What exactly is factor investing? How does factor investing differ from other investment styles, such as smart beta or risk premia?

Factor investing is an investment strategy where assets or securities are selected on the basis of attributes such as price-earnings multiples etc. The goal is to generate a higher return than in a passive investment based on market capitalisation only. Similar terms are smart beta or risk premia investing. Probably the best differentiator between smart beta and factor investing is that smart beta is more focused on a risk/return ratio by lowering risk, while the goal for factor investing is to achieve better returns with similar risk. Risk premia investing could be described as a subset of factor investing. It relates to the ‘why’ there should be a higher return. Some factors could be interpreted as being remuneration for taking additional risks; not necessarily a market risk, but often personal risks. For example, as a contrarian value risk premia investor you are positioned against the crowd and you may be wrong for a long period of time. This may trigger many questions and pose your career at risk.

By contrast, a factor investing strategy like quality does not target remuneration for risk, but exploits inefficiencies in information processing. Quality is difficult to analyse and measure. Investors who are able to identify well-run companies on a large scale can benefit from these information processing capabilities.

How has factor investing evolved? Has it been around long, or is it still quite new?

The key question is more a question about terminology. So the terminology ‘factor investing’ is fairly new. But the underlying principles are fairly old. In the 1990s we researched factors that outperformed the market. At the time it was called ‘market anomalies’ and ‘style investing’. Obviously, with advanced technology, factor calculations have become more sophisticated.

I think what’s fairly new, though, is that you have passive or semi-passive ways to implement factor portfolios, of which many use exactly the same factor definitions. This is coupled with a more active factor allocation policy conducted by in-house teams or consultants. Historically, you would have a quantitative manager who identified and combined factors, but the new idea is to identify or combine factors yourself, or using a consultant, and then hire a passive implementer like an index provider or an ETF. The problem with that is that factor portfolios are not 100 per cent passive in the sense that they have limited capacity. Too many people may be copying the same factor or portfolio, so we run into a factor bubble trap.

How popular is factor investing for European pension fund investors?

Currently we see a growing interest from institutional investors in general. The clear advantage institutional investors seem to see in factor investing is mainly a cost advantage. There is a big pressure because of lower returns in capital markets, and regulatory complications. So there is a strong desire on the asset owner’s side to reduce costs within active management. However, the challenge is to see the complexities related to that and that they have to invest in resources to pick and combine factors and choose the right vehicle or manager for implementing factors.

What are the challenges and pitfalls with factor investing?

One benefit is that you have something better than just passive, i.e. market cap investment, with less cost than a full-fledged active product. However, the challenge is that as an
What are the pros and cons of single-factor investing versus multi-factor investing?

The big advantage of single-factor investing is that it is simple. You have a single rule that is well described, so you can implement it cheaply. You can buy something like an index product; it’s all very simple. The disadvantage is that it may not work over a long period of time. Let’s take the example of ‘value’. Something like a value factor means you buy cheap stocks measured by multiples. Now, that worked great after the TMT bubble, where all the overvalued stocks underperformed. But it did not work at all during the financial crisis and the following Euro crisis, where cheap stocks were typically banks or financials or other cyclical stocks. They underperformed, although the market was already falling. One remedy to that would be that you look at multiple factors or multiple dimensions of companies. So you would not buy the cheapest stocks but you would buy cheap stocks if you adjust for the profitability of a company or its leverage. That would mean, in practice, you would not buy banks but you might buy some industrial company.

Is it possible to time factors and if so, how?

It would be great if we always knew for certain which factors work beforehand. However, it turns out that in practice it is quite difficult because you have trends that last for a long time. However, there are techniques where you can at least identify when certain styles or certain market segments are extremely expensive or overcrowded and these are situations where you should probably be careful.

What are the warning signs of factors looking overcrowded?

Warning signs are definitely flows. So if you can identify (technically that’s a little bit of homework to do) that a lot of money is going into certain styles or factors, then that is a warning sign. If the dispersion of fundamental characteristics between one factor portfolio and the market is becoming too large, for example if a factor portfolio is becoming expensive measured relative to the market, that’s a warning sign. Also if the outperformance of a sector is enormously high compared to history, that’s a warning signal too.

Where do you think factor investing fits within an institutional investor’s portfolio?

Well, clearly it fits somewhere between pure passive, which I would define as market cap, and traditional active. In my opinion you should have a clear strategy. So if you want to follow the semi-passive route using factor indices or ETFs, then you need to allocate internal resources to it. If you don’t have them, then you would be better off using active quant managers with this expertise.

Quoniam has expertise in factor investing since 1999. So we think that, as an active factor investor, we can clearly show that over various market cycles this approach has generated outperformance, while many of the index products, or simple factor portfolios, are relatively new and do not have real life track records. If you look at something like an index ETF, the index is back-calculated and then the ETF product is launched. It is not that you have 10 or 15 year of live track record for the ETF portfolio.

What do you think investors need to do to implement factor investing? What practical tips would you give?

There is always the question of how much you want to do internally versus outsourcing asset management. One approach is to insource lots of things, where you would have to build up an internal expertise on factors. At least you would need strategic portfolio management in house. The other extreme would be to outsource most of the factor allocation and factor combination to external managers. That could be an active quantitative manager. And you have things in between, where for example a consultant would select factors or factor managers. But the more you want to save on costs or on management expertise, the more you need to do in house. So there’s nothing like a completely free lunch.

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