Summary
- Once a niche part of financial academia, risk factor investing has gained popularity.
- Investors need to be aware of differences in using the approach with fixed income.
- The approach can help identify truly skilled managers or those 'riding the wave'.

Factoring in bonds

Elizabeth Pfeuti examines how factor investing can be applied to fixed income

Since the financial crisis, a previously niche part of economic theory has become mainstream in investor portfolios and parlance.

Risk factors, a term once only found in academic journals or within the blurb of highly quantitative-led strategies, can now be seen taking centre stage in the portfolios of even some of the smallest pension funds.

Often using the moniker of 'smart beta', these factor-led strategies promise to tease out what drives performance in certain conditions and fails in others. By using these levers carefully, investors – in theory – can ride the right wave at the right time.

They have been so popular that exchange-traded funds running these strategies have outstripped the explosive growth seen in the sector as a whole. The assets in plain vanilla ETFs grew 321 per cent in the decade since 2009, while the money in smart beta ETFs grew 4,870 per cent, according to data by Refinitiv.

However, until recently, smart beta and factor-based strategies were mainly confined to equity investing both in mutual funds and ETFs. Now, they seem set to take over other parts of the investment world, but for different reasons than what attracted investors to stock market-based strategies.

The move to factor investing in equities was largely driven by a "revolution in manager selection", according to Research Affiliates' European research and business strategy lead, Vitali Kalesnik.

"Factor investment and smart beta became popular in equities as investors realised how large fees were in active management," says Kalesnik. "By using factor-based strategies, investors could get active-like performance, but for lower fees."

For investors burned by the financial crisis it was a no-brainer.

Getting smart (beta)

"Factor investing sat between active and passive," says Kalesnik. "There was a need in the market for investors who wanted higher than passive returns, but for a simple, transparent fee."

Whether investors opted for a branded smart beta fund or used other ways of implementing the strategy, the die was set, and the idea took hold.

The next step is to explore how these factors can be applied in fixed income, but it is not a straight copy and paste exercise from one sector to another.

For Amundi head of smart beta and factor investing, Bruno Taillardat, there are many benefits to taking this approach but investors need to be prudent.

"There are differences in how the two asset classes function with a risk-factor approach," says Taillardat. With equities, investors saw factor investing as a pure substitute for beta, although with the potential for some alpha, too.

"Applying a risk factor approach to fixed income, you are not just trying to capture the same beta," says Taillardat. "You will not create a substitute for beta – you will get something additional."

For Quoniam Asset Management head of fixed income, Andrea Dacquin, this "something additional" might come from not only selecting the usual large issuers that appear in many bond funds with more targeted precision, but also finding smaller issuers that have less research coverage.

Dacquin says: "A second consequence of a broader investment universe coverage is usually a higher degree of portfolio diversification, which results in less unsystematic (issuer-specific) risk

in the portfolio, more and smaller active positions, and lower tracking errors."

There is an additional diversification bonus in adding a manager with a risk factor approach to an existing portfolio.

"The return profile of factor strategies tends to differ considerably from traditional investment styles, allowing investors to achieve style diversification between different bond managers," says Dacquin.

Even if a fund manager does not construct their portfolio using a factor-based approach, the factors are still present and are driving performance.

"An important incentive in the use of factor-based strategies in fixed-income is risk reduction, which is achieved by diversification over a number of factor classes that are lowly correlated," Dacquin adds.

Risk management

However, investors need to be aware that there are additional, different factors to consider that do not appear in the world of equities. With credit, which is where the approach is most applicable, credit, duration and liquidity are important factors that can impact a return, says Taillardat.

While some factors like quality or carry are identical or very similar in both fixed income and equities, other bond-specific aspects have to be taken into account when constructing portfolios.

The major difference between factor investing in corporate bonds and equities is that the risk premium is directly observable for corporate bonds – the spread – while it has to be estimated by making model assumptions for equities, according to Dacquin. This should, in theory, lead to "less noisy factor premia estimates" for bonds.

"On the other hand, volatility is much lower in investment grade corporate bonds compared to equities, which means outperformance is more difficult to achieve in a fixed income universe," says Dacquin.

Is this why it has taken so long for the approach to shift across to fixed income?

Shifting sands

MSCI global head of factor index products, Mark Carver, says part of the reason is a lack of data.

"With equities, we have very clear data from more than a century," says Carver. "We can test and determine factors and forecast risk. Other asset classes don't have that level of historical data."

Additionally, due to their nature of being predominantly traded over the counter, transaction costs are higher with bonds, impacting their pricing, and the asset class's liquidity is not the same as equities', many of which are traded every split second.

However, there is a push from regulators to get more bonds traded on exchanges, which should rapidly increase the amount of reliable data that can be used to figure out which factor is driving performance.

MSCI is working on a range of indices across various asset classes against which investors can measure their returns and spot where one factor or another was doing the work.

"Then we will be able to see which managers were truly skilful and those who were just riding the wave," says Carver.

This could also lead to an uptake in the number of investors taking this approach as there has been a perception that while active equity managers often overcharged for underperformance, bond managers have offered value.

"It became apparent, that for equity investors, showing alpha creation outside these factors was hard," said Kalesnik.

Outcome-focused

With the advent of better benchmarks, investors will be able to look closer into how fixed income managers have performed, but that is only one benefit.

"This shift is more evidence of the evolution of how investors allocate capital," says Carver. "It is moving from asset classes to factors, which means they are focusing more on outcomes and precision."

If you don't know what your risk is or where it is coming from, you cannot diversify properly.

"It is important for trustees to know what to expect from different factors in different scenarios," says Taillardat. "It is important to try and avoid big surprises."

Using, or at least being able to understand what factors are driving returns – or losses – in a portfolio is vital, especially in a time of crisis.

"Some factors will bounce back quicker than others, but some may not have fallen so far to begin with," says Taillardat. "It is all about diversification."

While it is not as straightforward as assessing a company balance sheet, using factors to select bond purchases can help diversify a range of fixed-income instruments to help protect a portfolio from prolonged downturns in a transparent way.

With all this in mind, should we expect the risk factor juggernaut to hit fixed income?

Dacquin foresees a steady flow of investors considering the move.

"The biggest challenge for investors remains the low-yield environment and this means the right choice in terms of issuer selection, diversification but also transparency is even more important today than it was in the past," she says.

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