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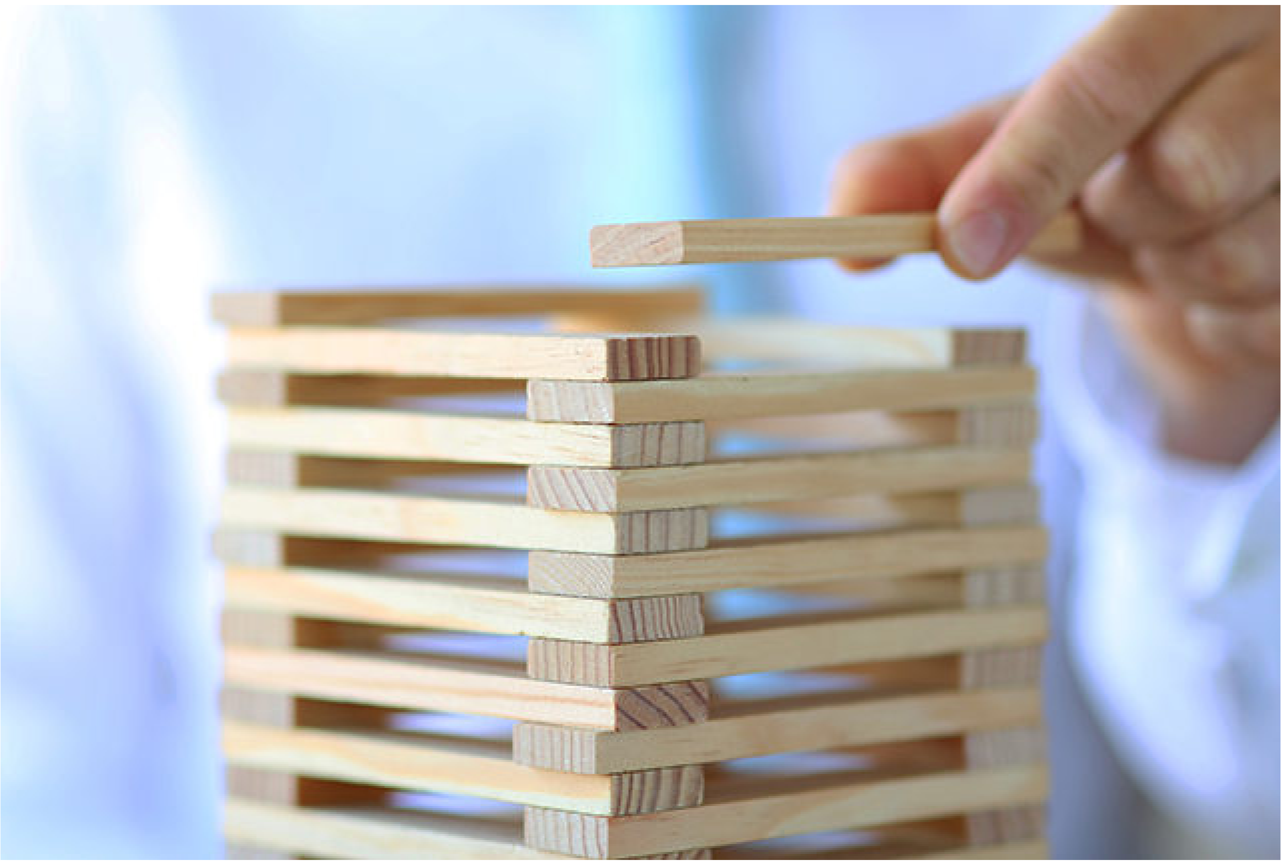
Factor-based investing – are you and your clients up to speed?



- Demographic shifts caused by baby boomers entering retirement
- New regulations
- The low return environment
- A forensic look at costs

These are a few of the trends causing a growing number of investors to seek alternative, transparent and cost-effective investments that can help them bypass some of the common challenges of actively-managed funds and market-weighted indexes. These investors aren't necessarily shunning traditional cap-weighted indexes or the principles of active management. Rather, many are looking for a way to *optimize* the range of active and passive strategies that may make up their total portfolios.

Increasingly, investors are turning to factor investing strategies (sometimes called smart beta) for this. It helps that implementing factor beliefs has become easier and more cost-effective as the instruments and trading strategies required have become more widely available. In our view, continued growth in adoption of factor investing appears likely.

For those not as familiar with factor investing strategies, a quick refresher may be helpful:

How factor-based strategies work: Factor based strategies are designed to add value by systematically selecting, weighting, and rebalancing portfolio holdings on the basis of an investment characteristics other than market capitalization.

The 4 most common factors used in equity investing, based on our research

1. **Value**

   One of the oldest forms of active equity investing, value investing focuses on companies with high intrinsic value, where the stock is selling at a market price below the true value. We often find that value investors can go for extended periods where their portfolios are underperforming the market, and then recover in a relatively short time.

2. **Momentum**

   Pioneered in the early 1990s, momentum investing presumes that if stocks have performed well for the past 12 months, they probably will continue outperforming the market for a short period in the future. Momentum and value tend to be negatively correlated - when value is outperforming the market, momentum often isn't doing well.

3. **Quality**

   The most recent factor to join the list, quality investing considers three essential elements of a company: management efficiency, financial strength, and earnings profile stability. Quality is also considered one of the most stable factors, which means that excess returns can be fairly consistent over time. This factor also tends to see small active drawdown levels, but that means the excess returns delivered by quality are often not as strong as those from factors such as value or momentum.

4. **Low-volatility**

   It identifies stocks that display a lower level of risk than the overall market. Low-volatility equities often outperform when the market is falling, and frequently lag when the market is rising. From a performance pattern perspective, low volatility carries very low levels of absolute risk, but high levels of active risk relative to a cap-weighted index.

7 things to consider when choosing a factor-based strategy

1. **Due diligence**

   It is important to apply the same level of due diligence to a factor-based strategy as to any actively-managed portfolio.

2. **Long-term versus short-term performance behavior**

   The long-term performance of factor-based portfolios may be promising, but underperformance in the short-term is a real risk. Investors need a clear rationale for following a particular strategy, so they remain disciplined enough to stay the course during difficult times.

3. **Diversified mix of multiple factors**

   Investors should consider a starting strategic allocation to a diversified mix of multiple factors to attempt to achieve a smoother return stream. Although single factor exposures may be expected to outperform the market over the long-term, they may suffer prolonged periods of underperformance in the short term.

4. **Single multi-factor portfolio**

   Investors should consider a single multi-factor portfolio which aims to preserve the underlying single factor exposures but capitalizes on the cost-effectiveness of a single implemented portfolio.

5. **Value expertise**

   The quality of the factor construction and trading of the portfolio can have a meaningful impact on the return pattern of the strategy. This deep understanding requires expertise and resources.

6. **Intentional alignment with strategic beliefs**

   Investors should consider a holistic view of their portfolio to ensure the factors they are exposed to, from both active and passive strategies, are done so intentionally and are aligned to their strategic beliefs.

7. **Establish a reasonable time horizon**

   Given the variability in factor cycles, ensure that an appropriate time horizon is set to capture the factor returns over a full market cycle.

The bottom line

A number of trends are making factor investing a potentially attractive investment option for many investors. As with any investment, make sure your clients are aware of the benefits and drawbacks of such investments, and that they are clear about the role factor-based strategies can play in an overall portfolio.

Disclosures

Read this post on our blog: https://blog.helpingadvisors.com/2017/01/24/factor-based-investing-clients-speed/