

THE FACTOR

INVESTMENT ROUNDTABLE

Moving Beyond Traditional Investment Models

REVOLUTION

Grounded in decades of research showing there are certain factors such as size, valuation, and momentum that deliver a durable premium over the long term versus a market-cap weighted benchmark, factor investing is attracting new interest as more investors recognize that business as usual is unlikely to achieve their desired outcomes. In the following roundtable discussion, we hear from State Street Global Advisors (SSGA) investment leaders Lori Heinel, Ric Thomas and Jenn Bender as well as Nils Ladefoged of Denmark's PKA pension fund, one of the most innovative adopters of factor investing, and Fabio Cecutto of Willis Towers Watson on the implications of factor investing for asset owners and managers alike and what the future might hold.

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The current challenging return environment is prompting many investors to rethink traditional investment models and consider new ways to structure their portfolios to achieve their investment goals. While research on factor investing has been around for many years, significant progress in implementing factor-based approaches has broadened the accessibility of these strategies and prepared the ground for a transformation in how investors think about building more capital-efficient portfolios. Already factor investing is disrupting traditional active management, as it raises the bar for managers to show their skill-based returns beyond replicable factor-based returns. The next frontier is beginning to challenge the alternatives investment space.

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Q If the research around factor investing has been around for so long, why are we only now starting to see a broader uptake?

HEINEL One obvious catalyst is the expectation that returns are going to be lower than most investors had anticipated. Our projected returns across all asset classes are in the low single digits, so it is clear that for the next few years just relying on beta returns isn't going to be enough.

BENDER Against that lower return backdrop, we've also seen enormous interest in really understanding the sources of returns in portfolios across asset classes and within asset classes.

Factor investing gives you different ways to get at those sources of returns. On one end, you have Smart Beta, where you're trying to get exposure transparently in a low-cost, efficient vehicle to a particular factor or set of factors all the way to active quant approaches, where more discretion is given to the manager as to which factors to deploy, how to use them and when and how to combine them.

But it's not just that we're in a muted return environment. It's also that there is so much uncertainty in the markets. You can also use a factor-based approach to provide volatility management and downside protection in a low cost and efficient way, which is really compelling.

CECUTTO At Willis Towers Watson, the interest has stemmed from a progression of conversations we've had with clients over more than 10 years on how to improve portfolios without necessarily increasing complexity, governance or cost. I think there have been important changes on both the supply and the demand sides that explain the current interest. On the supply side, we have definitely seen improvements in technology and implementation capabilities, which allow for doing things in more cost-efficient and less complex ways.

On the demand side, we have seen a greater focus from asset owners on their governance budget: what additional complexity they are onboarding and what true value-add they get for the fees paid. This is a trend that has accelerated since the financial crisis and has become more acute in the current market environment, where improving portfolio efficiency is much needed but traditional asset class yields are so low. We have seen a switch from trying to do that by hiring a lot of active managers and paying up for alpha, to a mindset that is much more discerning about costs and complexity.

In this context we think Smart Beta can play a crucial role in an asset owner's portfolio. We define Smart Beta as a holistic concept that goes beyond factor investing. For us it refers to a broad implementation continuum between "passive" beta and "active" alpha, a smarter way for asset owners to go about investing in beta. It can apply to different risk premia across equities, fixed income and, increasingly, in the alternative asset class space.

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LORI HEINEL



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NILS
LADEFOGED

BENDER We know there is sometimes confusion around Smart Beta because of different interpretations of what it includes. That's why we say the label is less important than clearly understanding how a manager is implementing a particular strategy.

Q How did PKA first consider factor investing and what did the evolution look like?

LADEFOGED We actually started out with factor-based investing 15 years ago, but at the time it was less a conscious decision and more the case that a manager came to us with an equity strategy that tilted to value and momentum with good performance and at a reasonable cost. Since then it has been very much a learning process for us.

But there were two preconditions that probably made adopting and developing factor approaches easier for us than for other investors. First was the experience early on of hedging our liabilities with

swaps, so we became used to working with derivatives and leverage, getting comfortable with ISDAs and collateral management. Those are key components of how we operate today.

Second was an internally developed risk framework we created about eight years ago which allows us to model and compare all investment opportunities on an apples-to-apples basis. That means we can compare very different investments like a variance swap trade with a high yield investment with a long/short value strategy and very quickly understand the relative risks involved. This framework is crucial to our investment process and our ability to measure and manage risk, which is important to our board.

About seven years ago, we moved into factors with currencies and commodities, but still within the asset class sleeves and not scaled to the total investment portfolio. In 2011, we restructured the equity portfolio and after that rates, currencies and commodities. Now a dramatically larger part of the risk budget within all asset classes has greater exposure to the factors we want (though only a smaller part of the fixed income portfolio has been converted to a factor approach so far). When you have that basic understanding on the equity side about why value or momentum works here, then you know the right questions to ask within rates or currencies.

JENN
BENDER



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Q Is that a typical evolution for factor investors?

BENDER Yes, for first-time adopters with significant equity allocations, starting with a replacement of the core with, say, a 10–20% exposure to the durable factor premia that have been shown to perform well over time makes sense. You’re not deviating too significantly from the market-cap weighted starting point. From a capital efficiency standpoint, combining a low-cost, factor-tilted portfolio in a Smart Beta vehicle with a proprietary, active, high tracking error, high conviction manager that will charge higher fees but actually deliver on those high fees can be a very powerful mix. You want to spend your fees wisely.

THOMAS For large institutional investors, factor investing is very pertinent because they allocate to a large number of active managers and in aggregate, those managers diversify each other away. They end up with very little stock-specific risk and much more factor risk. We’ve seen this a number of times when we’ve looked at pension funds with allocations to seven or more active managers.

As the risk tools for disaggregating returns are becoming more common, more investors realize they should spend more of their time focused on their factor allocations. They’re looking for either episodic or persistent factors that can provide those returns. You start off with single-factor tilts, then you have multiple-factor tilts and then you have dynamic multiple-factor tilts.

HEINEL This is a way to think of more portfolio efficiency from a fee perspective. You tilt away from your passive cap-weighted core and you can improve your results. We think factor investing is like the new active. There are now signals, tools and data that can inform a decision in a way that we’ve never been able to inform a decision in the past.

BENDER And I think what’s changed is that there’s been a mass proliferation of concepts that were formerly widely known only by a very niche quant community. Now Barra, Axioma and some of the other risk models have pushed the conversation about factors as the real source of returns to a broader group of investors.

CECUTTO Clearly this has been a very disruptive trend, especially for the traditional active management model, but I think it has been a positive trend as well. For those active managers who provide truly differentiated alpha, they will be able to distinguish themselves even more in terms of emphasizing that what they deliver cannot be replicated.

For those who provide a more commoditized risk premium such as value, momentum or carry, it opens the door to relationships with a growing range of institutional investors, some of whom are highly sophisticated.

Q With so many benefits, why isn’t the shift happening more quickly?

CECUTTO We have found that asset owners need to have a certain level of education and set of beliefs before adopting it. So the first conversations we have typically focus on that belief structure and whether asset owners understand the characteristics of these strategies.

Another important issue is that an element of skill is being passed from the active manager back to the institutional investor’s governance board. An asset owner will not be able to blame a manager for the underperformance of, say, a value factor because the strategic decision to tilt toward that factor was taken internally.

So we begin with a conceptual discussion, talk about the governance implications and then consider the strategic fit of a particular risk premium within the portfolio and the asset owner's objectives.

LADEFOGED Based on our conversations with institutional investors around the world, governance challenges and peer risk are the two biggest headwinds. The governance challenge is about educating your board. You do need a good risk framework for this to work well, but that is a technicality more easily solved than the governance issues. Peer group risk keeps many institutions from allocating a larger share of their risk budgets to factor investing.

THOMAS Benchmarking the factor portfolios can also be hard for some organizations. We try to ask them to step away from rigidly benchmarking themselves against a relative performance space and think about the overall objective, particularly for pension funds. It's also important for their boards to understand that these factors will go through periods of underperformance, which is why we suggest having a blended exposure to three or four factors.

CECUTTO That's right. It's not a free lunch. Asset owners need to internalize those critical strategic long-term, asset-related decisions. Deciding whether you want exposure to value within your equity portfolio means that the asset owner needs to understand the characteristics of that risk premium: when value does well and when it does poorly. To that extent, it is no different from more traditional beta, like equity or credit: you should expect long-term returns associated with these risk premia, but also volatility in the interim. Being "smart" about these beta exposures also means using proper portfolio construction techniques to diversify away some of this volatility.

HEINEL I think another headwind toward faster adoption might simply be a lingering hesitation about quantitative investment approaches. Factor investing has traditionally been the domain of quant investors and now that we're bringing it to a broader group of investors, I think it can still feel somewhat intimidating to investors used to and comfortable with fundamental processes, even when those are less systematic and more dependent on individual judgment.

But I think that is changing as we see a broad-based shift across the entire culture from fundamental approaches to more technology-informed processes in everything from investing to how you choose a restaurant or movie in much more technology-savvy ways.

BENDER I think that's right. With the millennial "digital natives" starting to invest, there is a greater desire to understand what's happening in their portfolios, just as they use the internet and smartphones to have a more granular understanding of what's happening around the world. Technology is making that quant toolbox more accessible, less intimidating and less of a black box.

Q What does the future hold for factor investing?

BENDER We're definitely going to see continued innovation. There has been an enormous amount of R&D in recent years as more clients are thinking about factor investing and testing the limits of what they can do with it.

CECUTTO We are also very optimistic about the future. We have started from almost nothing as a base and now see it becoming a much larger exposure in an asset owner's portfolio. While large, more sophisticated asset owners were

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RIC THOMAS

among the earliest adopters of this concept, we are starting to see more mid-sized institutional investors beginning to adopt these approaches and more momentum across the board. In the long run, this should equate into better and longer-term portfolio decisions, and a much needed reduction in cost and complexity in the industry.

BENDER We also anticipate that other segments of the institutional marketplace such as defined contribution programs will begin to adopt factor investing tools to achieve core exposures in a very cost-effective manner. That's an area where we think Smart Beta ETFs lend themselves well to democratizing factor investing for a larger base of investors within DC plans. We're already seeing meaningful interest precisely because of their liquid, transparent and cost-efficient attributes.

Disrupting the Alternatives Landscape

CECUTTO An area ripe for disruption and innovation is within alternative asset classes. That is where we will see many new alternative betas and ways to capture uncorrelated risk premia in a cost-efficient and transparent way. For example, we did a study in which we took the hedge fund composite index and found that about 85% of the returns could be explained by factor risk exposures. Some of these can now be captured much more cheaply than in the traditional "2 and 20" fee model.

THOMAS We're already seeing that now. Of course, it's hard to generalize about what any given hedge fund is doing. But

if you pick factors that generally work, you could create a simple market-neutral strategy that has a positive expected return over long periods of time. The tracking error of that against hedge funds itself may be high, but it's getting you to the same objective. Low-correlation equities, positive return.

HEINEL That's right, Ric. People used to think of hedge funds as a separate asset class but increasingly now they're viewed as trading strategies that deliver the sort of betas of whatever asset class they're geared to. So there's a broader recognition that focusing solely on asset classes as your building blocks misses a lot of the underlying nuances of the drivers of risk and return and that the factor lens could provide interesting insights across a whole new range of investment opportunities.

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FABIO CECUTTO

LADEFOGED That has been very much part of our journey at PKA. If anything, we're seeing that we have certain advantages in putting on alternative trades that hedge funds don't have. Of course our risk model is essential in helping us quickly assess the merits of a trading idea based on a dislocation in the market that might be temporary or even longer term. With longer-term opportunities, we have the advantage of a bigger balance sheet and a longer investment horizon that allows us to keep trades on for longer than many hedge funds.

But the proof of the pudding is in the eating. When I look at our performance for 2015, despite the market challenges, we had a much better diversified portfolio and a significant part of our return came directly from our factor exposures. So at the end of the day, that's what we tell our investment committee and board about factor investing: it did deliver. ■

FOCUS ON FACTORS

For more on SSGA's factor investing thought leadership:

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