2020 Q3 Factor Return Update: Smart or Lucky?

COVID-19 and the looming US presidential election have caused unprecedented factor dispersion. For hedge fund investors, evaluating 2020 performance is extremely challenging. Most investors lack the tools to accurately separate factor-induced returns from alpha.

It is possible that a fund with high YTD returns, was able to take advantage of dislocations in this volatile market, but they may just have been lucky in having the right exposures to the right factors. Just a 10% overweight to **Technology** and a 10% underweight to **Energy**, would have increased returns by 7.9% during the first three quarters of 2020.

On the other end of the spectrum, mangers that were focused on hard hit sectors or regions, may have incurred significant losses, despite adding significant alpha. For an investor, the important thing is that you can tell the difference between alpha and factor-induced returns, between skill and luck. Nothstar can help both fund managers and investors tell the difference.

All Factors

On an absolute basis, it is not surprising that **Oil Services** and **Energy** were our worst performing factors over the first three quarter of 2020. The spat between Saudi Arabia and Russia earlier in the year, and the drop in demand due to COVID, resulted in far too much oil supply chasing too little demand. To be fair, the energy sector is highly volatile. On a risk adjusted basis, our **Value – Growth** factor was actually the worst performing factor (**Oil Services** did not even make the top 10 on a risk-adjusted basis).

Absolute Performance	
Return	**Factor**
−59.8%	Oil Service Excess
−49.7%	Energy Excess
−49.1%	Brazil Excess
−39.5%	Aerospace & Defense Excess
−36.7%	United Kingdom Excess
⋮	⋮
11.6%	Consumer Discretionary Excess
24.3%	Gold
29.1%	Information Technology Excess
34.5%	VIX Excess
107.9%	Gun Manufacturers Excess

Risk-Adjusted Performance[1]	
R/Vol	**Name**
−6.81	Value - Growth
−5.23	High Yield Excess
−4.81	Dividend Excess
−4.33	Aerospace & Defense Excess
−4.21	Energy Excess
⋮	⋮
2.33	Consumer Discretionary Excess
2.39	US IG Bonds
2.45	Gold
4.16	Gun Manufacturers Excess
5.02	Information Technology Excess

[1] Risk-adjusted performance, R/Vol, was calculated by dividing the factor return by the realized standard deviation of returns over the prior 12 months.

On a relative basis, **Information Technology** companies have emerged as the biggest winners this year, presumably benefiting from our increased use of technology to mitigate the impact of social distancing. On an absolute basis, though, **Gun Manufacturers** were the best performing factor. **Gun Manufacturers** is a new factor that we introduced as part of our analysis of the 2020 Election. It looks at the excess return of gun manufacturers relative to sporting goods manufacturers and retailers. Gun buyers stocking up ahead of a likely Biden win, recent civil unrest, and a decrease in sporting events, all likely contributed to this result.

Sector Factors

Beyond **Oil Services** and **Energy**, **Aerospace & Defense** and **Financials** were the worst performing sectors YTD.

Return	Name
−59.8%	Oil Service Excess
−49.7%	Energy Excess
−39.5%	Aerospace & Defense Excess
⋮	⋮
11.6%	Consumer Discretionary Excess
29.1%	Information Technology Excess
107.9%	Gun Manufacturers Excess

R/Vol	Name
−4.33	Aerospace & Defense Excess
−4.21	Energy Excess
−3.89	Financials Excess
⋮	⋮
2.33	Consumer Discretionary Excess
4.16	Gun Manufacturers Excess
5.02	Information Technology Excess

In addition to **Gun Manufacturers** and **IT**, **Consumer Discretionary** was among the best performing sectors YTD.

Country Factors

So far in 2020, most counties and regions have underperformed US markets. With the exception of our broad Asia factor, which was up just slightly (not statistically different than zero), all of our country and region factors are down YTD. The worst performing countries have been the **United Kingdom**, **Mexico**, and **Brazil**.

Return	Name
−49.1%	Brazil Excess
−36.7%	United Kingdom Excess
−32.6%	Mexico Excess

R/Vol	Name
−3.15	United Kingdom Excess
−2.50	Mexico Excess
−2.28	Brazil Excess

Style Factors

On both an absolute and relative basis, **Value – Growth** and **High Dividends** were the worst performing style factors. **Value – Growth** was likely a significant drag for many quant and fundamental long/short equity funds.

Return	Name
−31.7%	Value - Growth
−20.1%	Dividend Excess
⋮	⋮
8.8%	Momentum Excess

R/Vol	Name
−6.81	Value - Growth
−4.81	Dividend Excess
⋮	⋮
1.74	Momentum Excess

Some of these quant funds may have benefited from **Momentum**, which is the only style factor with positive performance for the first three quarters of 2020.

info@northstarrisk.com

Further Reading

For an overview of Northstar's approach to factor analysis, see our white paper *Next Generation Factor Models*.

For an introduction on how Northstar uses factors in profit attribution, see *Risk-Based Performance Attribution*.

You might also enjoy our review of *2019 Factor Returns*, and our article from June, *The Six-Standard Deviation Move that Wasn't*, about the extremely large moves in three factors on June 3rd 2019.