

Research Insight - Australian Small Caps Systematic Alpha Strategy

2020 and 2021 were years of extreme volatility in the markets, with Australian small caps being no exception. The magnitude of the movements, together with our in-depth daily monitoring of our strategies, has been helpful in uncovering new insights and has led to additional research and improvements in our strategy.

One of the key features of our process is diversification across our Signals. The Signals are designed to have generally low to negative correlations with each other, so that each is positioned to outperform in a different market environment.

To capture the maximum benefits of this diversification, the Diversified Alpha Signal generally aims to have an equal weighted exposure to its underlying Signals.

Alpha Signal Exposure Analysis

Looking at our daily historical Signal correlations in 2021, we observed that the correlation of the Diversified Signal with the Trend Signal was coming in lower than desired.

	Trend	Quality	Defensive	Value	Diversified	Systematic
Trend	1.00	-0.35	-0.38	-0.37	0.17	0.35
Quality	-0.35	1.00	0.30	0.34	0.64	0.28
Defensive	-0.38	0.30	1.00	0.73	0.64	0.50
Value	-0.37	0.34	0.73	1.00	0.59	0.53
Diversified	0.17	0.64	0.64	0.59	1.00	0.81
Systematic	0.35	0.28	0.50	0.53	0.81	1.00

Note that green is good, so low correlations between the four Alpha Signals is ideal, while high correlations with Diversified and Systematic shows what's driving them. Source: Blue Orbit, Factset.

The correlations between individual Alpha Signals and Diversified should generally be fairly even, around 0.4. However, we were observing the actual correlation between Diversified and Trend to be only 0.17. We confirmed this observation through further risk based analysis using Factset and Axioma.

The significant rally we saw in Trend in 2021 was largely driven by stocks without positive cash flows, earnings or dividends, which meant the line-up of stocks within Trend had very little in common with those in our other Signals (that are driven by fundamentals).

Conviction Upweight

Our Conviction Upweight enhancement (where stocks held in several different Signals receive an additional upweight in the Diversified Signal) was therefore primarily upweighting stocks that did not appear in the final Trend signal. In this market environment, this led to the reduced correlation between Diversified and Trend.

In less volatile market environments historically, the Conviction Upweight did not display such a bias against Trend stocks. However, the extremes of the post-COVID market movements gave us the opportunity to observe this new Signal behaviour within the Australian small cap market.

After in depth research and testing, we have made minor changes to both the Trend Signal construction and the final portfolio construction in response to our findings. These changes ensure that the contribution from the Trend Signal will be preserved in the final portfolio, without dilution from other processes such as the Conviction Upweight.

Continuous research, development and improvement is a key part of the Blue Orbit process. We are always observing and analysing our strategy to see if there are new insights, opportunities or areas of research that can add value.

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