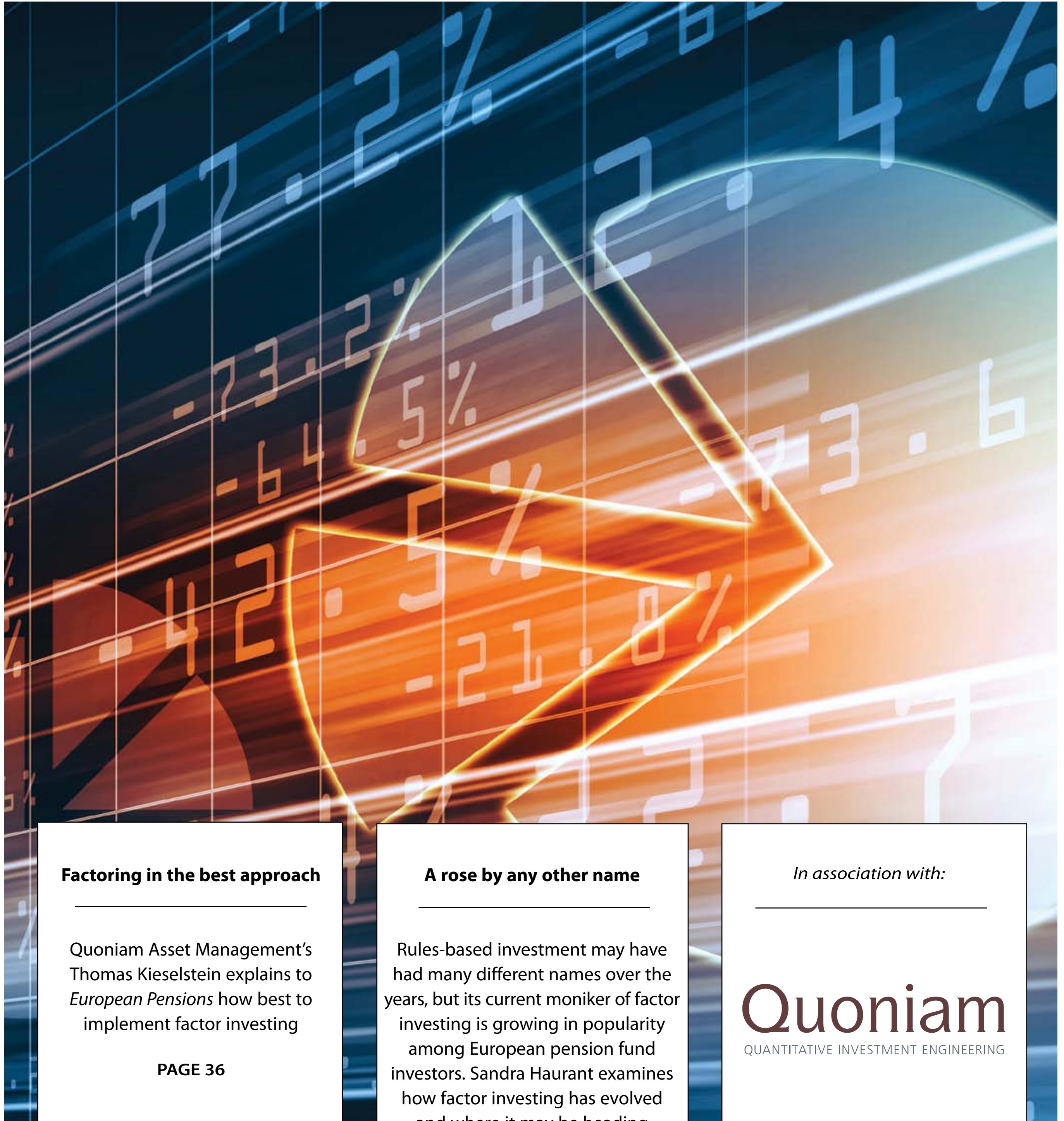
FACTOR INVESTING FOCUS:

ADDING VALUE



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INTERVIEW

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What exactly is factor investing? How does factor investing differ from other investment styles, such as smart beta or risk premia?

Factor investing is an investment strategy where assets or securities are selected on the basis of attributes such as price-earnings multiples etc. The goal is to generate a higher return than in a passive investment based on market capitalisation only. Similar terms are smart beta or risk premia investing. Probably the best differentiator between smart beta and factor investing is that smart beta is more focused on a risk/return ratio by lowering risk, while the goal for factor investing is to achieve better returns with similar risk. Risk premia investing could be described as a subset of factor investing. It relates to the 'why' there should be a higher return. Some factors could be interpreted as being remuneration for taking additional risks; not necessarily a market risk, but often personal risks. For example, as a contrarian value risk premia investor you are positioned against the crowd and you may be wrong for a long period of time. This may trigger many questions and pose your career at risk.

By contrast, a factor investing strategy like quality does not target remuneration for risk, but exploits inefficiencies in information processing. Quality is difficult to analyse and measure. Investors who are able to identify well-run companies on a large scale can benefit from these information processing capabilities.

How has factor investing evolved? Has it been around long, or is it still quite new?

The key question is more a question about terminology. So the terminology 'factor investing' is fairly new. But the underlying principles are fairly old. In the 1990s we researched factors that outperformed the market. At the time it was called 'market anomalies' and 'style investing'. Obviously, with advanced technology, factor calculations have become more sophisticated.

I think what's fairly new, though, is that you have passive or semi-passive ways to implement factor portfolios, of which many use exactly the same factor definitions. This is coupled with a more active factor allocation policy conducted by in-house teams or consultants. Historically, you would have a quantitative manager who identified and combined factors, but the new idea is to identify or combine factors yourself, or using a consultant, and then hire a passive implementer like an index provider or an ETF. The problem with that is that factor portfolios are not 100 per cent passive in the sense that they have limited capacity. Too many people may be copying the same factor or portfolio, so we run into a factor bubble trap.

How popular is factor investing for European pension fund investors?

Currently we see a growing interest from institutional investors in general. The clear advantage institutional investors seem to see in factor investing is mainly a cost advantage. There is a big pressure because of lower returns in capital markets, and regulatory complications. So there is a strong desire on the asset owner's side to reduce costs within active management. However, the challenge is to see the complexities related to that and that they have to invest in resources to pick and combine factors and choose the right vehicle or manager for implementing factors.

What are the challenges and pitfalls with factor investing?

One benefit is that you have something better than just passive, i.e. market cap investment, with less cost than a full-fledged active product. However, the challenge is that as an

investor or asset owner you have to have a good understanding of the factors in question and how they work. You also have to understand what other investors are doing because, as these ideas are quite popular, there may be a problem with capacity.
To avoid this you should clearly understand how many other people are actually following that trend or that factor. You should diversify across multiple factors. For example, you should not only screen for a simple valuation factor but combine valuation analysis with other aspects of investing, like quality.

And you should also try to use more sophisticated approaches and advanced factor definitions to not end up with identical portfolios.

What are the pros and cons of single-factor investing versus multi-factor investing?

The big advantage of single-factor investing is that it is simple. You have a single rule that is well described, so you can implement it cheaply. You can buy something like an index product; it's all very simple. The disadvantage is that it may not work over a long period of time. Let's take the example of 'value'. Something like a value factor means you buy cheap stocks measured by multiples. Now, that worked great after the TMT bubble, where all the overvalued stocks underperformed. But it did not work at all during the financial crisis and the following Euro crisis, where cheap stocks were typically banks or financials or other cyclical stocks. They underperformed, although the market was already falling. One remedy to that would be that you look at multiple factors or multiple dimensions of companies. So you would not buy the cheapest stocks but you would buy cheap stocks if you adjust for the profitability of a company or its leverage. That would mean, in practice, you would not buy banks but you might buy some industrial company.

Is it possible to time factors and if so, how?

It would be great if we always knew for certain which factors work beforehand. However, it turns out that in practice it is quite difficult because you have trends that last for a long time. However, there are techniques where you can at least identify when certain styles or certain market segments are extremely expensive or overcrowded and these are situations where you should probably be careful.

What are the warning signs of factors looking overcrowded?

Warning signs are definitely flows. So if you can identify (technically that's a little bit of homework to do) that a lot of money is going into certain styles or factors, then that is a warning sign. If the dispersion of fundamental characteristics between one factor portfolio and the market is becoming too large, for example if a factor portfolio is becoming expensive measured relative to the market, that's a warning sign. Also if the outperformance of a sector is enormously high compared to history, that's a warning signal too.

Where do you think factor investing fits within an institutional investor's portfolio?

Well, clearly it fits somewhere between pure passive, which I would define as market cap, and traditional active. In my opinion you should have a clear strategy. So if you want to follow the semi-passive route using factor indices or ETFs, then you need to allocate internal resources to it. If you don't have them, then you would be better off using active quant managers with this expertise.

Quoniam has expertise in factor investing since 1999. So we think that, as an active factor investor, we can clearly show that over various market cycles this approach has generated outperformance, while many of the index products, or simple factor portfolios, are relatively new and do not have real life track records. If you look at something like an index ETF, the index is back-calculated and then the ETF product is launched. It is not that you have 10 or 15 year of live track record for the ETF portfolio.

What do you think investors need to do to implement factor investing? What practical tips would you give?

There is always the question of how much you want to do internally versus outsourcing asset management. One approach is to insource lots of things, where you would have to build up an internal expertise on factors. At least you would need strategic portfolio management in house. The other extreme would be to outsource most of the factor allocation and factor combination to external managers. That could be an active quantitative manager. And you have things in between, where for example a consultant would select factors or factor managers. But the more you want to save on costs or on management expertise, the more you need to do in house. So there's nothing like a completely free lunch. ■

Thomas Kieselstein, CIO, Managing Partner, Quoniam Asset Management GmbH

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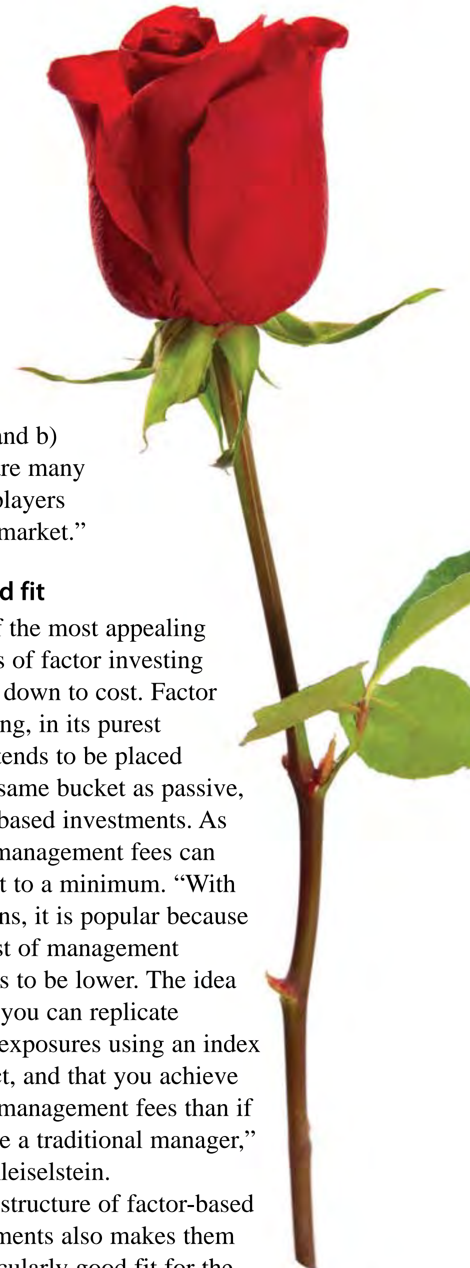
WRITTEN BY SANDRA HAURANT, A FREELANCE JOURNALIST



"You could say factor investing is old wine in new bottles," says Quoniam CIO Thomas Kieselstein. The term 'factor investing' is perhaps a recent one, but the approach is well-established and can be traced back over a number of decades.

In essence, factor investing, also broadly referred to as smart beta, involves using certain elements, or factors, within the markets, with an aim to achieving better returns but with lower risk levels. Those factors might boil down to company size, value or low volatility, for example. Assets within a portfolio would then be allocated according to a set of rules relating to the chosen factor.

A factor-based approach, known by other names, has been around in different shapes and sizes as far back as the 1950s and the days of Harry Markovitz's modern portfolio theory, which put emphasis on the relationship between returns and risks.

The theory was questioned in the 1970s, when academics and practitioners said that, in fact, lower risk stocks did better over the longer term. Low variance, one of the earlier smart beta techniques, was already around at this time, but, according to Candriam global head of investment solutions Kristof Wouters, there were very few people investing in this because it was seen as complicated.

"In the 2000s, we had research affiliates coming out with their studies, but their approach was very different," says Wouters. "It was a rules based, using fundamental factors instead of market capitalisation. There was a lot of research and publications, and providers launched indices that became very popular."

In the 1990s, the approach was known as style investing, but whatever the name, this practice of having a set of rules to follow when building a portfolio has had a more or less wide appeal for many years.

"Arguably, factor investing has always been available," says Aon Hewitt EMEA head of investment John Belgrove. "I've seen different cycles and phases associated with management styles, but if we bypass the marketing labels and look at what we are getting exposure to, we can readily see products that are more value focused or small cap focuses."

But, says Kieselstein: "The big difference between the approach in the 1990s and the way it works today is that a) there are many more factors used, and b) there are many more players in the market."

A good fit

One of the most appealing aspects of factor investing comes down to cost. Factor investing, in its purest form, tends to be placed in the same bucket as passive, index-based investments. As such, management fees can be kept to a minimum. "With pensions, it is popular because the cost of management appears to be lower. The idea is that you can replicate factor exposures using an index product, and that you achieve lower management fees than if you use a traditional manager," says Kleiselstein.

The structure of factor-based investments also makes them a particularly good fit for the pension regimes in certain parts of Europe, according to Wouters.

"Smart beta is extremely good for pension funds in a very rigid prudential regulation, such as in the Netherlands or in the Nordics," he says. "They are in a full LDI

investment process, since their pension fund regulation is in effect similar to what you have for insurance companies.

"They have a risk-based supervisory system, meaning that their regulatory capital requirements are a function of the overall risk on their balance sheet, which comes predominantly from the risk within the investment portfolio, and, when using smart beta, you can reduce the risk profile. So they are big buyers of smart beta; certain big pension funds have a very high allocation to smart beta in their portfolios."

Nonetheless, while there are attractive aspects, factor investing can place other stresses on pension funds, particularly when it comes to making the right choices. "It puts much more responsibility on the investor's side because they have to decide on the factor allocation themselves," says Kieselstein. "Asset owners are doing far more of the decision making than previously when we talk about factor investing."

Staying power

"It is a difficult balance," says Belgrove. "Just treating equities as an example, the right equity portfolio for an investor depends on their own risk and return objectives, their investment beliefs, cost constraints, government resources. A fall-back position of choosing an index-tracking portfolio on cap weighting is not a bad place to be. Doing something different to that *[such as factor investing]* exposes you to external scrutiny that you might have done something wrong, and the question is how much do you want to risk that?"

By their nature, single-factor funds are bound by their rules to stick with one factor – and if that factor is not performing how a pension fund would like it to be then there are decisions to be made.

"I think that it is fairly accepted that there are systematic effects in capital markets, and that such factors tend to work," adds Kieselstein. "However, it's not guaranteed that they work next year or over three or five years, so if you are deviating significantly from the market you probably would need a very long-term perspective, and that, I think, puts stress on the governance structures as asset owners."

"It does come with attendant possibility of criticism," agrees Belgrove. "We can empirically demonstrate, for example, that in the very long run certain biases have yielded premiums to investors, and we can assert that this relationship will hold true in the future. For example, being more value based has had a tendency to provide superior returns," he says.

"But the trouble is, you can get into extensive periods where value just stinks as a strategy, and all of those around you are outperforming. Behaviourally, it becomes very difficult, as an investor who has taken that decision, to stick with it," Belgrove adds.

Investors, he says, tend to lose confidence and shed the underperforming factor fund at the wrong point in the cycle, having a negative impact on their long-term record. "You've got to understand, if you do adopt portfolios with biases, that you got to be prepared to be wrong for periods of time and take the consequences of that," says Belgrove.

There are alternatives. Factor-based investing has evolved and single-factor funds are not the only option. "There are effectively three generations *[of factor investments]*," says Woutters. The first generation is single factor – such as value, minimum variance, small cap and so on. The second generation includes multi-factor investing, in which the weighting of different factors is fixed within the fund. So for example, it may contain 30 per cent value, 30 per cent low volatility, and so on. "The third, new generation, is dynamic multi-factor, where the weights of the styles change over time," says Woutters.

Managers of dynamic multi-factor funds are able to use a new level of flexibility, moving out of underperforming factors, changing weighting, effectively re-writing the rulebook, all within a structure that remains led by factors and their attributes. But here, of course, factor-based investing clearly moves out of the realms of the passive sphere and firmly into an active approach to investments, and this means the management costs are higher than in single-factor products.

Factor investing in its current form remains an appealing approach to the markets, and one that has room to grow. "People like it, it is working really well and above all, since it's considered rules-based or semi-rules based, quite often you can buy it cheaper. So it's cheaper and has better performance. Index providers, ETF providers and traditional asset managers have all got involved. It is increasingly popular because the techniques are becoming more refined," says Woutters.

But will its popularity continue? Kieselstein thinks so, one way or another. "I'm pretty sure there will be some disappointments along the way, as some strategies will become overcrowded. But I think factor investing will later come back again, perhaps with a slightly different name." ■

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