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UNDERSTANDING INVESTING

Multi-Factor Strategies

As investors seek to build diversified equity allocations with the objective of higher returns, they may consider multi-factor smart beta strategies, which offer the potential for attractive performance and increased diversification with lower fees than traditional active equity solutions.

WHAT ARE FACTORS?

A "factor" is a generic label for company and stock price characteristics that provide the common sources of return across a broad universe of equity securities. For example, the value factor includes stocks that are inexpensive relative to the market, while the momentum factor includes stocks that have had recent price acceleration. Investors have become increasingly interested in factor investing because of the return potential of factors.

While there are numerous factors and factor strategies available, there are a relatively small number of factors that are considered robust in seeking to generate a consistent, long-term return premium. The criteria often used to determine if a set of characteristics constitute an actual factor include:

- The factor is grounded in academic literature and vetted over decades;
- The factor is robust across definitions and geographies;
- The factor has a credible, economic reason to offer a persistent return premium.

There are five common factors that research has shown to have the potential to deliver higher returns than the market. **Value** and **momentum** seek to capture the predictability of stock prices – long-term mean reversion following short-term momentum. **Quality** measures the health of the business underlying the stock. An allocation to **low volatility** seeks to help reduce risk. And size comes into play because these factors tend to be more effective when applied to smaller, less efficiently priced stocks – so small companies may provide higher returns within a factor strategy.

To take advantage of the potential benefits of factors, many investors turn to smart beta, which is a label for transparent, relatively low cost and systematic investment approaches. Smart beta strategies are long-only portfolios that should be easy and inexpensive to invest in, and most commonly are offered in exchange-traded funds (ETFs).

WHAT ARE SINGLE-FACTOR STRATEGIES?

As their name suggests, single-factor strategies provide investors with exposure to one factor, such as value, low volatility or momentum. The attraction of single-factor strategies is that they may help investors pursue a specific outcome or range of outcomes, such as improving returns, generating income, or reducing risk.

While single-factor strategies have their benefits, there are also risks associated with these approaches. Many investors want smart beta and factor exposure but are confused by the variety of strategies available in the marketplace. As such, to select a factor portfolio, investors often screen strategies based on past performance. However, selecting recently outperforming strategies can result in favoring strategies that have become expensive; this performance chasing can have a detrimental impact on future returns. In addition, while robust factors are expected to provide higher returns over the long term, they invariably go through performance cycles and may be out of favor for extended periods of time.

THERE ARE FIVE COMMON FACTORS THAT RESEARCH HAS SHOWN TO HAVE THE POTENTIAL TO DELIVER HIGHER RETURNS THAN THE MARKET:

VALUE
Excess returns of stocks that are inexpensive relative to their fundamental value

MOMENTUM
Excess returns of stocks with strong recent performance due to trend following

QUALITY
Excess returns of stocks underpinned by a financially healthy business

LOW VOLATILITY
Excess returns of stocks with lower volatility

SIZE
Excess returns of smaller companies relative to larger counterparts

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Importantly, investors utilizing single-factor portfolios should be very aware of factor valuations compared to historical norms and the potential for high tracking error relative to the broad market.

WHAT ARE MULTI-FACTOR STRATEGIES?

In contrast to single-factor strategies, multi-factor smart beta strategies provide investors with exposure to all or a subset of the value, quality, low volatility, momentum and size factors. By gaining exposure to multiple factors, investors can achieve greater diversification and become less reliant on any one factor to drive returns. Investors have increasingly gravitated to multi-factor approaches for this diversification benefit and potential for a "smoother ride" as well as the potential for lower tracking error compared to single factor strategies.

Are all multi-factor strategies designed the same?

No. The methodologies used to create multi-factor equity strategies can be quite different across competing products. These key questions can help to differentiate multi-factor strategies:

- To which factors do the strategies seek to gain exposure?
- How are the factor portfolios constructed? Are stocks weighted by market capitalization or do the strategies break the link between price and portfolio weight, which may provide additional return potential?
- Are the factors equally weighted, or is there a dynamic allocation process that takes factor valuations into account?
- Is there a thoughtful implementation process designed to minimize transaction costs?

While there are differences in multi-factor approaches, investors should consider strategies with broad diversification, economic representation, low cost and large capacity and liquidity.

What is the role of a multi-factor strategy in a portfolio?

With expectations of lower returns and broad underperformance of stock pickers, multi-factor smart beta strategies can be utilized as a complement to or replacement for traditional passive and active equity allocations. By providing diversified exposure to multiple equity factors, multi-factor strategies offer the potential for higher returns within a core allocation, typically at a lower cost relative to active managers.

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