pi roundtable

FACTOR INVESTING

BlackRock

portfolio institutional
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DISCUSSION: FACTOR INVESTING

portfolio institutional's factor investing roundtable looked at many facets of the approach, which proved to be a highly fruitful debate. *Andrew Holt* witnessed the discussion.

Global markets consist of numerous asset classes and thousands of individual securities, making it challenging to discern what truly matters for an investment portfolio.

However, a few key drivers can help explain returns across asset classes.

And, it could be said, just as individuals have different nutritional needs, investors have different optimal exposures to various risk factors.

This was the premise to the portfolio institutional factor investing roundtable.

The best place to start such a conversation is by addressing the basic premise: what do we mean by factor investing? Jamie Forbes kicked off the discussion with her interpretation: "By definition, factors are drivers of risk in markets, and therefore, portfolio returns," she said.

Historically, Forbes added, active managers selected stocks based on certain characteristics.

"Academic evidence found that what these active managers were doing could be characterised by grouping these stocks into strong drivers of returns.

This led us to a world to target those factors and serve as a tool for portfolio managers to construct portfolios and manage risk."

Hence, factor investing was born.

On the underlying philosophy of factors, Forbes said that these are companies classically considered undervalued relative to fundamentals, or highly profitable companies with strong earnings, as well as low volatility stocks and small companies.

"These are characteristics that generally investors get paid a premium for holding the risk and deliver a premium over time and get compensated for holding them," she said.

On a similar level, Ben Garland said it is important to understand what factors are, and what they are not. "We can talk about factors as anything that describes a return. That is not really the case," he said.

"What we are talking about are a handful of fairly well-established value, quality, momentum size, low volatility, maybe high-yield, maybe growth factors. These are not new concepts," Garland said.

He then asked: the big question over the long run has to be, is there an associated premium with these style factors? "Over

the long run the data says: yes," Garland said, answering this question.

Factor logic

This then started a debate about the essence of factor investing.

Mark Thompson said the factors mentioned are "good ones," but he also said when investors invest in a factor there has to be some logic or belief as to why that factor will outperform. "For example, what is the theory of why the 'value' factor would work?"

Lynne Stewart-Brindle also wondered when is a good time to invest in factors.

Responding, Forbes said there are economic and financial analytical elements underpinning factor investing, as well as a diversification benefit, which will then serve as good guides for investors.

Continuing the questioning theme, Stewart-Brindle said she did wonder when things start to get "overly complicated" in the investment decision-making process, especially for trustees.

"I have seen different styles come and go. So while I can understand the [factor] concept, and while more data is good, I get slightly cynical about what is the real benefit and what is the value it is adding?"

Forbes contested that factor investing, given its underlining principles, is easy to understand.

But on value, Garland had something interesting to highlight. "Value over the last 10 years has struggled," he said. "So a lot of this comes down to philosophy: you need to believe in the economic rationale underpinning all of these factors. But you also need a long-term horizon."

> **"Even a market-cap benchmark is going to have factor biases in it.**
>
> Jamie Forbes, iShares EMEA

Speaking of factors in a different, but nonetheless positive way, Thompson said there is a cost benefit to factor investing. "You could just have a market-cap index. For that, a trustee would not pay a lot," he said.

THE PANEL

Jamie Forbes
Director
iShares EMEA

Ben Garland
EMEA head of factor index products
MSCI

Alan Pickering
President
Best Trustees

James Price
Investment consultant
Willis Towers Watson

Lynne Stewart-Brindle
Partner
Pan Trustees UK

Mark Thompson
Chair of trustees
M&G Group Pension Scheme

"A trustee could invest with an active 'value' equity manager for which the fee would be higher. A passive 'value' factor strategy would be a much lower cost. But you have to believe that 'value' is an appropriate approach to start with."

Factor or theme

A discussion then centered around what is a factor and what is a theme. For example, is artificial intelligence a factor? "No, it is a theme," said Garland. "That is where it can get confusing," he added. "People get thematic megatrend type of ideas that are cyclical rather than secular and confusing that with factor investing. The lexicon is those value, quality, momentum size, minimum volatility – that is factor investing."

When it comes to the benefits of factor investing, these are usually cited as three inter-related parts: one, an improvement in portfolio outcomes; two, a reduction in volatility, and three; an enhancement of diversification.

To these, the panel had much to say.

Garland said that to state the benefits of factor investing is, in fact, too vague. Instead, he set out how to approach factors. "Who should invest in factor-focused products? It is, after all, not for everybody. It requires sophistication.

"There exists a broad array of products. So investors should focus on their strategic asset allocation. Those building blocks will always be the major drivers of risk and return," he said.

> **We all are factor investors. To be an investor, is to be a factor investor.**
>
> Ben Garland, MSCI

Garland also said how some investors who say they do not use factors in their portfolio are, in fact, misguided. "That, using the food analogy, is like saying you don't eat fat, protein or carbs, I just eat food," Garland said. "It is uncontested in the industry that value, quality, momentum, growth and volatility are style factors that drive risk and return in markets. And factor investing helps investors to better understand the drivers of risk and return."

One size does not fit all

Therefore, through factors, investors can be more targeted about those drivers of return. "And ultimately building better portfolios," Garland said.

"Nobody panics when equities have a couple of bad years of return," he added. "It is a similar story with the value premium. Value stocks are riskier than growth stocks over the long run. There is no reason to panic. These are all premia that can be incorporated into your portfolio and build a better portfolio. But there is no one-size-fits-all."

James Price expanded on this. "There are several factors. They will do well at different times, so you probably want exposure to a range of them," he said.

When it came to the practical application of factor investing, Alan Pickering noted that factors have a valuable role to play in the world of defined contribution pensions. "Particularly where investors have different attitudes and a focus on ESG. And factor has a role to play, as I think responsible investment will be with us forever," he said.

Forbes also noted the strength of factors for those investors. "The DC [defined contribution] investor wants to have certainty of a good outcome, that means the growth of that pot, and doesn't want to see that fluctuate, so that is where factors can be put together and take advantage of the natural diversification benefits of combining factors to be a more cost-effective source of returns," she said. Although Forbes also said: "As well as having that lower volatility, they have to be used well in combination."

Garland noted that it came back to the point that factors are for the long-run investor. This is what investors in DC land want, Pickering said. "This should be the starting point for those governing DC schemes," he added.

> **"There is a fixation of liquidity in some investing, but I don't want DC members to be day traders.**
>
> Alan Pickering, Best Trustees

Thompson also argued a fourth point on the benefits of factor investing: lower cost. "Comparing it to an active manager doing these things, factor is cheaper," he said.

The cited benefits were not completely shared by all the panelists. "You could challenge all of those benefits," Stewart-Brindle said. "All of those benefits listed could equally be applied to any portfolio, which could not be described as factor investing."

Redefining factor

Moving the discussion on, Thompson said that how investors use factors can, and should, evolve. "You need to build into the investment process the ability to think about it and have the ability to change," he said.

Forbes said BlackRock has indeed evolved factor definitions over time. "Science-based targets and climate are good examples," she said. "A lot of research demonstrated an indication that science-based and climate commitments can capture quality companies."

But on the point of asset managers needing to evolve, Forbes added: "Yes, and our clients expect us to." On this, Garland said: "I don't think the industry needs more strategies and products. Albeit, everyone is trying to improve, enhance and do things better."

Another point made by Price was on the issue of investor choice. "Factors as a source of risk and return are still slightly unconventional," he said. "There is an understated commitment that the equity-risk premium is going to be fine. But if you exclude the US from global markets there are lots of equity markets that have gone sideways for long periods of time. At that point, if equities are not delivering the returns investors are looking for, capturing factor premium becomes more important."

Returning to the name of factor and its uses, Alan Pickering said: "What is factor? Is it not a case of harnessing different techniques and factors with a small 'f', which might be a technique or techniques that fit into a DC master trust for the next 20 or 30 years."

Stewart-Brindle highlighted the questions facing investors of when to go for value overgrowth, or active v passive. "It therefore adds yet another level of complexity to decide on factors."

The right framework

Which did raise the point of how do investors decide on the right factors for the right time?

"The framework we think about around which factors, and at what time, we look at three component parts," Forbes said. These, she said, are one, economic regime, and which factors do well in these regimes.

> **Factors as a source of risk and return are still slightly unconventional.**
>
> James Price, Willis Towers Watson

"Two is looking at the valuations, and what is attractively priced. The third is the momentum around a factor.

Although she noted institutional investors don't always follow this approach, they follow four or six factors and take a more long-term approach.

"We take a view that timing these factors is harder than timing sectors, asset classes or countries," Price said.

Back in fashion

The panel then turned to the issue of why factor investing is back in vogue.

"It has been for a while," Stewart-Brindle said. "Anything like factors that bring a degree of sophistication, along with a degree of confidence, is sought after to find new solutions to old problems."

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> Lynne Stewart-Brindle, Pan Trustees UK

Although Thompson offered a different take: "I wasn't aware it had gone out of vogue," he said. "It has grown rather than gone away."

But Garland conceded that factor investing has had a tough decade. "Several factors have performed fairly badly. And as such, interest has waned. There has been a huge focus on ESG and climate, and factors have taken a back seat during a period when performance has been challenged," he said.

But Garland added that there is real nuance within this, citing the last five years as an example, with factors lagging the broad market, which has been up 13% on average each year for the last five years. "But investors wanting a smoother ride, and up when the market is down, most would say sign me up to factors," Garland said.

On this, Pickering reiterated the point that in DC land institutional investors have a much longer-time horizon, and therefore factor fits the bill. "There is a fixation of liquidity in some investing, but I don't want DC members to be day traders," he said.

The issue of volatility, and how factor deals with it, was also important to Pickering. "Volatility is important in DC land. If we can dampen volatility without a paying too much of a premium, then members are going to have faith in what we are doing on their behalf," he said.

Factor investing could well be a good option for the DC world, agreed Stewart-Brindle.

Although Price countered that using factors to reduce volatility is not necessarily a strength in all cases. "You can use factor investing to reduce volatility, but you may also choose to have less in equities and more in bonds. These are great tools to manage a portfolio's risk profile. For some investors using factors will be an additional tool for portfolio management while, for others, it may not be something they wish to do," Price said.

Factor framework

Is there an optimal way of using a factor strategy? To this, Forbes responded: "You have to take into account all the constraints and intolerances of investors and take into account the risk controls.

"So investors are subject to a drawdown. So to what extent are we able to operate those risks within a factor investing framework to take advantage of the benefits of factors."

In short, it is complicated based on the investor's needs.

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>
> Mark Thompson, M&G Group Pension Scheme

What the industry needs to do as a first step, Garland noted, is to have better tools and datasets. "In the next quarterly report do a style analysis of the portfolio, so investors know what their exposures are, with a factsheet of all funds by country, currency, sector, industry and factor exposure. This then demystifies the whole factor world," he said.

"It comes down to the question of whether investors have the knowledge and fortitude to execute their chosen strategy," Price said. "Only with hindsight do we know what the right strategy was."

The ESG issue

And what about factors and ESG, given that the latter flows through most institutional investment these days? Forbes said: "As a fiduciary, our conversations with clients are, how can we help them achieve their investment goals."

"The two are being incorporated into more often than not these days," Garland added. He noted five years ago MSCI was building pure play multi- and single- asset factor indexes. "In the three years I have been in this role, everything I have done in terms of new product development has factors-plus usually ESG, as overlapping investment themes."

Although on ESG, Garland also added: "Intuitively, ESG and climate don't necessarily marry with all of the factors: some yes, some no.

"Value, for example, typically tilts towards traditional industries, which is not good ESG. That said, if you build a well thought out methodology that includes factor exposure and ESG within a portfolio construction you can still get good outcomes," he said.

Thompson also made a nuanced ESG differentiation. "The wider ESG part is tougher than the climate part," he said.

"Climate is all about carbon. It is a broad-brush thing. But I am not sure how good the wider data is on ESG."

Investment exposure

Summing up many of the topics, the panel went through key points. Pickering said: "Long-term savings vehicles can be run in a way that takes advantage of the investment tools that asset managers have, but that only applies if those tools make sense in context of the people you are trying to save for. We can make things better, if not optimal."

Forbes noted that the starting point for investors is to recognise what their existing exposures are in factors. "Even a market-cap benchmark is going to have factor biases in it. We see that in the MSCI World it is largely biased to quality. So being aware that there is no neutral position. Factors do drive a large source of risk and are a driver of returns in portfolios," she said.

Garland said the one thing he would like to dispel is a myth of those that see themselves as a factor investor or not a factor investor. "We all are factor investors. To be an investor, is to be a factor investor," he said. "Know what you own, then be far more deliberately targeted, and ask questions of your asset managers."

Thompson, speaking from the perspective of a DC scheme, said: "Putting factors into your investments you need to understand the theoretical part of why that is going to work over the long run. You must go in with your eyes wide open."

Price said the recognition of factors as being something that is ever present in markets, therefore, what it means for portfolios and the tool kit that gives to exposures is really useful and important.

Stewart-Brindle said she was very supportive of factor investing. "I recognise there is a place for factor investing." But she added a targeted factor investment means great responsibility will fall on investment consultants, who need to be up to the task.

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