer Staples, Health Care) reflecting future growth uncertainty. In parallel, it is negatively correlated to Financials and Energy returns. Looking at its correlation to other risk factors, we see that Momentum has been tantamount to Low Beta for some time. It is also increasingly vulnerable to rises in bond yields. We estimate that a +10bps rise in Treasury yields would drag Momentum's performance by -2.4%.

The above suggests that Momentum is vulnerable to richly valued sovereign bonds but at the same time is protected by asset purchases from central banks. The latter have de facto anchored bond yields at current levels. A sharp and sudden rebound in cyclical and/ or value stocks (i.e. Industrials, Materials, Energy, Financials, etc.) would be painful but seems unlikely due to uncertain economic prospects amid the COVID-19 resurgence. Yet, the relative performance of Momentum vs. Value has been so spectacular in the past year that we raise caution going forward. Factor rotations tend to cause substantial damage to some alternative strategies. CTAs are by construction exposed to the Momentum risk factor but from a cross-asset perspective. A vast amount of L/S Equity strategies, especially systematic Market Neutral ones are exposed to Momentum. Our stance on such strategies is currently defensive. Finally, Event-Driven is among the few strategies that does not bear Momentum risk.

A Spectacular outperformance of Momentum vs. Value raises question marks going forward





Sources: Macrobond, Dow Jones, Bloomberg, Lyxor AM

Hedge Fund Performance: Directional Strategies Embrace the Rally in October

Lyxor UCITS Peer Group Performance

	MTD	September	Q3	YTD
MSCI World	3.2%	-2.9%	6.8%	4.7%
Event-Driven: Special Situations	2.0%	0.7%	1.5%	-3.6%
L/S Equity Directional	1.2%	-0.5%	2.2%	-0.6%
Global Macro	0.7%	-1.0%	1.3%	-1.7%
Global Lyxor UCITS Peer Group	0.7%	-0.4%	1.1%	-2.0%
Event-Driven: Merger Arbitrage	0.5%	0.2%	1.3%	-1.4%
L/S Credit	0.5%	-0.2%	1.8%	0.9%
CTAs	0.3%	-1.5%	-1.0%	-4.1%
L/S Equity Market Neutral	0.0%	0.2%	0.5%	-0.9%
Bloomberg Barclays Global Aggregate Bond Index	0.0%	0.4%	0.7%	4.6%
Risk Premia	-0.1%	-0.2%	0.4%	-9.5%

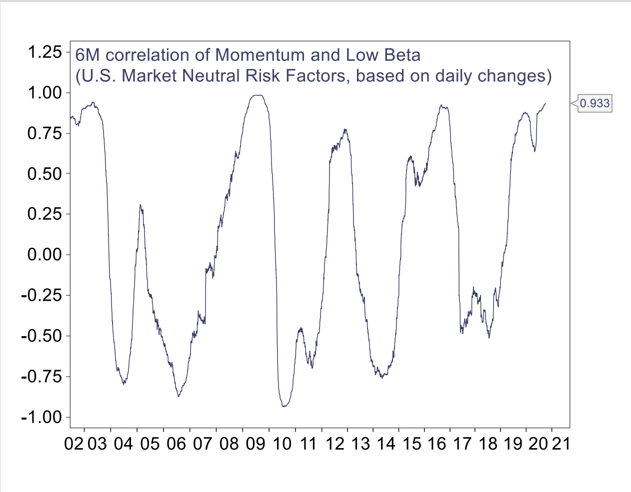
As of October 9th. Source: Bloomberg, Lyxor AM

The fall in risk aversion since early October has shown to be supportive for strategies with a higher market beta such as Directional L/S and Special Situations in Event-Driven.

Yet, most strategies have posted positive returns so far in October. Merger Arbitrage, which is rather a low beta strategy, has benefitted from a rising deal flow and attractive spreads on new deals.

Market Neutral L/S underperformed, with flat returns since the beginning of the month.

Momentum has been Tantamount to Low Beta in Recent Quarters



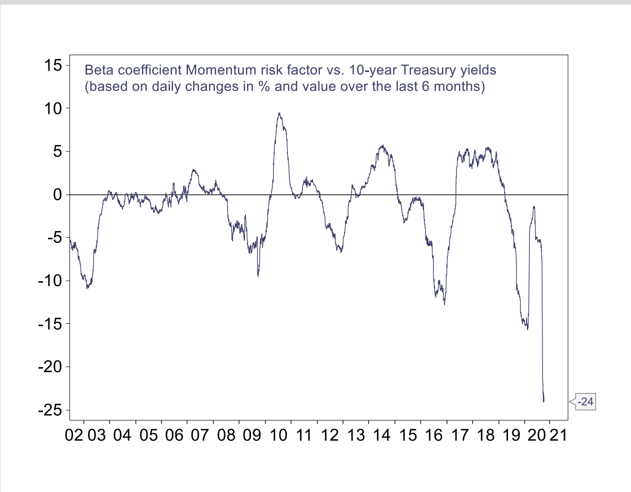
Source: Dow Jones, Macrobond, Lyxor AM

The correlation between Momentum and Low Beta stocks rebounded recently to 0.93. Although Momentum stocks outperformed Low Beta stocks over the past three months, they continue to move together but with a different pulse.

Momentum has had defensive properties for some time. Looking at the correlation within sector returns, we effectively find an elevated correlation with defensive sectors (Communication Services, Health Care, Consumer Staples) but also with IT and Consumer Discretionary returns.

Above all, this suggests that despite the ongoing economic recovery, market movements reflect cautiousness. At this stage of the business cycle we should see Value stocks outperforming and being increasingly correlated with Momentum stocks, which is not the case at present. Momentum appears vulnerable, in the short term.

Momentum Stocks Appear Vulnerable to Rises in Bond Yields



U.S. Market Neutral Dow Jones indices. Source: Dow Jones, Macrobond, Lyxor AM

A simple univariate regression between Momentum returns in the U.S. and changes in 10-year Treasury yields suggests the negative relationship has been significant in the past and has reached extreme levels at present.

We estimate that a +10bps rise in Treasury yields over the course of one day would drag Momentum's performance by -2.4%. Changes in Treasury yields are not the only determinant of Momentum returns but they are an important one (c. 20% of Momentum returns have been explained by changes in Treasury yields in the past six months).

A substantial rise in bond yields seems unlikely considering asset purchases from central banks, however, investors probably underestimate this source of risk at the time of gaining exposure to Momentum.

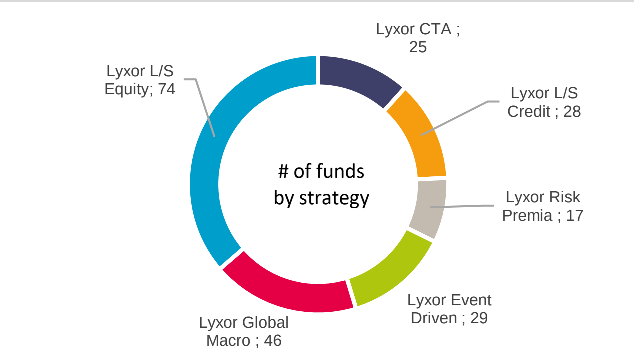
METHODOLOGICAL APPENDIX

The information contained in this report on the performance of hedge funds is based on publicly available information. The universe of underlying funds is relatively stable but varies depending on the criteria of inclusion presented below. It is based on an unbiased selection from our hedge fund analyst team.

Performance is calculated on a weekly basis, as of end-Tuesday, using an arithmetic average (equally weighted average).

Regarding share classes used in these peer groups, we selected the primary share class as referenced in Bloomberg. Non-USD share classes are hedged in USD based on hedging costs available on Bloomberg.

Lyxor Hedge Fund Peer Groups: number of funds by strategy



As of October, 2020

- 219 strategies across the main categories in the industry
- USD 174 billion of assets under management

Criteria of inclusion

The criteria of inclusion are fourfold:

i) We only include UCITS strategies;

ii) Assessment by Lyxor's Hedge Fund selection team based on funds' materials or manager interaction;

iii) We only include strategies with assets under management of at least USD 50 million; and

iv) We only include strategies with at least a one-year track record.

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