April 11th, 2017

Russell Investments,

Multi-Asset investing: How might factor exposures help?

By Bob Collie, Chief Research Strategist – Americas Institutional

A few weeks ago, I posted about the use of factor exposures (widely referred to as smart beta) in a multi-asset portfolio. In this post, I return to that topic, focusing this time on the question of implementation.

A hierarchy of return sources

The most basic implementation decision is the size of the position to be taken. Once again, let's turn to Rob Balkema for a description of Russell Investments' approach to multi-asset portfolio construction (Rob is Senior Portfolio Manager, Multi-Asset Solutions, responsible for managing a number of multi-asset pools.) Top of the pile, as it has always been, is asset allocation policy: "Strategic asset allocation is the most impactful decision in meeting client outcomes."

He goes on to describe a hierarchy of strategies for generating excess returns above the policy, beginning with security selection: "We believe security selection skill is the most repeatable source of excess returns, so we want it to be the largest driver of our risk budgeting." The premia associated with factor exposures are next on the list: "The payoffs for these factors come in the long run, and there can be long periods of underperformance. The episodic payoff means we allocate a smaller portion of the risk budget and we are careful to diversify the positions we take."

In other words, even though factor exposure management grabs a lot of the attention these days, it's a complement to other sources of return in a multi-asset portfolio, rather than a replacement for them.

As well as the long-term premia associated with selected factor exposures, there is also the possibility of varying those exposures according to market conditions in order to seek to enhance returns further. Rob notes that this can be helpful - up to a point: "Dynamic management operates with a shorter horizon, and involves fewer positions. So we devote a relatively small portion of our risk budget to this. Importantly, much of the information on timing is in the extremes and we operate within a mantra of ‘first, do no harm'."

Within that general framework, the size of each exposures will depend on the conviction in the underlying belief and on a combination of fundamental analysis, quantitative risk analysis and the expectations created by past performance patterns. Rob describes it this way: "You need to look at the question through all three lenses: fundamental, risk and performance. How has each factor behaved historically in different regimes? And you need to think about what the numbers are telling you: for example, a currency value factor position would have meant being long the U.S. dollar in 2008, but in 2017 it means being long emerging market currencies. The historical performance would tell you one thing about the factor correlation and portfolio fit. It's the same factor but today's make up would give you a different answer around sizing and portfolio fit. This is why multiple lenses of analysis are needed."

Vehicles for implementing factor positions

Russell Investments portfolios make use of a combination of specialist money managers (primarily focused on security selection in their field of expertise) and direct management (used, for example, to achieve more precise management of overall portfolio positioning.) Factor positions might be managed through either of these. Direct management is often simplest and cheapest, but it's not always the chosen path. As Rob explains: "For a small cap position, for example, we believe there is a value return premium but there's also active return opportunity; alpha. We can get both by having a small cap specialist manage that exposure. We might also use a specialist manager when it's operationally difficult to capture an exposure: that's true, for example, of a multi-asset volatility exposure across rates, currency, equity, commodities and so on. It can be worth hiring a specialist for that."

Other practical considerations in the implementation of factor exposures include making sure constraints on leverage are satisfied, handling collateral and minimizing transactions costs.

In short: while factor exposure management is today playing a greater role than ever in multi-asset portfolios, we believe the implementation of a factor strategy is far from a trivial exercise.

Disclosures

Russell Investments' ownership is composed of a majority stake held by funds managed by TA Associates with minority stakes held by funds managed by Reverence Capital Partners and Russell Investments' management.

Frank Russell Company is the owner of the Russell trademarks contained in this material and all trademark rights related to the Russell trademarks, which the members of the Russell Investments group of companies are permitted to use under license from Frank Russell Company. The members of the Russell Investments group of companies are not affiliated in any manner with Frank Russell Company or any entity operating under the "FTSE RUSSELL" brand.

The Russell logo is a trademark and service mark of Russell Investments.

Copyright © Russell Investments Group, LLC 2017. All rights reserved. This material is proprietary and may not be reproduced, transferred, or distributed in any form without prior written permission from Russell Investments. It is delivered on an "as is" basis without warranty.

Russell Investments Financial Services, LLC, member FINRA (www.finra.org), part of Russell Investments.

Read this post on our blog: https://blog.helpingadvisors.com/2017/04/11/how-might-factor-exposures-help/