Factor investing

Market insight report

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Factor investing

Institutional investors face a number of pressures driven by regulation, the market environment, the global economy and their own internal policies. The rise of factor investing can help ease some of these burdens by introducing new levels of transparency and systematic portfolio construction which then allow for a better deployment of the available risk budget.

Factor investing is not new and has not been discovered recently, however changes in the way the returns generated are accessed can offer additional value and innovative benefits to investors. This has been driven by significant advances in technology, data gathering and analysis witnessed in the industry. In particular, the proliferation of big data has allowed for the increased capture of the premia from factor investing which are now being made available to a broader base of investors.

"Factors are common characteristics that affect the risk and performance of individual stocks and portfolios," explains Dimitris Melas, Managing Director and Global Head of Core Equity Research at MSCI. "Factor investing, in essence, reflects the way equity fund managers select stocks and construct portfolios. If you go down the list of how equity fund managers pick stocks and what they look for, you will find a lot of commonality between the characteristics they consider and the main factors."

The creation of factor indices has allowed investors to identify the returns associated with factors through index tracking products. Whenever making an investment allocation, within any market or any asset class, investors are exposed to factors. By identifying the factors and understanding what drives their performance, investors can seek to have a better grasp of the factors their investments are exposed to and find ways of taking advantage of them in a cost-efficient manner. This is what has changed – the factors themselves have always existed.

Head of Equity Applied Research for Americas and EMEA at MSCI, Raman Aylur Subramanian says: "Investors now have better tools to deploy their asset allocation in a more refined manner. They now have a set of index solutions at their disposal to help them create a rules-based investment process to harvest risk premia from factors. The factors in the market remained the same, so value remains value but the way the premia is captured is what has changed."

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Dimitris Melas, MSCI

Factor investing is a growing part of investment management with strategies drawing sizeable inflows in the past few years. For example, low volatility strategies attracted $12 billion over the first six months of 2019. Further, large institutional investors in the Nordics and the US, like AP3, ATP, PKA and PSERS, are leading the charge and allocating to alternative risk premia, in some cases to replace direct hedge fund investments.

A bigger toolkit

In the past, investors would employ active managers to access these risk premia but they were dependent on that manager and had no way of confirming they were being given the exposure they were promised. Subramanian says: "Now investors can get exposure to factors in a much more consistent fashion. The creation of rules-based indices means you can more easily construct a portfolio with greater levels of transparency in the performance of those portfolios. Then you can easily deploy them in your overall asset allocation."

Mark Carver, Executive Director and Global Head of Factor Index Products at MSCI talks about the role MSCI has played in making this a reality, "by making factors accessible through indexing, MSCI's work has allowed clients to understand that these exposures can be captured in a systemic way with transparency in a rules-based fashion. It has allowed investors to change the way they select active managers and has freed up active managers to pursue alpha beyond the common factors which can be delivered in indexes."

Melas elaborates on this, saying investors now have a toolkit at their disposal which gives them more choice and flexibility in how they manage their portfolios. He says: "When institutional investors make an allocation to equities, they also need to decide how to split that allocation. Selecting one or more factor mandates allows them to allocate the rest of the money to high conviction active managers who build concentrated portfolios.

"So now when institutional investors hire an active manager, they really look for high tracking error, high conviction concentrated portfolios because they can get the market returns through ETFs, indexes and they can get factor premia through factor mandates. So, this all allows them to allocate their risk budget more effectively and more efficiently to high conviction concentrated mandates."

Another key development has been the rise of multi-factor indices. "Previously investors had to hire different managers to get exposure to the individual factors – value, quality, etc – but now with multi-factor portfolios investors are able to harvest multiple risk premia in the one single construct," Subramanian, explains, "This has allowed them to not only capture the premia in a single construct but also bring down the cost of implementing the entire portfolio."

Melas says this approach is of particular benefit to investors who may not have a strong view on which factors they believe will perform. "In this case the best solution would often be to diversify their portfolio across three or four factors and make an allocation to a multifactor mandate. The thinking there is that they don't necessarily have a view on which factor will perform better or worse over the coming period, but they expect that over a full market cycle, a diversified portfolio which has high exposure to multiple factors will deliver risk adjusted returns," he says.

Beyond active and passive

Historically investment management has been considered either active or passive and some industry commentators have hailed factor investing as an approach with blends the two philosophies. Melas however believes this debate is misplaced. "There is only one type of investing and that's active investing. Indexes and ETFs offer tools to investors to construct portfolios and implement their asset allocation. Individuals who use these tools have already made an active decision, for example to invest in equities and not fixed income or to increase allocation to equities. Then they

may select to use an ETF or an index fund to implement that decision – they are part of the toolkit investors have at their disposal when making active investment decisions," he says, "I think many of us are guilty of confusing security selection with active investing – when really active investing is a lot more than security selection."

Subramanian believes factor investing complements both investment approaches – those focused on the beta end and also those who make greater use of stock picking managers at the other. He says: "Factors are a good way of integrating the two approaches. You may still have a bias on whether you want a view on pure market beta or a bias on active management but since it complements both ends of the spectrum, it is easier for investors to create a portfolio which will have them achieving their long term objectives."

One of the steps investors can take in their factor journey is to analyse their existing portfolio to understand what factors are actually driving their returns and what factor exposure they may have but are not aware of. Carver explains: "The truth is all investors are already factor investors. They may not have deliberately taken or chosen that exposure but fact of the matter is when they're allocating to a certain set of ideas, whether they do that through indexes or active managers, there will be factor exposures embedded in those portfolios and as a consequence all investors are factor investors."

To help investors have a better view into what factors they are exposed to, MSCI created FaCS a factor classification standard, which was rolled out a year ago. "This tool allows clients to see the factor exposures they have inside their portfolio in aggregate. Then if they want to look at a particular manager or group of managers, they can see what factor bias they might have within that subset of managers," Carver says.

This level of transparency has provided clients better insight into their allocations and into whether they have the diversification they intended in their portfolios. This information has provided a whole new lens that was lacking prior to MSCI introducing it.

Launched in 2018, MSCI FaCS is a classification standard and framework for analysing and reporting style factors in equity portfolios. The standard is based on the factor structure in the latest global Barra equity factor risk model, the Barra Global Total Market Equity Model for Long-Term Investors (GEMLT). The standard organises the 16 style factors of GEMLT into eight factor groups – Value, Size, Momentum, Volatility, Quality, Yield, Growth and Liquidity.

The goal is for this tool to create a common language and definitions around style factors to be used by asset owners, managers, advisors, consultants and investors. Managers can use the framework to analyse and report factor characteristics, while investors and consultants can use the data to compare funds and monitor exposures over time using common definitions.

By deploying the FaCS, investors can have a better understanding of what they are paying for. "By using this tool, you will know that you're paying active fees for truly active portfolios and lower, beta fees for more systematic type exposures," Carver says, "You need to have real transparency in those exposures and the FaCS enables investors to have this. They can then use that information to control the cost of their allocations. This is highly appealing to most investors."

He explains that investors are more comfortable today with systematic approaches to all things in life and are utilising data and information to make decisions a lot more nowadays. "That plays well into factor investing where 10 years ago you didn't have that same level of comfort or that same demand for transparency. These trends are not likely to slow down; they're likely to accelerate and as a consequence the appetite for factors not only as investments but also as broader tools, will increase," Carver adds.

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Mark Carver, MSCI

Factor investing adds a certain level of predictability to an investor's portfolio performance. Each factor is impacted by market events in different ways, but that impact is always the same. Subramanian says: "If you have a view on what is going to happen in the market, then you will know what will happen to the performance of the factor. This is not the case with an active manager – you can't know whether an active manager will perform well or not depending on the state of the economy because you don't have the full view of what is in that portfolio."

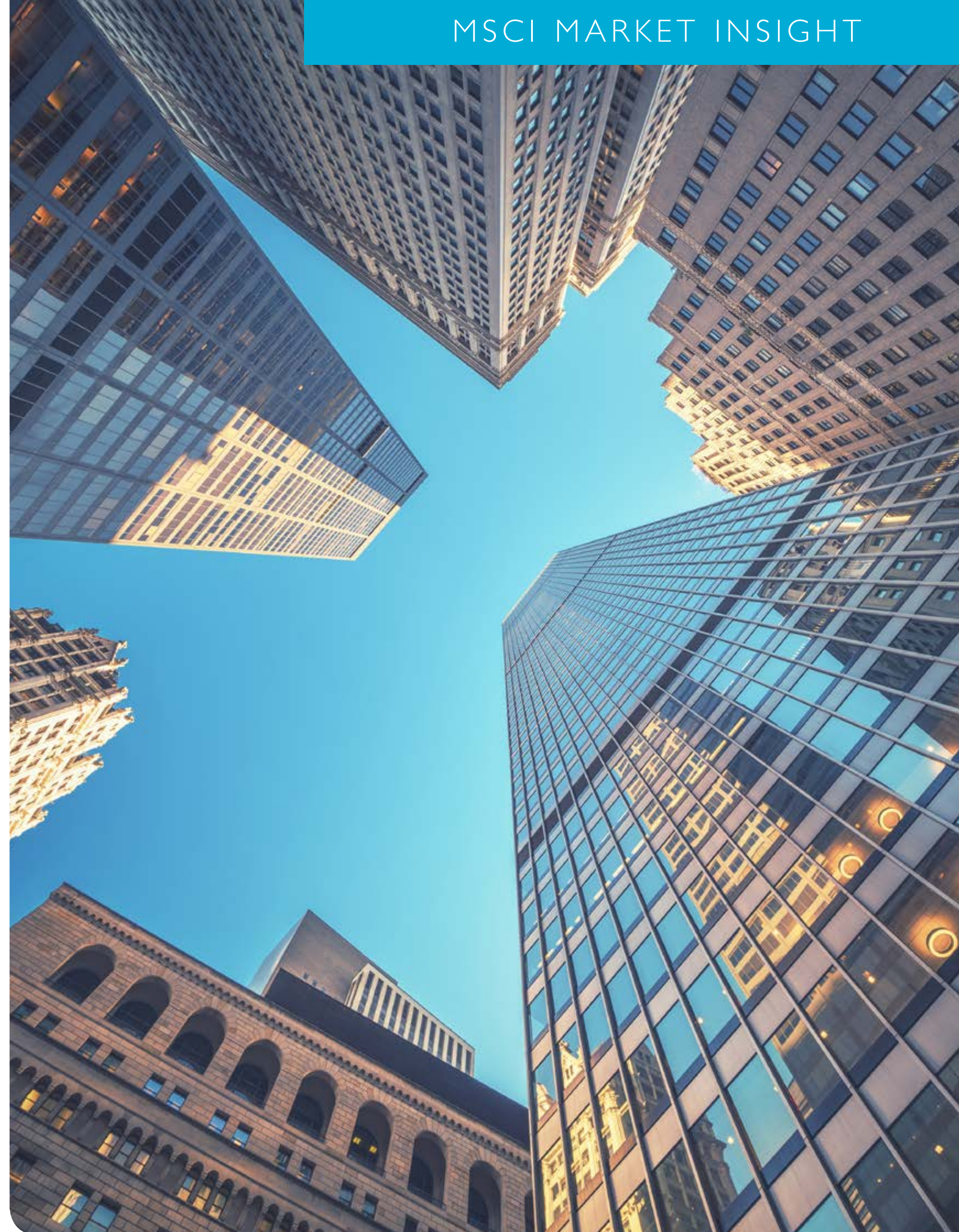
According to Melas, investors are driven to factor investing by a number of motivations. He says: "There are a number of incentives investors have when they consider making factor allocations. Performance is one but also transparency and simplicity. They appreciate the fact that through separate factor mandates they have a better understanding of how their portfolio is constructed.

"There are cost considerations as well. A number of investors face cost pressures and they want to use their resources as efficiently as possible. They recognise there are talented active fund managers and perhaps it's worth paying high fees for their stock selection skills, but to be able to do that, they need to be more efficient in how they spend their risk budget and the total pool of fees they have at their disposal."

So, the attraction of factor investing is a combination of performance, risk, transparency and cost considerations.

Knowledge is key

But this does not come without difficulties. One of the most significant challenges factor investing poses is related to investor understanding of their cyclicality. Subramanian explains how important it is for internal committees and trustees to fully understand the reasons why factors behave the way they do. "If they don't fully grasp how it all works, they risk getting into a factor investment



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Raman Aylur Subramanian, MSCI

programme and questioning the whole thing,” he says. “Value is a good example. For the last six/seven years value was not seen as the factor to invest in but if you look at the last 30 to 40 years, it was the best performing factor in the world. So, understanding why factors perform and what causes their cyclicity is something investors are always challenged with. Therefore, reporting and governance are crucial for a factor investing programme to succeed,” Subramanian continues.

Although factor investing can be integrated into a portfolio of any size and for any type of investor, this knowledge curve makes retail uptake slightly more difficult. Subramanian says, “Some of the more advanced advisers understand, but the average retail portfolio, even the model portfolios built by wealth managers are not fully exposed to factors. So penetration of factor investing has not fully happened in the retail space and we think there are considerable benefits to considering factors for retail investors.”

After deciding to allocate in factors, investors are faced with the dilemma of choice. Melas elaborates: “They need to decide which factors to allocate to. Some investors already have a view about a particular factor and they may decide to concentrate the allocation on one or two factors. Other investors have objectives related to lowering the risk of the portfolio in which case, low vol strategies are appropriate or perhaps even increasing the yield/the income of the portfolio in which case they would allocate to high dividend yield strategies.”

According to Carver ahead of these specifics, investors struggle to decide how to fund their factor investment. He says: “One of the biggest challenges our clients face is where to allocate the money from. Most investors have a portfolio allocated to a group of strategies already. So, when they’re going to add a factor portfolio as a new exposure, they have to decide – do they take it from an active mandate, a passive mandate the equity side, take down their fixed income position?”

Deep heritage in factor investing

MSCI is a unique player in the factor investing space. The investment professionals at MSCI, including Carver, Melas and Subramanian have been key influencers to the discussion and penetration of factor investing in the market today.

Carver says: “MSCI has been a part of the factor investing journey from the very beginning. You can argue that as an organisation, MSCI really lies at the centre of the factor conversation. We created the first factor risk model 45 years ago – an equity risk model based on the US market which looked at four factors – value, size, momentum and yield. Since then factors have moved from being a way to think about and attribute risk in a portfolio, to becoming an investable strategy in many different forms. And MSCI was there every step of the way.”

For over 40 years MSCI, starting with Barra, has researched and developed financial support tools, data models and factors to determine their effects on long term equity performance.

Barra was the original pioneer in researching and providing solutions to analyse the relationship and drivers of risk and return. The Barra Risk Factor Analysis was created by Barr Rosenberg, founder of Barra Inc. They pioneered the relationship between factors and security returns through models that could be used to predict and control risk and return. Barra transformed theory from academia into practical application, tools and solutions.

MSCI acquired Barra in 2004 and has paved the way for factor investing as we know it today, through factor risk models and factor indices.

“We are an independent research entity in the market,” adds Subramanian, “we have spent decades focusing on providing cutting edge factor investing solutions. Our mission is not complete as we continue to lead the future applications and research in this area.” ■

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MANAGING DIRECTOR AND GLOBAL HEAD OF CORE EQUITY RESEARCH

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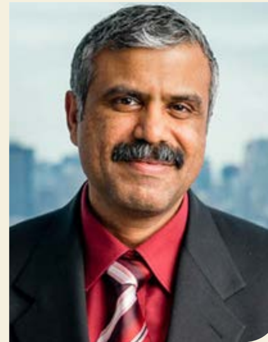
Dimitris Melas is Managing Director and Global Head of Core Equity Research at MSCI. Dimitris leads a team of researchers located in several cities around the world. The team develops all MSCI equity indexes and equity models and works with investors to help them integrate these tools into their investment process.

Prior to joining MSCI in 2006, Dimitris worked at HSBC Asset Management as Head of Research and Head of Quantitative Strategies. At HSBC, Dimitris was also a member of the Global Investment Strategy Group, the senior committee responsible for setting investment strategy and asset allocation policy.

Dimitris is a Chartered Financial Analyst (CFA) and holds an MSc in Electrical Engineering, an MBA in Finance, and a PhD in Financial Mathematics from the London School of Economics.

He currently serves as Editorial Board Member of the Journal of Portfolio Management and has published several research papers in academic and industry journals. His paper "Efficient Replication of Factor Returns" was voted "Best Index-Related Research Paper" at the 6th Annual William F. Sharpe Indexing Achievement Awards.



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As Head of Equity Applied Research for the Americas and EMEA, Raman Aylur Subramanian conducts research on MSCI product applications, and presents the results in interactive sessions with clients. Raman joined MSCI in 1999, and has been working in a variety of research roles and is a member of MSCI Equity Index Committee. Raman has established close relationships with clients and gained an in-depth understanding of their needs with respect to the MSCI indexes.

Prior to joining MSCI, Raman worked in the Indian petroleum industry where he worked on sales and product management.

Raman received a Bachelor of Technology in Petroleum Engineering from Indian Institute of Technology (Indian School of Mines), India, and a Masters in International Management from Thunderbird School of Global Management, USA. Additionally, he is a CFA charter holder from the CFA Institute in Virginia.

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EXECUTIVE DIRECTOR & GLOBAL HEAD OF FACTOR INDEX PRODUCTS

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Mark is an Executive Director and Global Head of Factor Index Products. In this role Mark is responsible for commercial strategy, client support & education and partners with Applied Research and New Product Development teams to develop strategies to enhance the industry leading MSCI factor index products. Mark led the 2018 launch of MSCI FaCSTM, the Factor Classification Standard, creating a common language and definitions for equity factors.

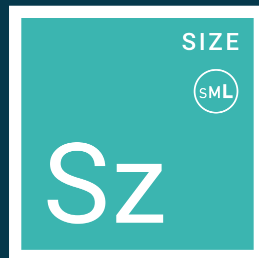
Prior to MSCI, Mark was a member of the Global Alternative Premia group at AQR Capital Management. Mark joined AQR from BlackRock where he spent ten years, most recently as a regional executive and Head of Smart Beta for iShares. In this role Mark was responsible for the commercial strategy, client support, product development and marketing for both active and index-based factor strategies. Before BlackRock Mark served as Vice President and Senior Client Portfolio Manager for fundamental growth at Columbia Management Group, now ColumbiaThreadneedle. Mark began his career at Fidelity Investments in Boston.

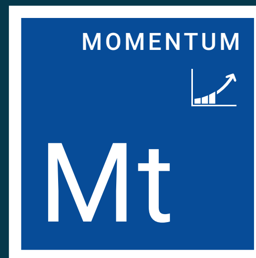
Mark earned an MBA from University of New Hampshire and an ALM with a concentration in Finance from Harvard. Mark lives in Westport, CT with his wife and two daughters.

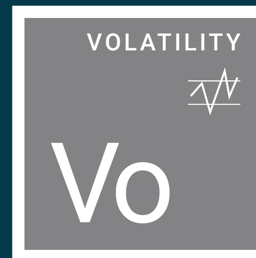
MSCI

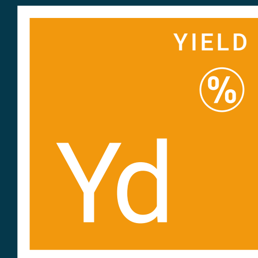
A common language for Factor Investing.

MSCI FaCS™









Put factors to work for your portfolio with MSCI FaCS.

To know more MSCI FaCS, mail us at **factorinvesting@msci.com**

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