Getting your factors straight

James Edwards explains how investors can make sense of the many different multi-factor strategies on offer

Factor investing has grown in popularity in recent years as investors seek low-cost ways to access well-understood drivers of return in markets. In response, the investment industry has seen an explosion of factor investment products, with 'styles' and 'smart beta' also used to describe the approach.

As diversification is the cornerstone of any strategy, it is perhaps therefore not surprising that a recent FTSE Russell survey found that multi-factor strategies have been the most popular approach for institutional investors around the world.

According to the 2018 Credit Suisse *Global Returns* yearbook, researchers have identified at least 316 factors that may drive markets. Whilst not all will stand up to independent testing, how are investors to make sense of what is on offer and the risks to which they are exposed with so many approaches?

Unintended consequences

Let's consider the momentum factor as an example. Momentum is the tendency for rising asset prices to rise further and for falling asset prices to fall further, perhaps reflecting investors' tendency to underreact to market moves. The momentum factor has had a strong run of performance: over the past 12 months to August 2018 the MSCI US Momentum index returned 28 per cent, outperforming the standard US index by over 8.5 per cent.

Whilst over the long-run momentum has performed strongly, it has seen some sharp reversals. Notably, momentum underperformed market cap weighted in 2008, and its maximum drawdown (peak to trough performance) during the financial crisis was almost 56 per cent. What has driven the recent run of strong performance? The largest constituents of the US Momentum index should need no introduction comprising household names such as Amazon, Microsoft, Netflix, Intel, Visa and Mastercard. Indeed, the index has around 42 per cent in technology companies.

Buy… high? Sell higher?

Momentum could be characterised as the strategy that buys high and sell higher, running counter to the classic maxim of buying low and selling high. It should come as no surprise then that the momentum factor is therefore underexposed to 'value' companies (companies that look cheap or less expensive relative to some measure of intrinsic value).

Given that momentum is underexposed to value, what do the largest stocks in the MSCI US Enhanced Value index look like? Household names again, including Apple, Pfizer, Bank of America, Intel, Cisco and Citigroup amongst them. In fact, 12 per cent of the index is Apple alone, with around 27 per cent of the index represented by technology firms.

It is clear therefore that stocks will often exhibit one or more factors due to the simple fact that the correlation of the company fundamentals used to construct a factor will not be zero. Because of these correlations, a simple combination of the most common and well understood factors may result in a portfolio with unintended exposures: a portfolio that does not differ much to the cap weighted index, or alternatively a portfolio with unintended concentration in particular segments of the market.

Styles come and go and but true style is timeless

We are strong advocates of multi-factor approaches. We believe they fulfil an important role in pension fund portfolios and enable access to systematic return drivers at low cost.

We believe that insufficient attention is paid to the construction of the underlying single factors however. In a perfect world, the underlying factors would be entirely uncorrelated. Put another way, when constructing a factor, investors should adjust the underlying data for common factors, so that the end result is a pure or 'true' factor.

Why does this matter? As noted earlier, the commonality across different factors means that the correlation between these 'raw' factors may be high, making diversification more challenging. In the case of the momentum and value examples, we have the opposite problem: the strategies are almost entirely opposite, so a naïve combination of the 'raw' value and momentum factors could end up with almost no difference in position versus the cap weighted index.

So, constructing a multi-factor portfolio with 'true' styles should therefore offer better diversification versus market cap weighted portfolios and a more optimal combination of factors. The optimal portfolio should in turn lead to better risk-adjusted returns in the long run and therefore offer pension schemes a better chance of meeting their long-term investment objectives.

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