Factor Investing Insights

Considerations from our recent review of factor-based strategies

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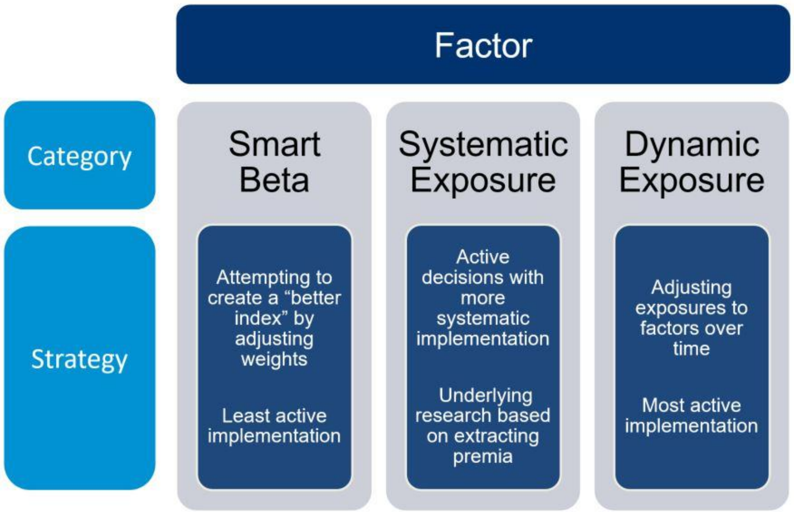
- Factor investing is nothing new – the philosophy of stylistic investing has been around for decades. Now, managers are more systematic and sophisticated in their approaches.
- There is a consensus of commonly accepted factors – value, momentum, quality, low volatility – but there are a variety of ways to measure them. How managers measure can result in differences between portfolios with similar goals.
- How factor portfolios are constructed can also have a material impact on performance. The urgency to minimize or eliminate unintended bets can be more important than attempting to maximize intended bets.

For several years, factor investing has grown substantially in both assets and popularity. The marketplace dynamics driving this include: 1) a greater use of systematic or quantitative methods, 2) a push by investors to achieve lower fees, and 3) the continued pursuit of excess returns.

As passive investment allocations continue taking lunch money from active managers, factor-based strategies have taken a seat at the dining room table as well.



Morningstar cites 882 mutual funds or exchange traded funds (ETFs) as "strategic beta" – a term synonymous as factor investing – that are traded within the United States. Of these 301 strategies, over one-third, have been added since the beginning of 2016.[1]

What is factor? This basic, but often overlooked, question is difficult to answer, but drives at the fundamentals of the space. What separates passive from factor? What separates factor from active? The clear, even lines we like to draw as investors – stocks or bonds, international or

[1] Source: Morningstar Direct, 11/30/2018

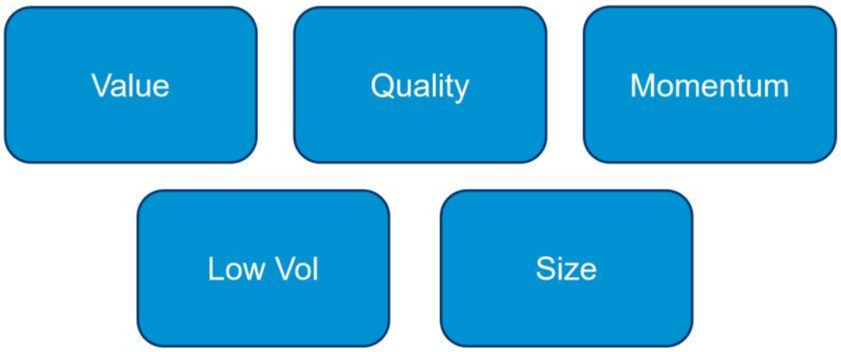
domestic, gain or loss – are significantly blurry in this space. There is not simply one category of factor, but rather a continuum of categories.

The common thread among all factor-based strategies is a systematic deviation from benchmark exposure in an effort to enhance returns, reduce risk, or both. We've have categorized the numerous approaches to into three groups: smart beta, systematic exposure, and dynamic exposure. In our attempt to better organize the space, the level of active intervention and where that occurred in the investment process was a key differentiator among strategies.

A group most often referred to as "smart beta" incurs the least amount of active decision-making. We view this as the most passive form of factor investing. Active decisions are made at the outset as to how to reconstruct an index to gain exposure to a predetermined factor. Following the initial decision, the process follows a rules-based implementation that over time remains static. Rinse, Wash, Repeat. As you move left to right across the chart, the level of active intervention increases. The "second level" of strategies, systematic exposure, are often grounded in history or academic theory and utilize large amounts of data to extract premiums through exposure to particular factors. While working to find additional sources of premia, the desired factor exposures are largely static or shift at a glacial pace. Implementation is an active decision which forces managers to weigh the tradeoffs between the explicit and implicit costs of making a trade against the benefit of achieving an optimal portfolio.

The last category, dynamic factor exposure, has the highest level of active intervention. Its exposure to factors changes over time; sometimes rapidly, as the market unfolds. Firms in this category certainly toe the line into active management, but view the avenue to excess returns through factor exposure in the market.

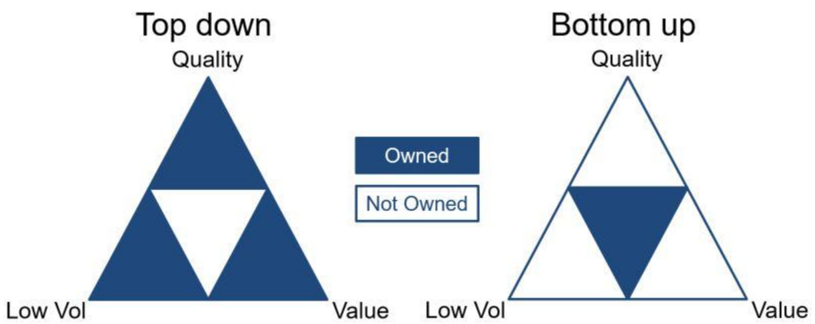
Within this space, a common misunderstanding is there are hundreds, even thousands, of factors that can be applied to generate excess return. In fact, there are only a handful of widely accepted factors, listed in the chart to the right.



To be widely accepted, a factor must hold over long periods of time and across countries, sectors, and definitions (e.g., price-to-book or price-to-earnings for value). Additionally, there must be a logical explanation for the existence of the factor – often due to compensation for excess risk or a behavioral bias. In addition, this advantage must hold after trading costs are incorporated. For each of the factors listed to the right, we can highlight and explain the characteristics.

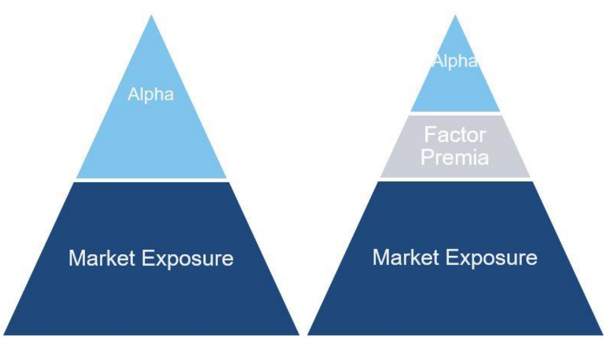
A key differentiator among managers employing a factor-based strategy is how factors are measured. Universal index providers, including Russell, determine value based on the measurement of book value from the balance sheet. Depending on a particular manager's interpretation of value, they can choose metrics other than book value to determine whether it is "cheap." Similar differentiators come in the measurements of quality or momentum. Even a factor such as low volatility can be measured in a variety of ways. Certain metrics may be more fruitful in some sectors than others or persist for longer periods or in particular market regimes.

More crucial to a desired outcome than gaining the selected factor exposure is avoiding unintended exposures. The approach investment managers take when constructing a portfolio is critical. When searching for a desired exposure, it is easy to unintentionally allocate to strategies that have negative correlation to other factors. For example, the excess returns between the value factor and momentum factor tend to be negatively correlated. When momentum is doing well, value is underperforming and vice versa. Sure, this portfolio will perform well when the value factor is in vogue, but will likely underperform by substantially more than the market if momentum has been performing well. By naively ranking and creating a portfolio of the “cheapest” stocks, an unintended exposure results in an unfavorable outcome. This problem is more pervasive in multi-factor portfolios.



Factor based strategies typically employ either top down or bottom up approaches to portfolio construction. In an example of a top down philosophy, a manager chooses to combine the highest ranked value stocks with the highest ranked quality stocks assuming they have a “quality-value” portfolio. This sleeved approach can result in factor exposures that are dilutive to other factors or emphasize unintended exposures. For example, using a sleeved approach to gain exposure to quality, value and low volatility results in a portfolio that emphasizes volatility while value and quality both languish. Meanwhile, the bottom-up portfolio construction process targets stocks with attractive exposure to all of the targeted factors. While this may not seem intuitive, the risks for unintended exposures are minimized significantly.

Sources of Manager Return



Resembling its use as a risk management tool, factor exposures have altered how traditional active managers view their own risk. Oftentimes, equity managers have factor biases. For instance, many equity managers have exposure to the value factor through targeting stocks trading at a discount to their peers, while also taking on quality biases through targeting stocks with above-average profitability and modest debt profiles. Historically, any return generated in excess of the market was attributed to skill; however, with the heightened understanding of factors and how to measure them, managers are now held to a higher standard.

Generating alpha through factor exposure can be a cyclical experience, while management of risk through factor exposure can be persistent. Factors, including active managers, passive managers, countries, sectors, and broad asset classes, go through periods of underperformance. There’s little investors can do to avoid the cyclicality. However, as practitioners of risk management, we can manage the magnitude of exposures to particular factors and better understand how investment managers and portfolios will perform under various scenarios. A better assessment of risk will ultimately minimize the unintended bets in a portfolio, ideally lowering the probability of drastically negative outcomes and increasing the likelihood of achieving the desired investment goals.

For more information, please contact any of the professionals at DiMeo Schneider & Associates, L.L.C.

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Michael researches and performs operational due diligence on core and real asset investment managers. Mike is a member of the firm's Core Investment Strategy Group and Real Assets Research Team. Prior to joining the firm in 2015, Michael was a Financial Analyst at General Growth Properties and a Research Analyst with Caldera Investment Group. Michael graduated from the University of Chicago with a BA in Economics and was a star point guard on the basketball team. Michael is a CFA® charterholder. His jump shot is still best in the office.

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