Summary
- Multi-factor investment strategies aim to systematically select companies based on characteristics such as value, quality, momentum, size and low volatility.
- This is a very different approach to the more usual market cap strategy, which sees funds allocate greater sums to larger cap companies.
- Given that the biggest companies in the world today are almost all US tech firms, this creates a concentration risk.
- Multi-factor approaches can help to alleviate this risk by investing in a range of companies that will behave differently in different economic situations, increasing diversification and potentially returns.

Multi-factor investing: Finding the right approach

Sandra Haurant considers the role multi-factor investing can play in a pension fund portfolio

Most index funds or exchange-traded funds (ETFs) base their investment strategy on market capitalisation (or market cap), weighting investment allocations according to the size of companies in which they invest. The aim, simply put, is to predict which stocks will outperform and to invest more in those. It's an approach that has long been widely used, and with good reason. Larger firms tend to be more established, stable and reliable in tougher times, while providing dependable growth in better conditions.

Multi-factor investing provides a different approach, one which can alleviate some of the risks inherent to market cap, and offer a built-in diversification that can benefit schemes in the long term. Instead of relying proportionally more on the growth of larger firms, and attempting to predict which will outperform the markets, the multi-factor approach targets a range of different factors, aiming to gain from each of these in different ways and at different times.

It's particularly useful at times where the markets are dominated by a small number of sectors, says Hymans Robertson partner and senior DC investment consultant, Mark Jaffray: "Market-cap indices can become heavily concentrated in a small number of companies, sectors or regions, particularly when a handful of firms are driving market performance. We've seen those concentration risks become much more apparent in recent years."

Concentration risks effectively amount to having all of one's eggs in one basket – something that is ill-advised for any investor. And today, with big tech firms dominating the holdings lists, it's very much a current topic. The so-called Magnificent Seven companies – Nvidia, Apple, Microsoft, and Google's parent company Alphabet, Tesla, Meta and Amazon (in no particular order), all sit in the top 10 holdings of the global tracker funds, while SpaceX is waiting in the wings to make a big entrance on most, following its record-breaking IPO in June 2026.

With it's more varied approach to selection, some argue that multi-factor investing offers a solution to this concentration risk. WTW lead portfolio specialist, Lucy Kruimel, says: "The primary objective of multi-factor investing is to improve long-term portfolio outcomes by systematically capturing multiple sources of return. A key part of achieving this is diversification, as spreading exposure across a range of return drivers can reduce reliance on a narrow group of stocks, sectors or investment styles and help create a more balanced and resilient source of return."

Multi-factors in action

What makes it work, according to Jaffray, is the fact that it removes the idea that bigger is necessarily better. "Most passive equity strategies allocate more money to companies simply because they are larger," he says. "A multi-factor approach takes a different path, systematically selecting companies based on characteristics such as value, quality, momentum, size and low volatility that have historically been associated with stronger long-term returns." It's not about predicting which stocks will outperform in the coming year, Jaffray adds, but about building a portfolio that is balanced and can deliver the best outcomes over time.

And where the multi-factor approach particularly effective is that different factors tend to perform better in different sets of circumstances. "Value may outperform during recoveries, quality may be more resilient during periods of uncertainty, and momentum can benefit from persistent market trends," says Isio director and head of defined contribution (DC) investment, Helyne Slade. "By combining factors, investors can reduce dependence on any one market regime."

Striking the right balance

Multi-factor strategies are mainly used with equities, says Russell Investments fiduciary manager, Aqib Merchant. Here the approach can be used to "replace part of a market cap weighted passive allocation, sit alongside active managers, or form part of a completion portfolio that corrects unintended biases across the manager line-up", he says. "Some schemes also apply factor approaches within credit, while factor analysis can identify common risks across the total portfolio."

When it comes to building an effective multi-factor strategy, then, it is a question of finding out exactly what is required for a given scheme. "There is no single model," says Kruimel. "Multi-factor investing can be used as a core equity allocation, replacing part of a traditional passive global equity portfolio, or as a building block alongside active equity managers. Many schemes view it as sitting between pure passive and traditional fundamental active management, offering systematic exposure to return drivers while maintaining broad diversification."

"For some schemes, this means building exposure through systematic index-based approaches, which seek to deliver transparent, scalable and cost-efficient implementation," Kruimel adds.

For other schemes, quantitative active managers might be a better fit, providing "greater flexibility to adapt factor exposures over time but typically at a higher cost and with greater manager discretion", says Kruimel. But ultimately, she says: "The appropriate approach will depend on an investor's objectives, governance budget and beliefs."

Multi-factor can be relevant for both DC and DB schemes, although the role a multi-allocation plays is likely to differ, says Kruimel: "In DC arrangements, multi-factor approaches are increasingly used within default strategies where trustees are seeking efficient, scalable equity exposure for a large membership base at a low cost."

"A multi-factor allocation can help build a more diversified equity portfolio and support better long-term retirement outcomes for members"

Importantly, as so often in pensions, the long game is what matters. Even small improvements to returns will make a big difference over long time horizons, thanks to compounding. "As a result, many DC investors view multi-factor investing as a way of seeking improved long-term risk-adjusted returns while maintaining broad diversification and cost efficiency," says Kruimel. And these strategies can be especially attractive because they frequently come with low fees.

As for DB, multi-factor can be particularly helpful "where schemes are looking to improve risk-adjusted returns without significantly increasing governance complexity", Kruimel says. "As schemes mature and become more focused on liability management, the overall allocation to equities may reduce, but multi-factor approaches can still play an important role within the remaining growth assets."

Diversification, improved returns over the long-term and lower fees are all big benefits for pensions investors – and Jaffray believes multi-factor has an important part to play in creating solid portfolios. "Passive equities remain the core building block of default strategies for members who are many years from retirement. However, more than half of the leading DC providers now use some form of multi-factor investing within at least part of their equity allocation," he says. "The rationale is straightforward. Providers are looking for ways to improve diversification, reduce concentration risk and potentially enhance long-term returns for members, while maintaining the cost and scalability benefits that make passive investing so attractive."

No silver bullet

While multi-factor approaches can be used to increase diversification and help to dissipate some of the concentration risks related to market cap funds, there are no guarantees. "Multi-factor portfolios weigh companies according to characteristics such as value, quality, momentum and low volatility, rather than market capitalisation alone," says Merchant. "A well-balanced combination may reduce reliance on the largest index constituents. However, if the portfolio is weighted towards growth or momentum, the overall portfolio may inherit that bias and retain significant exposure to technology and AI-related market leaders." He adds: "It should therefore not be viewed simply as a strategy for moving away from technology."

"Multi-factor investing isn't a silver bullet, and it certainly isn't a set-and-forget approach. Markets evolve and strategies need to evolve with them," Jaffray agrees. But, he adds: "Used thoughtfully, a multi-factor allocation can help build a more diversified equity portfolio and support better long-term retirement outcomes for members."

Written by Sandra Haurant, a freelance journalist