Vinit Srivastava
Managing Director
S&P Dow Jones Indices

Fees and Returns Drive Institutional Investors to Factor Investing

Institutional investors continue to ratchet down their expectations of returns from asset classes. Their long-term need for alpha has led to a greater focus on fees, which in turn is driving their interest in factor investing.

"As return expectations have been dialed down because of the environment that we're in, a lot of focus has been on generating more out of the equity asset class," said Vinit Srivastava, managing director at S&P Dow Jones Indices. "People are looking for additional returns. That's a secular trend. With this low-return environment comes a focus on fees. When times are good, people don't pay that much attention to fees."

In fact, one recent survey of institutional investors found that they plan to increase their factor allocations to 18% from 12% over the next five years.

The focus on factor investing reflects investor desire to maximize risk-adjusted returns and transparency, according to Srivastava. Interest in factor investing has been on the rise since 2008, when the financial crisis put a glaring spotlight on how underlying factors can impact correlation in seemingly unrelated assets.

"There's an increased focus on risk post-2008," Srivastava said. "You're trying to maximize those risk-adjusted returns." This has led to increased interest in the S&P 500 Low Volatility Index strategy, for example, which has outperformed its benchmark by 84 basis points annually, with only 70% of the volatility over the 10-year period that ended July 31.

Factor investing is a systematic way to maximize assets, at a lower cost, over the long term. At a fraction of the cost of active management, factor investing has the potential to deliver a return that is less correlated to market cycles than some passive strategies.

"With factor investing, you know why you're getting what you're getting," Srivastava said. "That return attribution and the transparency of the factor return, I think, is why institutional investors are — and should be — looking at factor-based investing today."

In addition to factor-based strategies for equity investments, companies are now starting to develop similar transparent, rules-based solutions based on academic research for fixed-income and other asset classes.

MYTH BUSTING

Even as factor investing continues to grow, some institutional investors still harbor misperceptions about it. A common one, for example, is that factor strategies will always provide better risk-adjusted returns than other methods of investing. However, single factors go through down cycles, so it's important for investors to keep in mind that factor investing remains a medium- to longer-term play and should be part of a diversified, holistic strategy. Factors are cyclical, just like any other investment, and this approach to investing isn't fundamentally different than what's been done in the past, often by active managers who charged hefty fees for it.

"This was done in a different wrapper before," Srivastava said. "What's new now is that you are more equipped to know what's going on and to do it at a cheaper cost."

Another misconception among some institutional investors is that outperformance may dissipate as more capital gets allocated to factor-based strategies. That's a concern that's been growing as the market for factor-based investments has been advancing toward $500 billion. Srivastava said it's a misplaced concern.

> "We're seeing a lot more strategic investing. When plan sponsors have done a more strategic allocation to factors, depending on the size, they can see some of the effects on the overall portfolio."

"A lot of what's happening on the passive side and the smart beta factor investing landscape has been that asset owners who use active strategies to access factor returns are now doing a passive wrapper, a more systematic wrapper," he said. "There's not a lot of new money that's running, so that you are at risk of arbitraging away something that's existed for a long time."

Institutional investors incorporate factor investing into their portfolios in various ways. Some might be looking for traditional benchmarking, while others take a tactical approach. The most prevalent usage is strategic, with investors taking a chunk of their core equity allocation — as much as 30% or more — and betting on factors such as quality, momentum or value.

"We're seeing a lot more strategic investing nowadays as plan sponsors have become more sophisticated," Srivastava said. "And when plans have done a more strategic allocation to factors, depending on the size, they can see some of the effects on the overall portfolio. It has to be a decent chunk in order to be able to see that."

SINGLE OR MULTI-FACTOR

One important thing for investors to consider as they move into factor investing is whether a single- or multiple-factor strategy works for them. Single-factor implementation tends to be more straightforward, and easier to construct and adjust to reflect the desired exposure going forward, Srivastava said.

Investors, for example, can easily home in on factors such as value or low volatility. However, single-factor investments may have periods in which they underperform the benchmark, and it's possible that investors will invest at the wrong time or choose the wrong factor in which to invest. So this strategy is best suited for investors with a long time horizon or a strong conviction about the market strength of a particular factor.

Multi-factor indexes offer additional diversification benefits, which may make them a more attractive option, even if they require a slightly more complicated investment process. Investors considering a multi-factor strategy must first select which factors they prefer to invest in, and then consider the construction of the investments themselves.

"At a high level, once you make the choice of factors, you have two options: You can do a very simple Lego block combination of an index of indexes, or you can take a bottom-up approach, constructing the portfolio to give you the maximum exposure to your chosen factors, for a certain level of risk," Srivastava said.

While the simpler construction makes attribution easier, the latter method may create an even more efficient portfolio. It's important for plan sponsors going that route to spend time not only on selecting the factors, but also on the construction of the portfolio and how the portfolio manager is defining the factors.

Considerations beyond portfolio construction include capacity and trading, and whether the portfolio can handle liquidity. It's also important to discuss measurement, whether to have a more model- or return-based attribution, Srivastava said.

"Once you select factors and do portfolio construction, the most important thing is how do you measure," he said. "How do you measure that thing that you just created? We talk with many clients about how they're spending a lot of time asking whomever they work with to provide that." ■

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