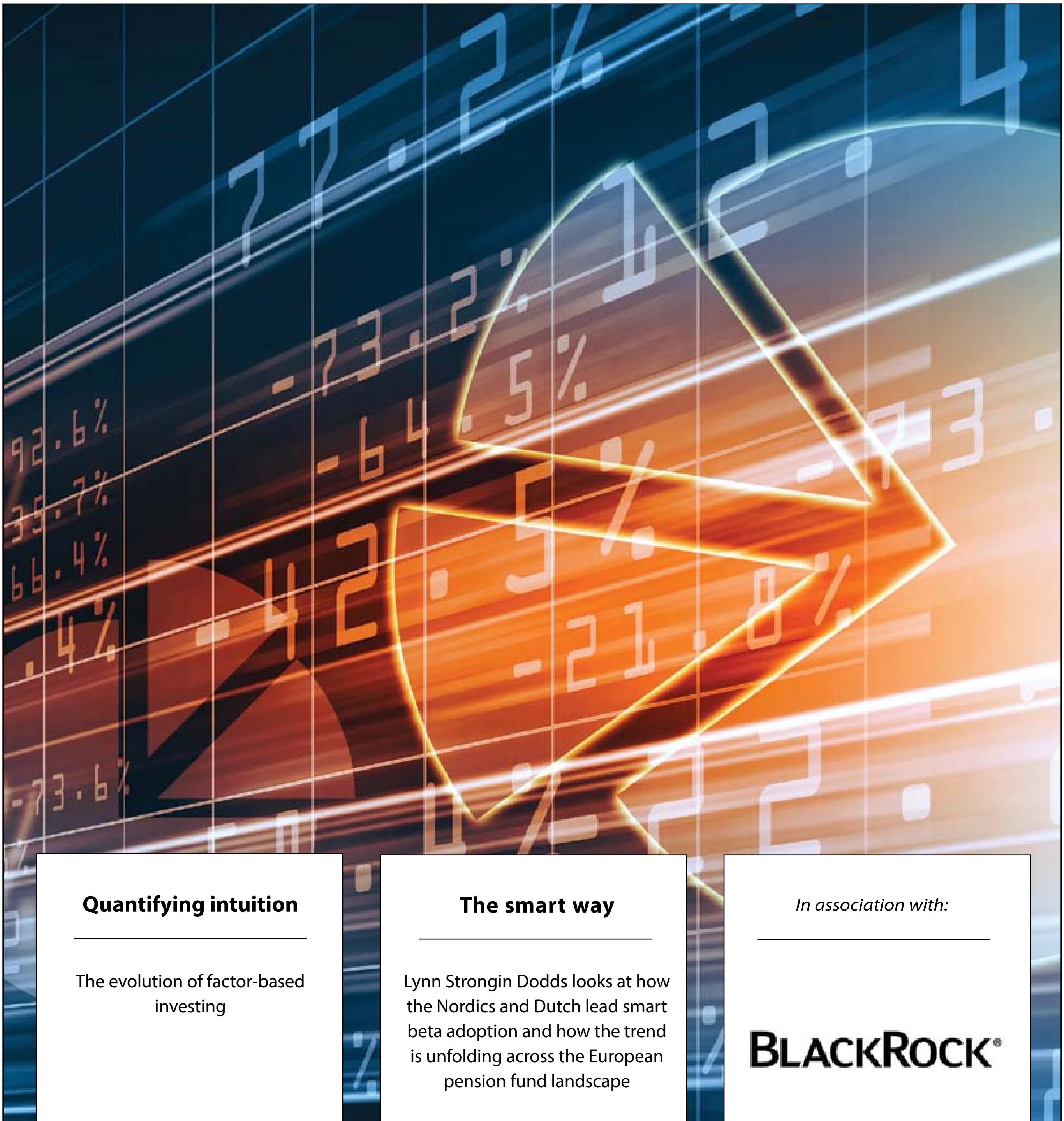
Factor investing focus:

LEVERAGING INSIGHTS TO IMPROVE PERFORMANCE



Quantifying intuition

The evolution of factor-based investing

PAGE 30

The smart way

Lynn Strongin Dodds looks at how the Nordics and Dutch lead smart beta adoption and how the trend is unfolding across the European pension fund landscape

PAGE 34

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Quantifying intuition: The evolution of factor-based investing

Factor-based investing leverages insights about the broad, persistent forces that drive investment returns to help investors enhance performance, manage risk, and seek genuine diversification. It's becoming increasingly popular. A 2016 survey from BlackRock found that 87 per cent of institutional investors used factors as part of their investment process, and that nearly two-thirds increased their use of factors over the previous three years. To find out where factor investing fits into the current landscape, how it works for clients and how it can add value, we talked to BlackRock's Andrew Ang, head of factor investing, and Sara Shores, head of factor-based investment strategy

Why is factor investing such a relevant theme for investors today?

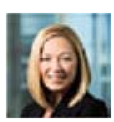
Andrew Ang:

This is a difficult environment. There are low yields, increasing interest rates, geopolitical uncertainty, and anomalously low volatility. Factors present a well-known, academically rigorous and efficient source of potential returns. That makes factor investing particularly attractive for investors seeking performance greater than market benchmarks or looking for additional diversification.

Using factors to help navigate these difficult investment times allows us to build more robust investment portfolios, mitigate riskon the downside, and seek the returns that investors need in the long term.

How can investors start to incorporate factors into their overall allocation?

Sara Shores: Bringing factors into



asset allocation represents the quantification of investor intuition. We know that there are commonalities across asset classes. When most investors embark upon their strategic asset allocation, they think about allocating capital across stocks, bonds, and alternatives.They might divide that universe into U.S. equity, global equity, investment grade bonds, high yield bonds, private equity, and real estate. We pretend as if those labels create a distinction between the behaviours of the asset classes. But we know that there are linkages across them.

For instance, if the Fed unexpectedly increased rates tomorrow, you would see the effects ripple through the prices of equities, fixed income, real estate, and hedge funds. Factors help quantify those linkages across both public and private asset classes.

Many investors have done this in a heuristic way for a long time. For instance, they will categorise elements of their portfolio as either safe or risky assets. Now we have the tools to analyse factor exposures across asset classes.

We know that there are common sources of risk. Factor analysis helps us quantify them.

Are there sources of risk that investors are overlooking?

Ang: Yes. Many portfolios aren't as balanced as you'd think. Economic growth, for example, tends to dominate many portfolios as that factor drives the majority of risk across many widely held asset classes. See the different assets, common risks chart.

That growth bias means that many portfolios are dominated by exposure to the economic cycle. If growth is stronger than expected, those portfolios tend to do well. If growth is weaker than expected, they tend to do less well. Plus, there are many components of our private lives — salaries, bonuses, house prices — that are also heavily linked to the economic cycle. One of the common themes we hear today is that investors want to diversify their portfolios away from economic growth into other rewarded factors.

We have developed a tool called Aladdin Factor Workbench that allows us to view asset allocation through a factor lens. It helps us think about adding more balanced sources of return that have the potential to add diversification while seeking to improve long-run results.

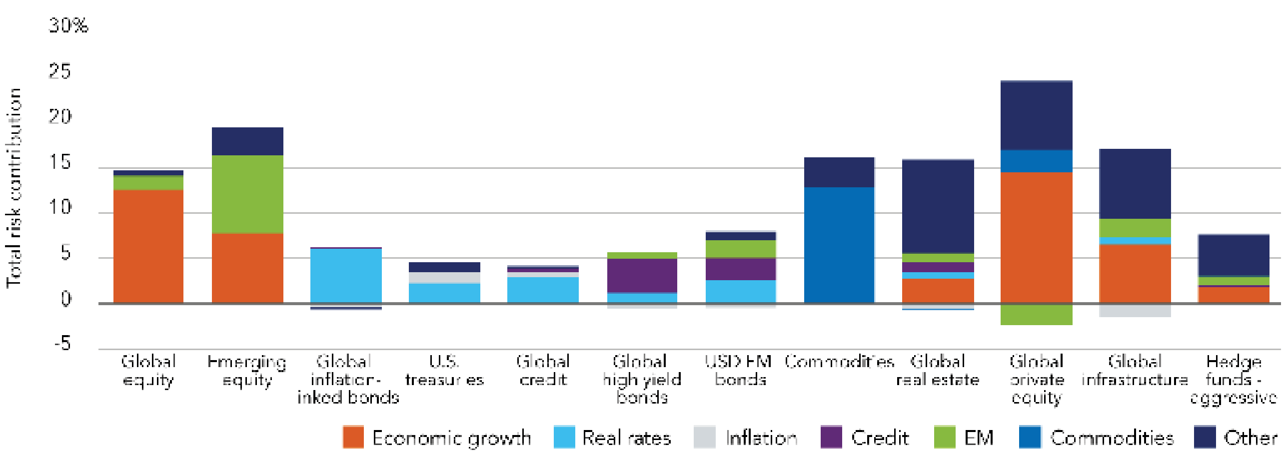
FACTOR INVESTING [IS] PARTICULARLY ATTRACTIVE FOR INVESTORS SEEKING PERFORMANCE GREATER THAN MARKET BENCHMARKS OR LOOKING FOR ADDITIONAL DIVERSIFICATION

How is factor-based investing evolving? What are some new ideas you're seeing gain traction?

Shores: Many investors start with a form of smart beta – the long-only, index-driven form of factor-based investing – to achieve the potential benefits of passive investing, while maintaining the possibility of outperforming the benchmark. Smart beta is about making elements already present in cap-weighted indices work harder to seek enhanced performance.

From there, investors may think about using factors to complement the active strategies in their portfolios. Say you have an active manager who tends to have a value bias. You may want to complement that manager with

Different assets, common risks: macro factor decomposition of different asset classes



Source: Aladdin Factor Workbench, June, 2018. Global asset classes are all hedged to USD. Risk contribution is the risk decomposition of the portfolio by factor, taking into account the correlations between the factors and the benefits of diversification, using a lookback period of 15 years. 'Other' includes risk contributions from style factor exposures and idiosyncratic risks. Asset classes are represented by the following indices: Global equity, MSCI All Country World Index; Emerging equity, MSCI Emerging Marets; Global inflation-linked bonds, BofA ML Global Governments Inflation-Linked Index; U.S. Treasuries, Bloomberg Barclays Government Index; Global credit, Bloomberg Barclays Global Aggregate Corporate Index; Global high yield bonds, Bloomberg Barclays Global High Yield Index; USD EM Bonds, JP Morgan EMBI Global Diversified Index; Commodities, Bloomberg Commodity Index Total Return; Global real estate, BlackRock Proxy; Global private equity, BlackRock Proxy; Global infrastructure, BlackRock Proxy; Hedge funds — aggressive, HFRI Equity Hedge Index.

some exposure to quality or momentum, to build a more diversified portfolio.

In our experience, once investors become accustomed to factor investing, they're often interested in a fuller expression of it. Instead of just looking at U.S. value, they look at value globally. They look at value not just in equities, but also in fixed income, currencies, and commodities.

Taking it one step further, if we construct a portfolio with both long and short positions, we can create a potential source of liquid absolute returns which, ideally, has no correlation to the broader stock/bond portfolio. That may provide a diversified and resilient source of returns. As hedge funds fees have come under increasing scrutiny, we've seen many investors use long/short factor strategies as a lower-cost replacement.

ONCE INVESTORS BECOME ACCUSTOMED TO FACTOR INVESTING, THEY'RE OFTEN INTERESTED IN A FULLER EXPRESSION OF IT

Andrew, you've mentioned that the fundamental ideas behind factor-based investing have been consistent, what has changed?

Ang: Factors have been around a long time.It's the applications that have changed, and technology has enabled that. You can read about value and quality in Graham and Dodd's 'Security Analysis,' from 1934. But today, we can analyse thousands of investments, across multiple assets, to identify value, quality and other factors, and we can trade those securities efficiently to help meet our investment objectives. So the conversations we're having today are not so much about what factors are or why they're important. They're more about how we can use them effectively in portfolios, whether as stand-alone strategies to help enhance returns or mitigate risk, as overlays to offset factor exposures already in portfolios, or as a diversifying, low-correlation alternative allocation. The conversation has really changed to how we can use factors to help investors in a difficult environment.■

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The smart way

Lynn Strongin Dodds looks at how the Nordics and Dutch lead smart beta adoption and how the trend is unfolding across the European pension fund landscape

WRITTEN BY LYNN STRONGIN DODDS, A FREELANCE JOURNALIST

The recently published 2018 FTSE Russell global institutional smart beta survey shows that Europeans asset owners have the highest rate of factor adoption at 61 per cent but acceptance does not seem to be widespread. Anecdotal evidence suggests that the Nordics and Dutch, and to a lesser extent the UK and France, are ahead of the curve while the rest of the region is lagging behind.

First movers included Denmark's ATP, Sweden's SPK, and the Dutch pension funds APG and PGGM, along with France's Fonds de réserve pour les retraites (FFR) and the UK's RPMI Railpen, manager of the Railways Pensions Scheme (RPS). However, many believe that the Norwegian government's global pension fund kicked off the debate in Europe when it published an influential paper by Andrew Ang, William Goetzmann, and Stephen Schaefer that concluded a significant proportion of the long-term performance of the fund could be attributed to its exposure to various factors. The authors recommended that the pension fund consider obtaining long-term exposure to systematic factor returns by means of a lower-cost, passive implementation of such an approach.

One of the biggest challenges in Europe and elsewhere is that there are several variations on the factor investing or smart beta theme. However, there are also common threads in terms of the goals and objectives. "Factor-based investing provides a lens into a portfolio and provides a better understanding of the drivers of risk and return," says BlackRock's EMEA head of investment strategy for factor-based strategies, David Gibbon. He says there is a common thread: "It helps investors make better informed investment decisions and build diversified portfolios. The strategies can also be extended beyond the public markets to private markets of private equity, infrastructure and commodities."

It is no surprise though that large sophisticated pension funds have been in the vanguard. As Legal and General Investment Managers head of index equity and smart beta David Barron notes the Dutch and Nordic pension funds have large in-house teams with quant backgrounds that can conduct the research internally and then outsource the implementation to an external manager.

There is also a cultural element, according to Mercer global director of strategic research Phil Edwards. These countries are home to large pension funds that wield influence and act as role models to their smaller brethren. "Some large funds in the UK, Dutch and Swedish markets, for example, have embraced factor-based investing and have to some extent popularised it with other investors in their countries," he adds.

By contrast, German institutions have been slow to the party due to their fixed income bias but given the low interest rates and bond yields, they have increasingly looked out of their traditional comfort zone to these mainly equity-focused products. This is not only the case with the country's final salary schemes but a growing number of DC schemes are also increasing their asset allocation to different equity strategies.

Motivating factors

To date, equities have been the most popular testing ground because the classic factors of value, momentum, low volatility, size and quality are steeped in a wealth of academic research. Studies first appeared in the US in the 1920s and the UK in the 1950s, although the seeds of factor investing were sown in the 1960 when the capital asset pricing model (CAPM) was first introduced. While these studies captured the fund management imagination, interest has been sparked by the debate over active management fees and whether pension funds are receiving value for money.

However, as in past surveys, the FTSE Russell survey, which canvassed 185 asset owners across North America, Europe and Asia, found that risk reduction remains the number one reason for embracing these strategies. Return enhancement continues to be firmly in second place, followed by improved diversification, focus on fees and cost savings, as budgetary considerations continued to play a significant role in investment planning.

Invesco's *Global Factor Investing Study* last year echoes these results. "We found that the risk argument is the most important reason why pension funds use factor-based investing," says the fund manager's senior portfolio manager for quantitative strategies Georg Elsaesser. "The strategies have spread across Europe in line with the global trend and we are seeing them being used as a third pillar to active and passive investing in equities. Investors are either using single or multi-factor strategies in equities because they offer different risk return profiles."

Legal & General Investment Management investment strategist, index and factor-based investing, Aniket Das, believes that multi-factor investing is one of the big trends because "investors are looking at more strategic way of building diversified portfolios that can withstand cycles and reduce stock-specific concentration. There is an expectation of outperformance but there is a better understanding that there are periods of underperformance and drawdowns".

Research from BlackRock shows that multi-factor has become increasingly popular, with assets growing rapidly from $3.8 billion at the end of 2009 to $70 billion as of March 2018. In addition, the FTSE Russell report reveals that 87 per cent of those who have implemented a smart beta strategy for the first time within the past two years are using a multi-factor approach.

There are a couple of ways that investors can approach multi-factor investing, explains Gibbon. One is to blend single factors together in one portfolio while the other is selecting stocks that can score well across various style metrics. "Both make sense but it depends on how strategic or tactical you want to be," he says, adding that a blended approach may be easier for tactical investors because they can change an exposure of a particular factor at a certain time. Recent research by BlackRock has found that factor valuations, relative strength, and dispersion are among the signals than can be used to predict future style returns and position portfolios accordingly. "We have seen interest in this approach across the continent, and particularly in Germany," he adds.

Gibbon notes that the other option is geared more for strategic asset allocation as it enables investors to adjust factor, sector and risk exposures holistically, which is more difficult to do and control in a blended approach. "You can have a portfolio of good value companies that are also trending positively with strong quality metrics and low volatility."

A changing climate

There is also growing demand to inject environment, social and governance (ESG) criteria into these multi-factor funds. This is particularly the case in Dutch and Nordic pension fund community but the idea is also spreading to the rest of the continent, UK and US. Although ESG in itself is not a traditional factor it can be used to lower risk in portfolios. "In our multi-factor strategies, it acts more as an overlay and is not implemented as a specific factor," says Amundi global head of smart beta and factor investing Bruno Taillardat. "It is part of the risk management process and can mean excluding companies that have poor ESG ratings or high carbon footprint for instance."

Although most of the product development has been in the equity space, there is a lot of work being done in fixed income. There are far more hurdles though most notably a lack of historical data and academic research to validate the performance of these strategies as well as high transaction costs. "These portfolios are more complex because there are a far greater number of unique bonds than stocks," says AQR's principal Chris Palazzolo.

"There is also less familiarity with quantitative approaches as it has been less systematic up until now. We are seeing more products being developed but it will take time and education for investors to adjust."

The FTSE Russell survey reflects this gradual tone by showing that fixed income smart beta strategies have been embraced by 9 per cent of asset owners surveyed, up from 7 per cent last year. Around 24 per cent are currently evaluating or planning to evaluate fixed income smart beta strategies in the next 18 months compared to 20 per cent last year. ■

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