Factor investing: It works for credits too

Patrick Houweling explains how factor investing can be an advantageous strategy within credit markets

With extensive academic research to support the existence of factor premiums, much of the conversation to date has been about factor investing in equities. Many of the explanations that apply to equities are also relevant to factor investing in credits. Research by Robeco explains how investors can exploit the presence of factor premiums by applying a multi-factor credit strategy to a fixed income portfolio.

Robeco developed its multi-factor credit strategy based on an academic research paper, *Factor investing in the corporate bond market*, written in 2014 by portfolio manager Patrick Houweling and his quantitative research colleague Jeroen van Zundert. The paper, which builds on 15 years of prior research, was the first of its kind to show that factors also work in credit markets. The strategy gives a portfolio exposure to the four critical factors of low risk, value, momentum and size. When applied to a multi-factor credit portfolio, it has been found to generate substantial premiums in the form of better risk-adjusted returns, with back-testing to prove it.

The basis of the research dates back as early as 1998, when Robeco formed a collaborative data exchange and research partnership with the world's largest fixed income benchmark provider. Through this collaboration Robeco was able to build granular datasets that provided a head start in the research and model development process, with the first credit selection model developed as early as 1999. The strategy builds upon Robeco's factor investing expertise in equities and low risk investing in credits.

So how does the strategy work? It invests in global investment-grade bonds and enables institutional investors to take advantage of the low risk, value, momentum and size factors. Each factor has its own characteristics. As its name suggests, the low-risk factor strategy selects low-risk bonds issued by low-risk companies. Value selects bonds that are cheap relative to their associated level of risk, and momentum selects recent winners, on the concept that companies enjoying past success (thereby gathering momentum) will continue to do so. In addition to these three factors, size has been included by applying an equal weight to the holdings in the portfolio rather than being constrained by tracking an index and its weightings. Compared to market cap-dominated benchmarks, smaller companies get a larger relative weight. This approach, amongst others, takes advantage of the liquidity premium, which plays a more significant role in less liquid markets – such as the corporate bond market – than it does for equities.

The strategy aims for a better return than the market, but with a similar risk profile. The low-risk factor, top-down portfolio constraints and diversification all work as a way to reduce risk and to balance the higher risk of the value factor. We make sure that the portfolio is well diversified across companies and factors. Performance should not come from one or two winners. Instead, it should come from the exposure to the factors. We believe that by combining multiple factors in a portfolio, more stable performance can be achieved in the longer term compared to single-factor strategies.

Institutional investors have shown considerable interest in the strategy. Long-term back-tests demonstrate that applying multi-factor investing to equities and credits can enhance returns without increasing risks. Those who might already apply a factor approach to the equity portion of their portfolio may also see it as an opportunity to implement factor investing across multiple asset classes in their portfolio. Some also see it as a style diversifier to their actively managed credit portfolios, while others regarded it as a replacement for their passive index portfolios. We believe that the fact that the strategy is research-driven will also appeal to investors. There is a huge body of academic literature that proves the existence of the factor premiums.

Robeco executive director, researcher and portfolio manager Patrick Houweling

One reason why factor investing is so effective is it is a rules-based approach. Behavioral biases that can creep into investment decisions can be cancelled out. However, there is inevitably some tension between the factors – a low-risk credit may be expensive, for example – so it is also important to avoid different factors working against each other. While exposure can be given to one factor in a fundamental approach, this may at the same time go against another factor. In our approach, all factors are given consistent exposure, which makes it more balanced.

But the word has yet to get out. An analysis of a large universe of credit mutual funds showed that only a very small percentage give access to all four factors, which is the explicit goal of Robeco's Multi-Factor Credits strategy. However, those funds that did apply all four achieved the highest alpha over a 20-year back-testing period. And therefore we firmly believe that a multi-factor approach deserves a place in a diversified fixed income portfolio.

For more information, please visit: www.robeco.com/factor-investing

Written by Patrick Houweling, executive director, researcher and portfolio manager quantitive credits, Robeco

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Summary
- Smart beta as an investment approach has begun to encroach on the roles of the two pillars of investment – active and passive.
- There has been an ongoing adoption across the pensions industry of the investment strategy, with particularly impressive growth rates.
- Issues remain however over a lack of definition surrounding smart beta. The term smart beta is now widely used but is not universally accepted. Other terms referring to roughly the same category of investment products include factor investing, risk-based investing, premium investing, alternatively-weighted indexes, strategic beta, non-traditional indices, advanced beta, beta plus, engineered beta and second generation indices.
- Smart beta is not replacing entire active exposure but tends to be an addition to pension funds' core holdings.

Coming along nicely

The use of the smart beta approach to investing has gained traction in recent years, with increasing numbers of funds looking to implement its philosophies. Peter Carvill explores its rise, its issues and what its long-term prognosis may be

The global financial crisis that erupted in 2008 caused many to reassess not only the business and investments they had undertaken, but the processes that had led them to those decisions. And from this point, the investment approach of smart beta has begun to encroach on the roles of the two pillars of investment - active and passive.

"That crisis," Robeco head of factor investing research Joop Huij says, "made a lot of investors - and also financial market authorities—re-evaluate assessment systems. If you look at a lot of those systems in place, there's not a lot of evidence supporting the effectiveness of those approaches."

Adoption

Since that time, smart beta has seen an ongoing adoption across the pension industry. A 2014 report from the National Association of Pensions Funds (now the Pensions and Lifetimes Savings Association, or PLSA), *Smart Beta Made Simple*, reported that 40 per cent of those surveyed had made an allocation to smart beta strategies, with European institutions having already allocated $100 billion. At the time, predictions were made that this would increase four-fold by 2018. Despite the rosy forecast, the numbers were still relatively small: of those allocating via smart beta, the vast majority (40 per cent) were only allocating zero to 5 per cent of their equity portfolio, according to Russell Investment's institutional market survey *Smart Beta: A Deeper Look at Asset Owner Perceptions*.

Anecdotal evidence, however, suggests a shift. Russell Investments director of EMEA indexes Jamie Forbes says the scale of those allocations has "definitely changed". She adds: "With some of the initial investors, we often heard that they were dipping their toes. They saw it as relatively new and weren't willing to put in a larger allocation. We are starting to see that shift as a lot of these products and those that had been more based on explicitly capturing those factors have behaved as expected."

State Street Global Advisors portfolio strategist for global equity beta solutions Ana Harris is more sanguine about the uptake of smart beta. "There were people that talked about high targets for these strategies in a short space of time. I think the take up has been slower than some expected. But they were growing from a very low base. In terms of growth rate and numbers, it's still pretty impressive."

A lack of definition

While its growth may be impressive, there are issues around smart beta, including its lack of definition and the debate over which would be its most accurate name.

Leaving aside the issue of name for a few moments, smart beta's lack of definition is slightly problematic. In its *Smart Beta: A Deeper Look at Asset Owner Perceptions* survey, Russell Investments gives this version, chosen by just 45 per cent of respondents: "Alternative ways to construct market exposures such as minimum variance, fundamental weighting, maximum diversification, equal risk, or equal weighted."

Yet in 2016, even Russell Investments is adjusting how it defines smart beta. "We have a slightly broader definition now," Forbes mentions. "It would also cover any strategies that target the specific factors."

The naming of these approaches has also proven problematic in recent years. Last year, Source executive director for equities product management, Chris Mellor, wrote a white paper, *Being Smarter about Smart Beta*. There, he wrote: "The term smart beta is now widely used but it is not universally accepted. There are many other terms that refer to roughly the same category of investment products, including strategic beta, non-traditional indices, advanced beta, enhanced beta, beta plus, engineered beta and second generation indices."

Elsewhere in the white paper, Mellor acknowledges: "Smart beta is often portrayed as a new buzzword or some kind of marketing gimmick. The term smart beta does invite criticism, and it doesn't help that there is also widespread confusion about what it means."

Huij says that smart beta is a very unambiguous concept. Instead, his company refers to it as factor investing. There are, he says, different names in use, including risk-based investing and premium investing. The reason factor investing is used within Robeco, he says, is because the others explicitly indicate that you should take risk as an investor. "A lot of people believe that these premiums that you try to earn when you use smart beta are compensating for risk. Our research shows that there is no evidence supporting that. That's why we use a different definition."

The naming of this approach was also tackled in the *Smart Beta Survey 2014*, released by Russell Investments. In its survey, the company found that there was no strong preference for any of the names in use. Within North America, a third of respondents preferred alternatively-weighted indexes, while a slightly proportion of funds within Europe preferred smart beta. Preferences also varied across fund sizes: those with AUM of under $1 billion preferred the term alternatively-weighted indexes, those with an AUM between $1 billion and $10 billion made no clear choice between the two, and those with AUMs over $10 billion opted for smart beta.

Forbes calls this confusion over names a potential liability for the uptake of smart beta. "It's critical that providers and consultants are very clear at understanding how different strategies are constructed and what is beneath the name, what styles and factors are driving the performance," she adds. "Let's be clear about that. The less clear we are about it, the more it will hamper develop. It's critical to be clear about calling it what it is."

The end of active management?

One outside influence aiding smart beta is the diminishing of faith in the role of active managers. A few years ago, the Norwegian government looked at this, post-financial crisis, and concluded that returns were 'idiosyncratic' and 'extremely small'. State Street Global Advisors, in its *Advanced Beta Comes of Age* report, found that between 2009 and 2013, there was a fall of 13.8 per cent of assets under active management in the UK.

"In certain regions and parts of the market, we have seen some of active management losing its lustre," Harris says. "There are different pressures on the asset owners in that regard. Some might be disappointed that active managers have not delivered. They were expecting that those managers could navigate tricky markets over the last couple of years. Not all of them have been able to do so successfully. Another point of pressure for asset owners is around the fees they can spend on their investment manager budget."

"It would be dangerous to say it's the end of active management," Mellor states. "It's probably a symptom of its problems where you have 85 to 88 per cent of funds not beating their benchmark after fees. There has to be question over the breadth of active managers. But there are 15 per cent of funds that beat the benchmark. But it's question of identifying which 15 per cent. It may not be the same next year as it is this year."

Despite the issues around smart beta, those interviewed expressed great hope for its future, with some even saying it was a game changer and that it would become one of the three pillars of investing, next to active and passive approaches.

Harris offers a measured assessment of its future. "What investors have done is think about the outcomes they want to achieve rather than the labels. Smart beta is a just a tool in the same way that indexing or active management is."

The financial crisis was a lesson that predictions can be a fool's game. Forecasting the future of smart beta may prove to be just that. But for now, there is potential. Mellor speaks to this. "Most investors we speak to," he says, "are using smart beta as part of their portfolio. I don't think they're replacing their entire active exposure. It tends instead to be an addition to their core holdings. That how I think most people are using it. But that does illustrate its scope for growth."

Written by Peter Carvill, a freelance journalist

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