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Multi-factors smooth the ride

A smart beta fund built on the factors of value, quality and low volatility, the SPDR MSCI World Quality Mix Fund produces a diversified return stream without the big drawdowns of single factor strategies.

Over the last six months State Street Global Advisors (SSGA) has seen its strongest investor interest in multi-factor investment strategies.

It reflects a time where traditional single-factor investment approaches, normally the domain of sophisticated and large investors, have been put aside to target a smoother ride in volatile and often event-driven markets.

State Street Global Advisors APAC head of portfolio strategists, Jonathan Shead [01], says this increased interest in multi-factor investing was born out of the Global Financial Crisis – and more so over the last five years.

Shead says post-GFC, SSGA has seen more interest in factors such as quality and low volatility. However over the last three to six months the firm has seen more enquiries about value as a factor.

"But behind all of that, what we've seen the strongest growth in is multi-factor strategies – investors not trying to pick one strategy but choosing to get exposure to multiple factors," Shead says.

The increasing interest in multi-factor investing is identified in funds such as the SPDR MSCI World Quality Mix Fund (QMIX). It seeks to provide investment results that, before fees and expenses, generally correspond to the total return performance of the MSCI World Factor Mix A-Series Index. Since inception in 2015 the fund has a return of 6.46% net of fees. The index has a return of 6.26%.

The index is also an equally weighted combination of three factor indexes — MSCI Value Weighted, MSCI Minimum Volatility, and MSCI Quality — rebalanced semi-annually to keep weights in line.

QMIX delivers rules based active factor exposures, similar to the stock selection techniques used by fundamental or quantitative active managers, but with the benefits of passive investment efficiency.

"When we built QMIX we were looking for value, low volatility and quality – these being what we thought were three of the strongest factors that are most easily understood by the market," Shead says.

He says QMIX was appealing in its design because it fills the ETF remit: broadly diversified low cost exposure to a market – whether Australian or global. By geography QMIX's top weighting is in the US (about 58.6%), followed by Japan (8.8%), and the UK (5.7%). The fund's highest sector weighting is IT (16.9%), followed by financials (14.3%), and consumer staples (12.9%).

The value of smart beta

He says when investing in a factor-based ETF it's important to understand the factors that you're buying; understand how the ETF is put together; and then understand what the variance against more traditional indices is going to look like. SSGA likes smart beta ETFs that have clear factors and that are easy to understand.

Shead explains that as co-mingled investment products, ETFs and unlisted funds have become more readily accessible, "we've certainly seen the range of investors using smart beta strategies increasing."

"Smart beta strategies are both active and passive at the same time. They're active in as much as they don't track indices like the ASX200 or the MSCI World, but at the same time they're passive. They're passive because they're low cost, widely diversified and transparent," he says.

"If you want to try and improve your returns by being a bit more selective about the securities you've selected in your portfolio, then a smart beta ETF allows you to do that in a low-cost, diversified, transparent and effective way.

"In a way it's a natural progression from how ETFs have already been used by investors across the globe."

Adoption of smart beta strategies is something SSGA has seen grow over the last five to 10 years. Shead says if you wind the clock back over 10 years the earliest adopters tended to be value-type smart beta strategies, and although SSGA has seen more enquiries about value as a factor, investors are yet to really adopt value in smart beta.

He adds that historically large institutional investors would tend to go for a single factor approach because it allowed them to take full responsibility for exposure within portfolios. Other investors have been more likely to adopt multi-factor approaches, Shead says.

"Having said that – we've had conversations with very large investors in recent years that have been looking at multi-factor approaches as well," he says.

"In the early days it tended to be large investors, this was more a sophisticated approach to passive investing. But we've seen far more ETF and wealth-based clients using smart beta in the last few years."

The quote

We've had conversations with very large investors in recent years that have been looking at multi-factor approaches.

Watch the video on www.fsitv.com

Factor and event timing

Most fund managers would wish for a crystal ball for what to do in event-driven markets such as Brexit and Trump. Shead says investors should expect different factors to perform well or perform poorly in different environments.

"Going into Brexit it was the low volatility, the quality kind of factors that did particularly well. Coming out of the result in the US election, it was value type factors that tended to do particularly well," he says.

"What we see in multi-factor products is kind of a smoother ride, so you'll tend to get one factor contributing strongly, another factor perhaps detracting from returns and another factor somewhere in the middle."

He adds that multi-factor products over the last three to six months have produced reasonable returns without some of the big drawdowns that you see in single factor strategies. He says large institutions historically have tried to time factors in single factor approaches, but they soon realise just how hard it is to achieve.

SSGA says research has shown that stocks with inexpensive valuations, high quality balance sheets and earnings, as well as low volatility characteristics, have historically provided higher long-term, risk-adjusted returns with fewer drawdowns relative to traditional broad market exposures.

"It's not to say timing factors can't be done, it can be done, but it's much more difficult than people realise. If you look at the analogy of an equity market and timing an equity market, everyone knows how hard that is. You've got two or three decisions you have to get right over a five year period. Otherwise it's just not going to work," Shead says.

"Did you get the GFC right; did you get 1987 right; did you get the Trump election right – factor timing is a little bit like that – there tend to be two or three points in history you really need to get right, otherwise it's just a 50/50 call.

"We think the most sophisticated investors can probably get factor timing right six times out of 10, but for most investors we suggest just being diversified across a range of factors is the way to go." FS