Advantages of using a multi-factor approach

Factor-based strategies are increasingly being used not only for equities, but also for bonds. It is crucial for investors to look closely at the details, because the various systematic approaches can vary considerably

Why is factor investing in corporate bonds becoming increasingly popular?
An important incentive in the use of factor-based strategies in the fixed-income markets is that of risk reduction, which is achieved by diversification over a number of factor classes which have low correlations with one another. Another reason is the prospect of a higher extra return.

A systematic, factor-based evaluation of the corporate bond universe not only allows the usual large issuers to be considered, but also enables investment opportunities to be seized more effectively among smaller issuers who have less research coverage. Manager diversification is another argument in favour of using multi-factor investing. The distribution of outperformance for a factor-based approach differs from the distribution experienced with regard to a traditional investment approach, in terms of size and timing. The former thus also complements the latter in a meaningful way in the management of institutional fixed-income investments.

What are the best factors, and how are they combined?
Academic studies have shown that there are many hundreds of factors that have systematically led to excess returns in the past, compared to traditional indices based on market capitalisation. To simplify matters, however, the vast majority of factors can be grouped into a few superordinate styles. In contrast to equity investments, the correct modelling of downside risks is particularly important in the case of bonds, which is why fair value models that relate valuation and risk to one another are suitable. Enhanced by the 'Carry' and 'Sentiment' (Momentum) factor categories, a balanced multi-factor approach results. On the one hand, the complexity of the calculation of the factors has a decisive influence on the result, and this is where a detailed approach – with enhanced data input – is advantageous. On the other hand, the way in which factors are combined is also relevant: in principle, investors can choose between a mixture of portfolios made up of single factors (portfolio blending) or a mixture of factor signals at single-issue level as part of an integrated multi-factor approach (signal blending). The factor exposure of the overall portfolio in the portfolio blending approach is low due to negative correlations between the individual factor groups: it must therefore be obtained through very distinct positioning within the individual portfolios.

Therefore, it seems that the portfolio blending approach is not very practicable, particularly in fixed-income, as such extreme single-factor portfolios are unlikely to be implementable. With an integrated multi-factor approach, the factor signals are combined at the level of single securities, taking into account duration and yield curve risks. Such an active factor investing approach focuses on utilising issue-specific information inefficiencies, and not just on simply replicating risk premia.

Sustainability is becoming increasingly important. To what extent can this be reflected in factor investing approaches?
We now manage more than 40 per cent of our total assets on the basis of sustainable investment criteria. The prerequisite for the efficient integration of sustainability aspects into quantitative factor strategies is to have a high-tech infrastructure for processing data, with suitably reliable data sources. In principle, sustainability aspects within quantitative approaches can be integrated in two ways. First, negative screening identifies issuers with problematic business practices, such as child labour, or problematic business activities – involving the production of weapons of mass destruction, for example. The second way allows quantitative sustainability measures such as ESG scores or the carbon footprint of issuers to be integrated as risk factors into the portfolio construction. However, this approach also emphasises the importance of ensuring that the primary investment objectives, such as risk-adjusted performance, are not compromised. The way in which sustainability aspects are considered also depends to a large extent on individual client preferences – for example, there are major country-specific deviations in respect of the use of nuclear energy.

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