Research Review: Factor investing

Ron Bird | University of Technology Sydney | 15 May 2017

Factor investing has its foundation in the empirical studies of the efficient markets hypothesis (EMH). These studies have substantiated enduring anomalies which have led to identifying numerous stock characteristics associated with superior investment returns. One example is value investing – investing in stocks which have been identified as being cheap by some metric (e.g. high book-to-market) that has been shown to be correlated with market outperformance. The traditional way to exploit this anomaly has been to build a portfolio of stocks selected because they are cheap. The "new" way to exploit this opportunity is by investing directly in a portfolio that has been designed to deliver the mispriced factor.

Of course, we don't have to build these factor-based portfolios ourselves, as a number of providers do the packaging for us. MSCI has been providing factor-based indices on several markets dating back as far as 1990. They currently offer six such indices: value, small cap, momentum, high yield, low volatility and quality.

Even better, there are now numerous exchange traded funds that provide access to many of these factors at a very low cost – so these days, investors can very quickly build and adjust a portfolio around exposure to these factors. We now live in a world where the possibility of factor investing is available to almost everyone.

Creating the case for why these mispriced factors both exist and persist is well beyond the scope of this review. However, one only has to look as far as behavioural traits and how they impact on pricing to explain the mispricings.

We can gain solace from the fact that many of the mispriced factors were first identified over 25 years ago but still persist today.

Three recent papers are useful in exploring further.

1. Smart Beta: Capturing the Power of Factor Investing

This paper by BlackRock provides a useful, basic background on factor investing.

2. Life Cycle Investing and Smart Beta Strategies

This is another paper out of the Black Rock stable that shows how factor portfolios can be used to help construct a target date fund. The concept behind a target date fund is that a person becomes increasingly more risk averse as they approach retirement. Hence, a target date fund is progresses an individual from an aggressive portfolio when first starting to accumulate savings to a highly defensive portfolio as retirement approaches.

The paper highlights that factors like value and momentum are more suitable in the early stages of the life cycle, while low volatility is a factor that is more suitable closer to retirement. The paper demonstrates how a traditional target date strategy can be enhanced by rotating through the factors. (Of course, this begs the question as to whether a target date strategy is a good idea in the first place, which is something that we will address in a future review.)

3. Contrarian Factor Timing is Deceptively Difficult

This paper by Cliff Assness and colleagues at AQR Capital Management looks at timing within a factor-based strategy, specifically by varying the exposure to the value factor based on the magnitude of the value spread. As the gap between the market valuation of the expensive and cheap stocks increases (decreases), the portfolio's exposure to the value factor is increased (decreased).

The authors find that the timing does not add anything to the performance of the "untimed" value strategy, which they put down to the timing only doubling up on the value bet.

Ron Bird is a Professor with the Business School of University of Technology Sydney. From 1989 to 1998, Ron held a number of non-academic roles include heading the asset consulting practice and global research unit of Towers Perrin, and investment positions with Westpac Investment management and GMO. Ron returned to academia in 1999 in the Finance department of UTS. For the past 15 years, Ron has also been the director of the Investment Management Analyst Course (IMAC), a key component of the Certified Investment Management Analyst® certification program for Australian candidates.
