Factor investing proves useful to some

Blends of momentum, value and volatility stocks will not yet oust portfolios balanced by sector

What should the building blocks of a portfolio be — sectors or factors? This sounds an annoyingly abstract and philosophical question, but is at the heart of how equity management is being rebuilt post-crisis.

Traditionally, assets are allocated using economic and industrial sectors, according to what a company does. Investors can allocate to financials, consumer durables, utilities and so on. As the economic cycle turns, so they can adjust, with cyclical sectors on the way up, and defensive sectors when they think the economy is heading down.

But the idea is taking hold that portfolios should be built according to investment factors — derived from the way a company performs financially and from how its stock performs, but divorced from how the company makes money. The rise of factor investing has seen funds and indices focus on value (stocks that look cheap compared with their fundamentals), or momentum (current winners, that tend to keep on winning), or low volatility (stocks whose prices are relatively stable).

Index providers are eagerly producing indices to track either factors or sectors, while the exchange traded fund industry will happily produce ETFs that will track them.

Factor investing pulls apart the ways in which active managers have beaten the market. Consciously or not, successful managers were exploiting one or more investment factors. Using historical data, it is not difficult for academics to isolate factors that would have worked in the past.

Factor investing, as this column has explained before, is thus the flavour of the month as it endangers (or even, to use the buzzword of the moment, disrupts) passive and traditional active investment alike.

The question now is: Can factors be harnessed to work for the future? If so, how? And are there simply too many of them?

The answer to the final question is “yes” to judge by recent research led by Campbell Harvey of Duke University’s Fuqua business school. Pointing out that many stock market anomalies become much less anomalous once they have been published — because traders effectively arbitrage them away by trying to take advantage of them — the team of researchers found no fewer than 316 putative factors that have been put forward in leading financial journals alone.

These cover a huge range: from balance sheet factors, through changes in accounting standards to the number of analysts who follow them, with everything in between. Unsurprisingly, the researchers found that most fail to withstand tests for statistical rigour.
Using statistical tests borrowed from medical research, they suggest that up to half of these factors are false discoveries, while about 70 per cent of the remainder are so small as not to be meaningful. They suggest far tougher statistical hurdles before accepting new factors into the investment universe.

Another study, led by Marie Briere, head of Amundi’s investor research centre, sets up a contest between how factor and sector investing would have fared for US stocks over the half century from 1963 to 2014, using a battery of statistical tests on the database kept by Ken French of Dartmouth University, which classifies stock returns using both factors and industrial sectors.

This study focused on the factors that Mr French records and have been most closely monitored and shown to work in the long run, including value, momentum and size. It does not include many of the more questionable factors that academics have dredged up in recent years.

Its conclusion is that factor investing does indeed fulfil many of the claims made for it. Diversifying according to factors tended to provide better returns and lower volatility. But it “still has a long way to go before it can oust sector investing”. The margins were not great. In particular, the problem is to make sure that strategies based on factors can be made to work with real money, rather than figures in Excel spreadsheets. For many factors, there is a risk that transaction costs would gobble up any extra returns. That is not a problem for sectoral investing.

Factor investing is most useful to those with a high risk tolerance, who tend to be those who can afford to take a long-term view.

Factors performed best, and became meaningfully superior, only when the researchers assumed it was possible to sell short, or bet on stocks to fall. Without this weapon, their outperformance was far more modest.

Also, when tested during significant bear markets, factors tended to underperform sectors. They largely take advantage of anomalies that take a long time to correct, and which are formed during downturns, so this is not surprising. Momentum, for example, is subject to sharp reverses, while value stocks tend to become cheap during sell-offs. That raises the issue of whether it is possible to rotate between factors as asset allocators rotate between sectors, and whether holding several factors at once might tend to cancel out benefits.

The conclusion, therefore, is that factor investing is most useful to those with a high risk tolerance, who tend to be those who can afford to take a long-term view, and those who can amplify their factor returns by selling short. Its applications for endowments or hedge funds are obvious.

Beyond that, it is a challenge for the investment industry to drive down costs and find a way to offer these advantages to individual retail investors. And they must also resist the urge to do what may be happening at present, which is overcomplicate the issue and flood the market with “factors” that will not stand the test of time.

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