INVESTMENT THEMES 2020

Canaccord Genuity Wealth Management

Factor investing explained

During the coming year, we expect that an investment approach known as 'factor investing' will continue to gain prominence. Investors will need to pay attention, as it is likely to play an even more important role in determining investment returns.

What is factor investing?

Essentially, it is an investment approach that identifies and targets investments which exhibit certain quantifiable characteristics or 'factors'. These factors have been shown, over time, to specifically drive investment risk and return.

Factor-based investing is rooted in the world of academia, and academics have now identified over 600 factors which they contend will influence risk and return. However, many of these are simply 'statistical noise' and will not persistently and reliably enhance a portfolio's risk and return profile. For example, between 2010 and 2012 alone, experts supposedly discovered 59 new factors. In reality, many of these will simply have been used as marketing justification for the launch of a new product.

How does factor investing work?

Factor investment is most widely applied to company selection within stock markets, although it can be extended to other asset classes. By either capturing, or avoiding, certain factors in an objective way, the aim is to improve portfolio returns, reduce risk and/or enhance diversification. Consequently, it is seen as a third approach to investing, sitting between full passive investing (whereby an investor seeks to match the return of a market capitalisation-based index) and traditional active management (where a fund manager will aim to outperform a stock market or index based on their subjective assessment of a particular stock's investment potential).

What's the difference between factor investing and 'smart beta'?

The investment industry is renowned for unnecessary complication and it's worth highlighting that the terms 'factor investing' and 'smart beta' are increasingly used interchangeably. While there may be nuanced differences, they are both based on the same broad concept – that it is possible to outperform traditional market cap weighted indices such as the FTSE 100 and S&P 500 by targeting specific stock characteristics (factors). For our purposes, we will treat factor investing and smart beta as one and the same.

What are the most important factors to identify?

There are five primary style factors commonly accepted, building on the three factors which were first identified by Eugene F. Fama and Kenneth B. French in their 1992 paper[1].

Value

This is the tendency for stocks that trade at a discount to similar companies based on fundamental valuation measures, such as cash flow or book value[2], to outperform more expensive assets. Purchasing securities at lower prices could lead to higher returns.

Quality

High quality stocks, defined by reference to metrics such as strong cash flow or high profitability, will generally outperform lower quality companies.

Size

Smaller companies in aggregate will, over time, have a tendency to offer a higher return than larger companies.

Momentum

Stocks which have recently outperformed an index will tend to continue outperforming and vice versa; the winners will keep winning, the losers will keep losing.

Volatility

This describes the propensity for low-volatility stocks to outperform high-volatility stocks on a risk-adjusted basis.

[1] The Cross-Section of Expected Stock Returns – Journal of Finance 1992.

[2] The book value is the value of a business according to its books (accounts) that is reflected through its financial statements.

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As mentioned earlier, these are just a small selection of the attributes which have been identified as performance drivers. There are many others, such as dividend yield, liquidity and capital intensity, which we could highlight, but for the purposes of this article we will concentrate on these five primary factors.

What are the implications for investors?

There's one main reason why the factor approach has gained popularity. It is because indices constructed using solely the investment style factors of **value, quality, size, momentum** or **volatility** have all been shown to outperform traditional equity indices constructed purely by reference to market cap over the long term.

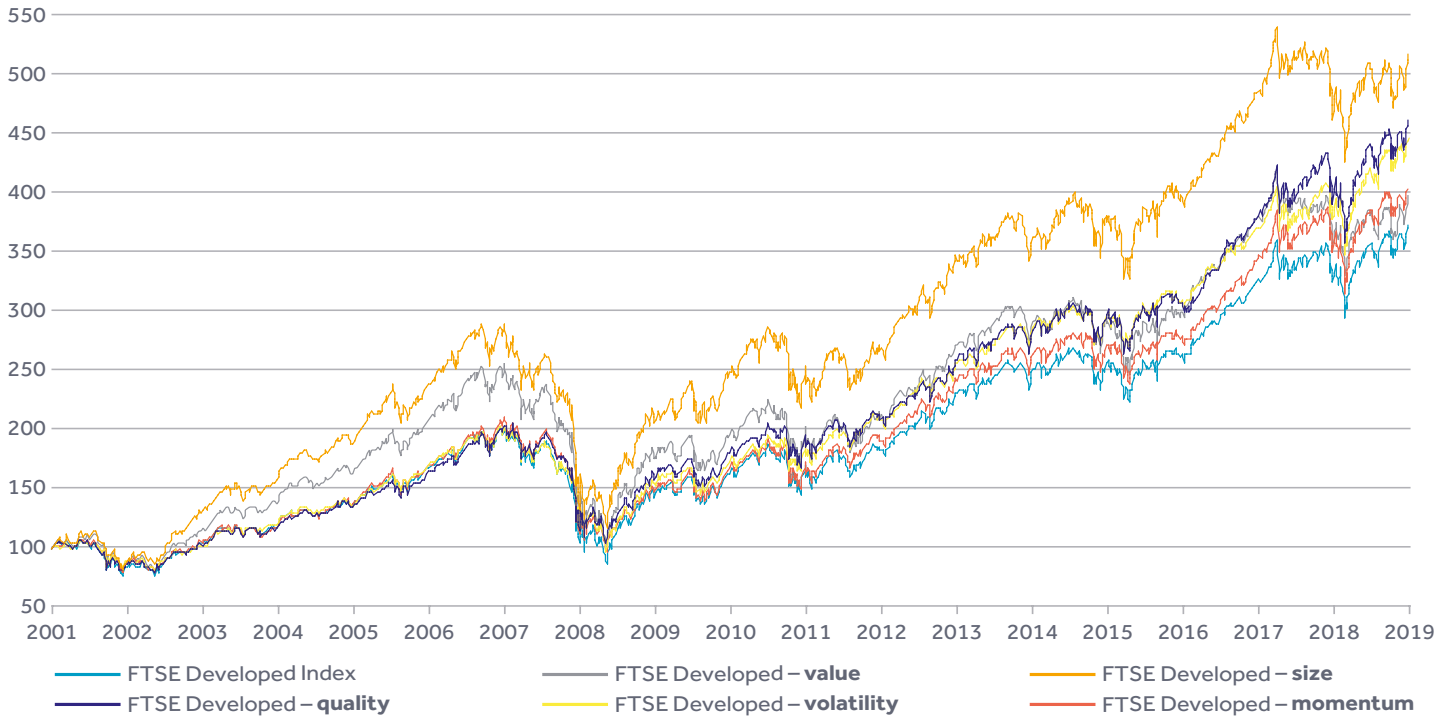
This is partly intuitive as, within market cap-weighted indices such as the FTSE World Index, stocks which have a high valuation tend to receive a higher weighting than those with a low valuation. So the index can be dominated by a few large companies whose prices are high relative to their financial characteristics.

Value, quality, size, momentum, volatility relative to market cap

The chart below shows the returns of indices that purely comprise companies which fit each of these five primary style factors, relative to the market cap weighted alternative. Each style factor has delivered outperformance over time.

Over this 20-year period, these particular style factors have been shown to add value. However, it's important to understand that this is not linear or consistent out-performance. Over time, factors will move in and out of favour and the outperformance of a factor in one year does not guarantee outperformance in the next. This can be seen in the table below:

Long-term factor returns rebased to 100



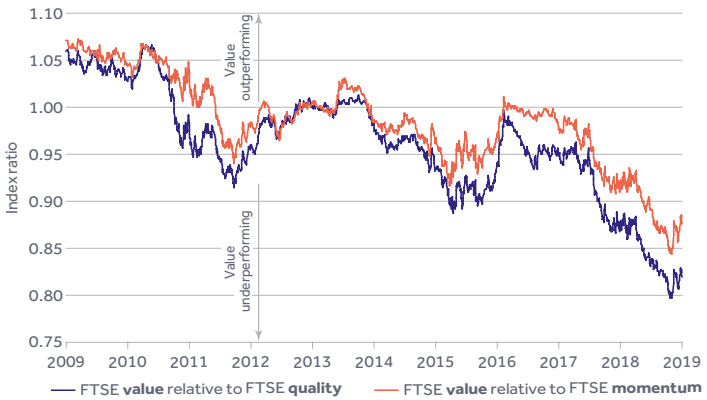
Source: FTSE

Absolute returns for the FTSE Developed factor indices

2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Size 40.67%	Size 21.06%	Volatility 3.59%	Size 18.62%	Value 28.14%	Volatility 9.34%	Size 1.91%	Value 12.45%	Quality 27.95%	Quality -4.98%
Value 32.59%	Momentum 12.00%	Quality 0.06%	Momentum 18.07%	Momentum 27.79%	Quality 6.47%	Quality 1.51%	Size 9.21%	Size 25.84%	Volatility -5.42%
Quality 28.87%	Quality 11.67%	Momentum -4.44%	Value 17.19%	Size 25.84%	Momentum 5.20%	Momentum 1.14%	Volatility 9.08%	Momentum 25.46%	Momentum -7.00%
Volatility 25.65%	Value 10.58%	Value -8.07%	Volatility 14.99%	Quality 25.69%	Value 3.39%	Volatility 0.69%	Momentum 5.83%	Value 24.12%	Size -13.08%
Momentum 24.41%	Volatility 9.31%	Size -10.19%	Quality 13.81%	Volatility 25.12%	Size 2.87%	Value -3.33%	Quality 5.59%	Volatility 20.77%	Value -13.82%

Source: FTSE, Bloomberg, CGWM. Calendar year returns; data to 31 December 2018. All returns US$ terms, total return.

Value factor relative to quality and momentum

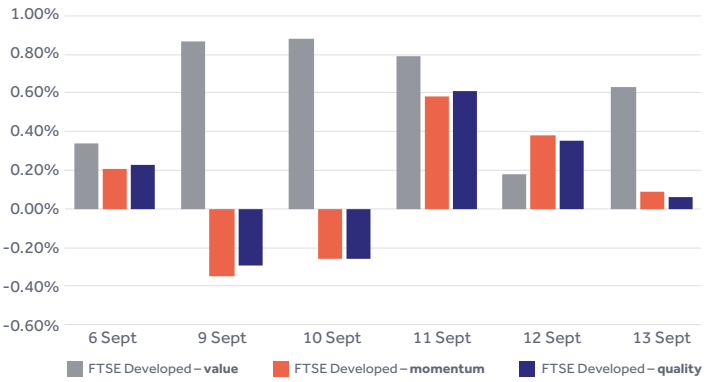


Source: FTSE

It may therefore be beneficial for investors to combine exposure to different factors, rather than relying on one single characteristic. This can be seen most clearly when considering the **value** style factor. Over the past few years, **value** stocks have consistently underperformed growth (where one is paying a high price for future growth prospects; the opposite of **value**), **quality** and **momentum** factors. This is despite the fact that longer-term history has shown that, as a factor, **value** has delivered outperformance of the broad market.

What is particularly noteworthy for investors, however, is the abrupt and significant short-term outperformance of **value** stocks in September 2019. Over six trading days between 6 and 13 September, the FTSE Developed Value Index outperformed the FTSE Developed Momentum and Quality Indices by over 3%. Up until then, for the year to date, **momentum** and **quality** factor investing had outperformed **value** by just over 8%. This outperformance was over 20% when measured from the end of 2016.

Short-term value/momentum performance – September 2019

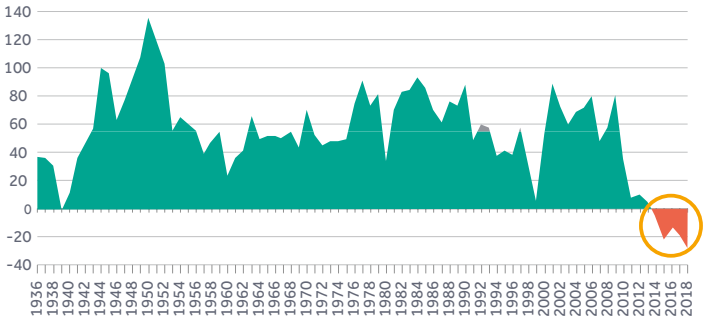


Source: FTSE

Given the significant underperformance of **value** and outperformance of **quality** and **momentum** as factors, it is reasonable to expect that 2020 may bring with it a reversal, with **value** set to outperform.

As the chart below shows, the underperformance of **value** as a style factor is as pronounced as it has ever been when measured back to the 1930s. Even at the peak of the technology bubble at the end of the 1990s, when growth was seemingly all investors cared about, **value** had not underperformed to the extent it has now. To use an analogy, if we were to imagine an elastic band with **value** at one end, and growth (non value) at the other, then **value** is becoming cheaper at one end (so stretching one way) and at the same time, growth is becoming more expensive at the other end (stretching the other way). Therefore, the relative valuation difference between the two is getting bigger because one is moving one way and the other is going in the opposite direction. At some stage, there will be a snap back and **value** will significantly outperform.

Rolling 10-year total return difference: Fama-French HML (value vs growth)



Source: Schroders

How could the performance of value stocks affect my investment strategy?

This has two implications for investors.

First, they may wish to consider incorporating a dedicated exposure to **value** stocks; or, at the very least, ensure they are not under-represented to this factor.

Second, there are strategies and funds which have significantly benefitted from their focus on **quality** – essentially companies which have demonstrated reliable profitability and strong balance sheets. These companies have also displayed **momentum**; they keep on outperforming. At some stage, this style will fall out of favour and these companies, and the funds which have incorporated a heavy weighting to them, will underperform.

Perhaps the most prominent examples of funds which have successfully ridden this wave of outperformance are the Lindsell Train UK and Global Equity funds, and the Fundsmith Equity Fund. All have performed extremely well. However, as Nick Train, portfolio manager of the Lindsell Train UK Equity Fund, has stated, "We love to outperform for our investors, but have to state the obvious: it would not at all be a surprise if such a highly concentrated portfolio that had performed well embarked on a period of poor performance at some point."[3]

[3] Fund factsheet for the UK Equity fund as at the end of May 2019

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Do factor strategies perform consistently during an economic cycle?

This brings us to the next point, which is that factor strategies often perform quite differently in the various phases of the economic cycle. During periods of economic recovery, through which growth may be slow but accelerating, smaller and more flexible companies (the **size** factor) tend to perform better, as do **value** stocks. If growth is strong and/or stable but decelerating (which best describes the environment which has dominated much of 2019), **quality** stocks lead the way.

Quality and low **volatility** factors have worked particularly well during periods of stress – and clearly, the current environment with trade wars and Brexit is a period of heightened uncertainty.

Since July 2009, when the current bull market began to take hold, movements in the yield curve (which plots bond yields for various maturities of debt) have also had a significant impact on the performance of individual factors. A flattening yield curve aids **momentum** and **quality** factors, while a steepening curve assists smaller companies (the **size** factor) and the **value** factor.

For much of the past decade we have lived in an environment of low inflation, abundant quantitative easing and a flattening yield curve. For **value** to outperform again, we will probably require a normalisation in the bond market. Will this occur in 2020? Maybe not wholly, although it is difficult to foresee yield curves becoming more inverted than they were at their peak in 2019, or the value of negative yielding debt increasing significantly without a global recession happening, which is not our central case scenario.

Performance of factor strategies (where data is available) across economic cycles

The table below demonstrates the performance of various factors during economic expansions and recessions dating back to 1973.

Green shows best performing factor, red shows worst performing

						Cumulated excess return (US$)					
Regime	**Start**	**End**	**# months in sample**	**Background**	**US GDP growth**	**World market**	**Volatility**	**Momentum**	**Quality**	**Value**	**Size**
Recession	Nov-73	Mar-75	3	Oil crisis, US stagflation	-3.2%	23.6%		14.9%		21.0%	
Expansion	Apr-75	Jan-80	58		4.3%	13.8%		38.9%		30.5%	
Recession	Feb-80	Jul-80	6	Energy crisis, increasing rates	-2.2%	0.4%		0.3%		1.2%	
Expansion	Aug-80	Jul-81	12		4.4%	-9.5%		-12.1%		-5.8%	
Recession	Aug-81	Nov-82	16	US economic crisis	-2.7%	-15.2%		-12.3%		-15.5%	
Expansion	Dec-82	Jul-90	92		4.3%	116.7%		167.0%	93.9%	142.8%	
Recession	Aug-90	Mar-91	8	Oil price shock, US 'jobless recovery'	-1.4%	-7.4%	-9.4%	-4.8%	-0.3%	-8.8%	
Expansion	Apr-91	Mar-01	120		3.6%	46.1%	41.3%	115.7%	153.0%	63.6%	
Recession	Apr-01	Nov-01	8	Dot-com crisis	-0.3%	-7.5%	-4.2%	-11.4%	-0.9%	-9.7%	0.8%
Expansion	Dec-01	Dec-07	73		2.8%	46.8%	54.6%	97.9%	36.0%	55.6%	92.1%
Recession	Jan-08	Jun-09	18	Global fiscal and economic crisis	-5.1%	-39.0%	-31.5%	-45.8%	-30.5%	-40.2%	-35.5%
Expansion	Jul-09		107		2.2%	150.9%	150.9%	242.7%	194.7%	122.8%	212.8%

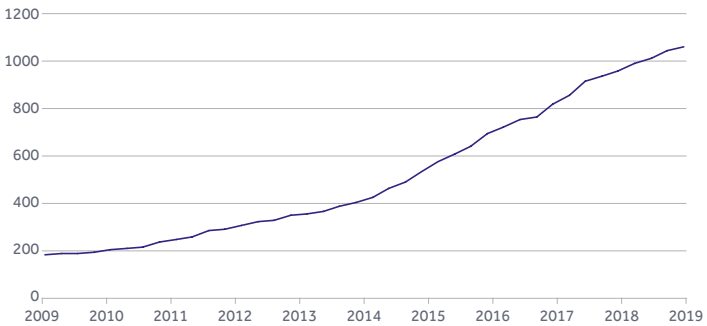
Source: MSCI Indicies (US$), Libor-Cash-Index, Bloomberg Vontobel calculations.
The excess returns of the various factor strategies were circulated by Vescore.

Is it easy to trade in and out of individual factors?

Actively increasing and reducing exposure to individual factors to capitalise on perceived shifts in the performance drivers of stock markets is extremely difficult, even for highly experienced professional investors. Yet the explosion in the number of exchange traded funds (ETFs) which are based on factor investing, or smart beta, has made it easier to do so. This may mean that it is much easier for certain style factors to become overcrowded and that, when reversals do occur, they are likely to correct more sharply and much more quickly than previously.

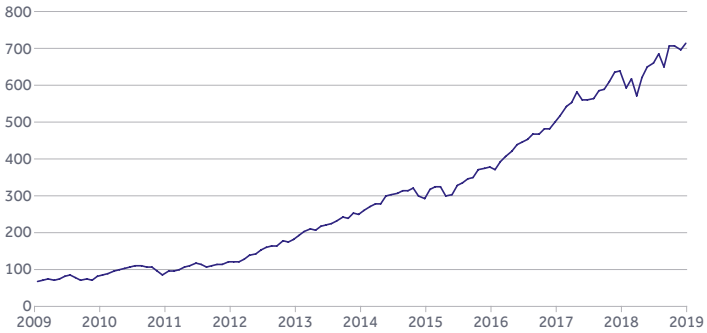
According to ETFGI, the independent research and consulting provider on ETFs, at the end of December 2018 there were 1,298 smart beta exchange traded vehicles and 159 providers of such funds. These were listed on 40 exchanges in 32 countries, and accounted for assets under management (AUM) of US$617.65bn. Similar data from Morningstar below shows 1,059 ETFs with a combined AUM of US$716bn.

Number of smart beta/factor exchange traded funds



Source: Morningstar Direct

AUM of smart beta/factor strategies (US$bn)



Source: Morningstar Direct

What conclusions can we draw?

Despite this significant increase in the tools available to investors, in many cases factor investing strategies have failed to match investors' perhaps over-optimistic expectations. As Lionel Martellini, a professor at France's Edhec Business School, has highlighted, "Smart beta is not a free lunch. A well-diversified exposure to factors which have been rewarded in the past will not always generate outperformance. Instead, it will likely provide superior risk-adjusted returns on average across market conditions in exchange for suffering pain in some market conditions."[4]

Whether investors appreciate it or not, investment returns will be influenced by an exposure to certain factors. All portfolios have exposure to factors, whether they specifically employ a factor-based strategy or not. Our job, as investment managers, is to understand what is driving performance, how much risk we are taking to achieve it and whether we could generate better returns, or reduce risk, by changing the allocation to certain factors. This role is potentially going to become even more important in 2020.

Given the significant performance divergence across factors which has been in evidence over the past few years, we would expect that 2020 will also be a year where **value**, as a factor, leads the way. However, it would be foolhardy to commit too much to this one factor. The rewards for being right could be significant, but so too could the cost of being wrong.

[4] FT on 27 July 2019

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About the author

Justin provides direct assistance to the Chief Investment Officer in maintaining responsibility for the investment philosophy, process and methodology of Canaccord Genuity Wealth Management, and acts as the alternate to the CIO. He is Chairman of Canaccord Genuity Wealth Management's Portfolio Construction Committee, a member of the Asset Allocation and Fund Selection committees and manages several of Canaccord Genuity Wealth Management's range of funds. Justin is a Chartered Fellow of the CISI and is a former President of the Guernsey Branch of the Institute.

Justin Oliver,
Deputy CIO,
International