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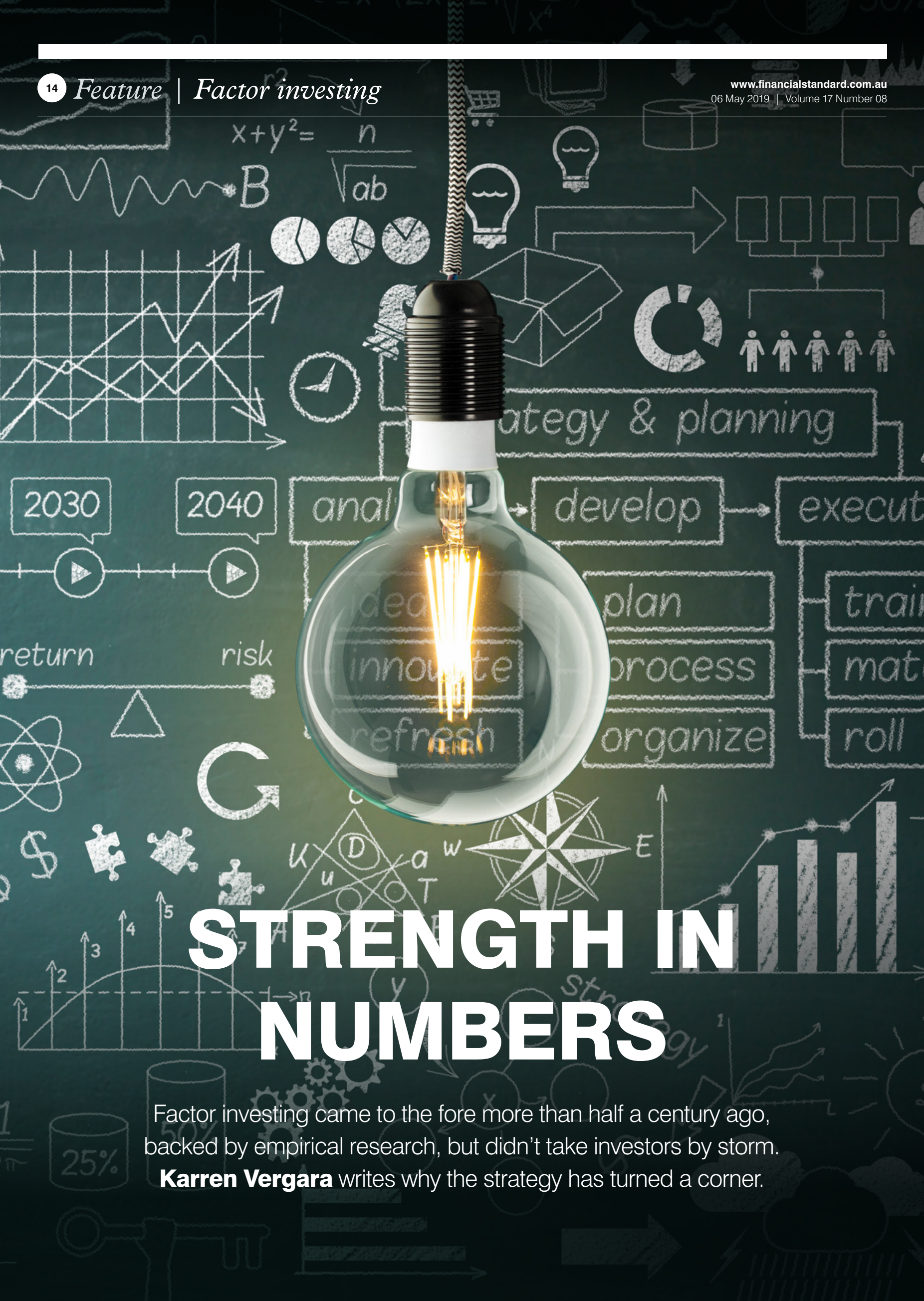

STRENGTH IN NUMBERS

Factor investing came to the fore more than half a century ago, backed by empirical research, but didn't take investors by storm. **Karren Vergara** writes why the strategy has turned a corner.

01:
Stephen Quance
director,
factor-based investing
Invesc

02:
Patrick Kuhner
head of client portfolio management,
Pan Asia
Rosenberg Equities

For an investment strategy that has origins dating back to the 1960s, it's a conundrum why factor investing has only gained more widespread acceptance in recent years.

Two years ago, Invesco director of factor-based investing Stephen Quance[01] said there was clear evidence that factor investing was getting closer to the "tipping point of mass adoption" in many markets.

While the complexity of factor investing remains challenging for all global investors, Quance admitted, a comprehensive survey by Invesco indicated that institutional and retail investors are poised to continue increasing factor allocations in the near term.

US fund manager BlackRock estimates the factor investing industry is worth US$1.9 trillion and in three years' time it will reach US$3.4 trillion.

This, however, is a sliver of the global asset management industry PwC calculates will balloon to US$145.4 trillion by 2025.

Yet, Quance is optimistic as he sees the market becoming more educated and comfortable with factor concepts.

"With the right support from the asset management community, factor investing can achieve its full potential as a permanent complement to other types of investment options," he says.

In its latest iteration of the study, which canvassed more than 300 institutional and wholesale investors globally in 2018, Invesco found factor investing is becoming the third pillar of strategic allocation alongside traditional active and passive or market-cap weighted strategies.

Invesco estimates about half of institutional investors and a minority (20%) of retail investors have adopted a factor strategy.

Albeit the smallest style component, what's promising for the factor-investing sector is the rate of adoption is no longer considered "experimental."

Eliminating biases

Factor investing essentially uses quantifiable attributes of a security or macroeconomic exposures to build portfolios, most commonly in equities and less so in other asset classes such as fixed income.

Figure 2 shows five of the most popular factors, but there are as many as 200 factors at play.

Patrick Kuhner[02], head of client portfolio management for Pan Asia at Rosenberg Equities, describes factors as a set of characteristics embedded in every stock.

"It is the quantification of these insights that has improved our ability to harness these factors as investors."

Visualise factor investing as a school of fish, Kuhner says, whereby each fish represents a stock. "Individually, each fish has its own characteristics, but as a group they act in a similar manner."

Each fish looks unique, just like each company is unique. But take a step back up, individual characteristics fade and common characteristics come into view, he says.

Thirty years ago, the idea of buying into 'value' as an investment idea wasn't so easy.

"What we have seen in the last 10 years is an explosion of tools and products targeting factor investing."

In the past, investment managers who thought they were delivering alpha generated something "unique," he says, but in fact their performance was driven by exposure to these now well-known factors.

As these ideas became more democratised in the market, new, inexpensive products were developed which investors embraced as an alternative for higher fee, active management.

Investors have caught on, meaning they did not want to pay a premium to a manager for simple factors like value, momentum, growth etc. because they can access those ideas cheaply today, he adds. "This is a big change in the industry."

According to Vanguard investment product strategy manager Rachel White[03], factor investing helps eliminate bias and streamline processes.

"Quantitative investing takes a systematic approach using formulas based on long-term academic theory and replaces financial anlaysis done by a human investment analyst at an active fund manager."

It takes the process of an investment analyst looking at price-to-earnings ratios and cash-flows and makes it extremely efficient, as well as removing the key man risk that is sometimes present in active management, she says.

Thanks to automation, quant and factor products are able to charge comparatively lower than active-style products.

Incidentally, White says Vanguard recently launched two factor-based global equity products: the Global Multi-factor Fund and Global Multi-factor Active ETF.

They combine three factors – value, momentum and quality – and charge 0.35% p.a. and 0.33% p.a. respectively.

While factor-investing demand historically came from global institutional channels, it has reached a turning point. "We are seeing that trickle down to the intermediary and advice clients and even to retail investors," she says.

The long game

Financial planning group Shadforth uses factoring investing when advising clients, but calls it "evidenced-based investing," says private client adviser Sally Huynh[04].

When 14 boutique wealth management and advisory firms merged in 2008 to form Shadforth, the advisers searched all the options available to recommend a core investment philosophy to clients. This included traditional active fund managers selecting stocks versus indexed strategies versus the evidence-based approach.

"We found the evidence-based investment approach to be the most efficient, effective and robust approach that would deliver the greatest benefit to our clients."

Furthermore, it reduces costs, minimises unnecessary trading and taxes, and implements a disciplined and well-diversified portfolio for clients, Huynh says.

Factors are blended as they all have a role to play and this provides an extra level of diversification.

"Some factors work well in some periods and others work in other periods. In the short term, sometimes they don't perform at all. That's why diversification is key."

Shadforth imprints a firm-wide investing philosophy among clients that investing is not for the short term for the reason that five to seven years is too short as economic cycles and share markets can take longer to recover over this time.

"If a new client comes to us wanting to invest over five to seven years, we turn them away. That does not fit our investment time horizon. "Our recommended horizon is seven to 10 years or more."

After taking clients through an educational journey of the group's investment process and philosophy they can choose to commit to, the advisers form a partnership.

"We believe this is a long term journey/partnership with our clients to help them through the good and the bad times in order for them to achieve a successful investment outcome," she says.

> *Investors predominantly see themselves as factor strategy investors, and that smart beta,and often active quant, are product applications of factor investing.*
> **Invesco**

Australia turns to growth

A 2017 UBS white paper that categorised countries across single factors – size, momentum, beta, value and growth – showed Australia represented significantly in the growth portfolio.

"This is interesting given Australia is often considered a value market due to its high dividend yield," it found.

It's not to say Australia hasn't demonstrated other factor characteristics at different points in time, the white paper said, but compared to the other 37 countries the Australian equity market spent most of its time exhibiting the growth factor.

Commodity-based markets New Zealand and Canada also exhibited similar results.

Frank Wirds[05], a client portfolio manager of quantitative equities at Robeco Hong Kong, says a low-volatility strategy typically does well when the equity markets generated negative returns because of its low-risk nature. The period between 2008 and 2011 is a prime example.

"On average, it performs significantly better when markets go down, it keeps pace in moderate returns, but in a strong bull market it typcally lacks."

ROBECO
The Investment Engineers

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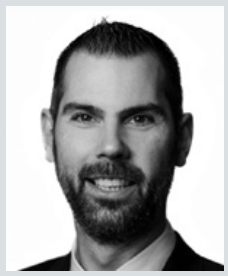
03:
Rachel White
investment product strategy manager
Vanguard

04:
Sally Huynh
private client adviser
Shadforth Financial Group



05:
Frank Wirds
client portfolio manager, quantitative equities
Robeco Hong Kong

He points out that it is better to do well in a down market than fully participate in a bull market because of compounding returns. "If you lose 50% you have to make up 100% to break even."

But institutional investors do not warmly embrace this type of investing.

Wirds says this is because they use benchmarks together with most equity managers who - unsurprisingly – are rewarded with bonuses if they outperform their benchmarks.

From a benchmark relative perspective, these low-risk stocks don't appear to be attractive. Wirds disagrees.

Low-risk stocks are attractive because they have a better Sharpe Ratio, a widely used measure of risk-adjusted returns, he says. "You get a better bang for your risk."

Kuhner says low volatility performed well in the last 10 years and incidentally, an influx of money flowed into low-volatility ETFs.

But low volatility underperformed the global index by 2% annualised over the 10-year period from 1990 – 1999, he notes.

"That can be a very difficult conversation with investors; to tell them one day this factor 'will pay off.' "While factor investing has a positive mean and upward sloping, it's not always positive or always upward sloping – it is on average – but there can be little consolation for those invested in low volatility during the 1990's," Kuhner says.

An academic paper by Robeco, *The volatility effect*, found low volatility earns high risk-adjusted returns after analysing about 2000 stock comprising the FTSE World Developed index during 1986 and 2006.

It highlighted the characteristics of a low-volatility strategy: relatively small drawdowns; low beta; outperformance in down markets and underperformance in up markets; and anti-bubble behavior.

While exploiting the volatility effect is not easy for benchmark-driven equity investors, the strategy is attractive for investors such as pension funds interested in high Sharpe Ratios, research co-author and Robeco head of conservative equities Pim van Vliet[06] said.

Such investors can shift from an allocation to traditional stocks to a higher allocation and to low-risk stocks by reducing their weighting to bonds.

"In order for this option to be taken adequately into account it is essential to include the decision to invest in low-risk stocks in the strategic asset allocation process," he wrote.

Asked why Robeco omits size a standalone factor, Wirds says it's because when looking at a small-cap portfolio it does not add enough value or improve higher risk-adjusted returns.

Embracing the evidence

Common practice in the Netherlands, Wirds says, is the adoption of low-risk investing and the shift away from the benchmark model.

Meanwhile, Australia is not necessarily letting go of benchmarks but it is starting to embrace the evidence that low volatility is a good diversifier in portfolios, he notes.

Wirds echoes the findings from the research conducted by UBS showing that value has been the most widely used factor here historically. But this is changing.

Superannuation funds for one, are increasingly adopting factor investing but still lag behind European pension funds, he says, which were one of the first to adopt low-risk investing, and lately are branching into other factors such as value or multi-factors.

Some factors work well in some periods and others work in other periods. In the short term, sometimes they don't perform at all.
Sally Huynh

The $28.4 billion New Zealand Superannuation Fund has ramped up its factor-investing appetite in recent years. It flagged it will appoint an additional manager alongside incumbents AQR and Northern Trust for equity factors soon.

Some 10% of its net asset value is dedicated to factor strategies across both managers.

Northern Trust and AQR each manage low volatility and value mandates that are combined into a single, integrated multi-factor portfolio, a spokesperson says. "We will also shortly broaden the opportunity to include two additional factors: momentum and quality."

Parametric Australia won a $200 million factor-based mandate last December from an unnamed super fund.

The tax-managed factor mandate measured against a custom after-tax benchmark marked a first for Parametric.

"In our discussions with super funds, we've seen interest in after-tax investing and factor investing as separate themes growing, so it was only a matter of time before they came together as a powerful solution," Parametric Australia's chief executive Chris Briant[07] said at the time.

As an example, Briant uses global shares in the value strategy in which the price of a particular stock has risen so it no longer represents a value stock and must be sold.

A non-tax-managed strategy would sell the stock and not acknowledge that some of the gain has is taxed. The investor would then pay further tax out of this gain, he says.

"A tax-managed factor would go further and think about the most tax-effective way to sell the stock so that more of the gain stays in the hands of the investor."

Some techniques could include allocating stocks with embedded tax losses not gains; delaying the trade to attract the CGT discount and trading cum-dividend to reduce withholding tax payable, Briant says.

The three pillars

In the passive and active investing spectrum, factor investing sits snuggly in the middle. Its transparency, rules-based and low-cost attributes are like passive investing, but at the same time generates an active return.

Resonant Asset Management chief investment officer Nick Morton[08] says there are benefits to combining quant and fundamental techniques into an active portfolio process, in what is known as the "quantamental approach."

Quant, which focus on constructing investment factors built on sell-side analyst forecast data, market data, macro-economic data and so forth, has a long history in equity markets, but recently enjoyed greater uptake via advances in computing, cost pressures in the wealth man-

Figure 1: Five common style factors in equity

Systematic factors	Seeks to capture	Commonly captured by
Value	Excess returns to stocks that have low prices relative to peers with higher prices in the long run	Price/book ratio, price/earning ratio, cash earnings, net profit, dividend yields, cash flow
Size	Excess returns of smaller firms (by market capitalisation) relative to their larger counter parts	Market capitalisation (full or free float)
Momentum	Excess returns to stocks with stronger past performance	Relative returns (3-mth, 6-mth, 12-mth, sometimes with last 1-mth excluded) historical alpha, earnings expectation
Low volatility	Excess returns to stocks with lower than average volatility, beta, and/or idiosyncratic risk	Standard deviation (1-yr, 2-yrs, 3-yrs), downside standard deviation, standard deviation of idiosyncratic returns, beta
Quality	Excess returns to stocks that are characterised by low debt, stable earnings growth, profitability, and other "quality" metrics	Return on equity, earnings stability, dividend growth stability, strength of balance sheet, financial leverage, accounting policies, strength of management, accruals, cash flows

Source: Invesco

06:
Pim van Vliet
head of conservative equities
Robeco

07:
Chris Briant
chief executive
ParametricAustralia

08:
Nick Morton
chief investment officer
Resonant Asset Management

agement industry, and an explosion in smart beta funds both listed and unlisted, he says.

While its track record over the long term is positive, the strategy can struggle during bouts of volatility or shifts in the market regime.

This is precisely the periods where discretion or a fundamental strategy can supplement the portfolio, he points out.

Rosenberg Equities' Kuhner says a traditional stock picker on one hand, with a basket of 20 or 30 stocks is trying to find idiosyncratic or specific mispricing of a stock in order to generate alpha.

"They don't necessarily need to be in a particular economic cycle, or a specific style of stocks, or a sector or industry, they are looking for an individual stock mispricing opportunity. They just need this single, stock specific, mispricing opportunity to revert to the expected fair value."

Factor investors on the other hand, need broad trends to take hold in order to derive excess value.

In other words, the whole school of fish will need to swim in a certain direction for the factor to be rewarded, Kuhner explains.

"A stock picker would need one or two of the fish to perform."

To make a quantamental strategy successful, Horton says it needs to be an "equal marriage."

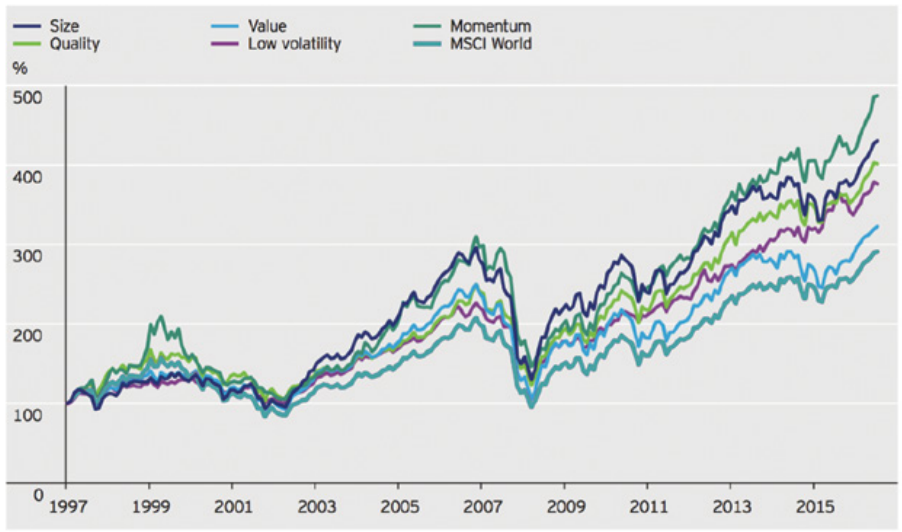
"Both quantitative and fundamental decision makers must have equal say in the portfolio. If either one or the other has precedence, there is no collaboration."

Next, technology and data collection must be up to scratch, and an investment culture of peer review and diverse perspectives are a key requirement.

The end goal of quantamental investing is to generate better risk-adjusted returns for clients, by tapping into factors and stock specifics to create a more resilient whole to various market conditions, Norton says.

The outcome is better than a pure quant process as the market switches from low volatility to a high volatility regime and more superior to a fundamental process when the opportunity set is poor and the market is trending, he notes.

Figure 2: Factor strategies – Historical index data shows outperformance potential



Source: Invesco and MSCI data from 31 December 1997 to 30 June 2017 (total return in USD)

U$1.9tn
Size of factor-investing sector.

Patience is key

While factor investing may be gaining the traction it deserves, a few barriers still prevent it fully moving from the margins to the mainstream.

For one, factor-investing terminology has yet to find its feet. Barriers such as vague definitions and poor communication still hinder its widespread take-up and how the strategy is applied in portfolios.

Three major terms are applied, which at times are used interchangeably or synonymously: factor, smart beta and active quantitative strategies, Invesco's 2018 study found.

Compounding the confusion, views vary widely on what each term means and how they relate to each other – even whether they are different.

In Invesco's survey, 'factor,' which describes the overall strategy of systematic investing, is the leading term among respondents.

"Investors predominantly see themselves as factor strategy investors, and that smart beta, and often active quant, are product applications of factor investing."

In other words, active quant and smart beta sit under the umbrella of a factor strategy term. This hierarchy resonates more in North America than Europe and APAC, Invesco found.

Another minor drawback is the investment timeframe. Given that it recently garnered more interest, few factor investors have a time horizon stretching back 10 years or more, the research said. Only a third has four to eight years of experience, and half are relatively new.

This is important because it is hard for investors "to assess the true effectiveness of factor investing until they have experienced a full market cycle, including volatile and declining markets."

But factor investing rewards investors' long-term commitment and patience. In Figure 2, the outperformance potential of factors says it all.

Shadforth financial advisers endorse factors or evidence-based strategies because it's simply that: black and white, transparent - and scientifically proven.

"If there's a better approach that has stood the test of time, we'd like to see the evidence," private client adviser Huynh says. **FS**