Factors that fit

As more investors benefit from factor-driven approaches, there's growing recognition that broader adoption could help them target their specific investment goals

Growing numbers of investors are looking to systematic rules-based approaches that allocate assets to investment factors (cohorts of securities chosen around certain characteristics) that have historically provided distinct return premiums. This trend has been fuelled by rising demand for more transparent and lower-cost solutions, alongside the desire for exposures that have low correlation with broad market moves.

Factor investing defines the smart-beta approach, whose underlying idea has been to capture equity risk factors, such as value, momentum and size. Over time, this approach has extended beyond equities and into bond markets.

More recently, the factor investing concept has begun to venture outside traditional asset classes to identify and capture alternative risk premiums—sources of systematic excess return from non-traditional investments and strategies.

These may involve equities, bonds, currencies and commodities and correspond to long/short portfolios (for example, the value factor for equities can be extended beyond long exposure to traditional equities into bonds, currencies and commodities). As well as capturing style and structural risk premiums from alternative investments, some approaches can replicate certain hedge-fund exposures in a highly cost-effective way.

In addition to worrying about the costs of accessing alternative investments, many investors also have concerns about their transparency and liquidity. Factor approaches targeting alternatives could open up attractive opportunities to access these investments' potent diversification and return potential with better transparency and higher liquidity—while also paying lower fees.

As the scope of factor use has widened, factor investing has also begun to encompass more bespoke approaches that rely heavily on managerial skills and proprietary research.

Factor premiums are expected to deliver over the long term because they reward investors for bearing risk or stem from markets' structural limitations and investors' behavioural biases. But the effectiveness of different risk premiums will change as the macroeconomic environment evolves. So investment managers need to make judgement calls on which factors to select—and when.

We believe a holistic assessment is the best approach to identifying which factors are attractive and which aren't. This analysis should include a quantitative assessment of potential upside, an evaluation of the macroeconomic environment and, finally, human judgement.

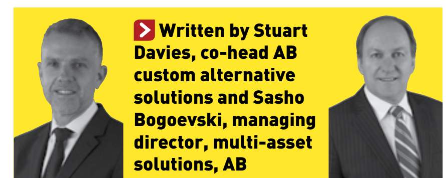
In our view, actively managed approaches that incorporate fundamental viewpoints can deliver much more rewarding outcomes than those that manage exposure mechanistically (for example, by dialling down equity exposure in response to volatility triggers). More dynamic approaches can, for example, choose to temper exposure to factors like momentum which tend to lag when equity markets are particularly volatile.

Unlike traditional assets, alternative risk premiums may be accessed by combining multiple trading instruments or assets (including long and short strategies) and applying specific trading rules to isolate the alternative risks being harvested. This means risk premiums can be tailored with great precision to deliver fully customised, actively managed solutions aimed at helping investors meet specific goals.

Getting the right fit involves a clear understanding of what investors are trying to accomplish with their portfolios—and determining how it can be achieved most effectively. This might involve more targeted exposures to desired factors, delivering specific outcomes at substantially lower costs or a focus on environmental, social and governance (ESG)-friendly investments.

How might this work in practice? Investors concerned about a more reflationary environment and unintended duration risks lurking in their overall portfolios might seek a bespoke 'reflation-proof' strategy. Others might require hedge fund like downside protection potential, but with daily liquidity.

These examples show that rather than providing 'one-size-fits-all' commoditised products, alternative risk premiums can be harnessed within highly focused investment solutions that seek to deliver bespoke tailoring at off-the-peg prices—while also providing valuable transparency and liquidity benefits.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