What is factor investing?

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Published: Oct 20, 2019 9:19 a.m. ET

Quantifiable returns + grand narrative = factor investing

You’ve read about the stock of the day and the ETF of the week. You’ve got a pile of newspaper clippings about the strategy of the month. You bookmarked an article somewhere about the newest rotation to read later.

But, despite it all, you have a nagging feeling: There’s got to be an easier way to invest.

If that sounds like you, it’s time to get acquainted with factors.

Consider factors the performance qualities of a stock that can be identified and tracked to create an investing strategy that outperforms the broader market. Factor investing isn’t new — it dates back to the mid 1970s — but it’s gotten a boost over the past few years from the proliferation of exchange-traded funds.

In fact, over $900 billion is now invested in about 820 ETFs that take this approach, according to FactSet data, meaning they use a rules-based approach to achieve better returns than the broader market, when adjusted for risk. (Funds constructed around factor-driven strategies are often called “smart beta.”)

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One of the firms that’s led both academic research into factors and the push to develop investing strategies around them is Newport Beach, Calif.-based Research Affiliates.

A 2016 study led by Campbell Harvey, a professor of finance at Duke University’s Fuqua School of Business and a senior fellow with Research Affiliates, surveyed the academic research into specific factors around which investment strategies are constructed and counted 316 distinct factors — an estimate he concluded was likely lower than the actual figure.

Jonathan Treussard, head of product management at Research Affiliates, said the firm’s thinking about factors focuses around four big ones. (There’s also a fifth — sort of. More about that in a bit.)

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MarketWatch spoke with Treussard about those four major factors.

Value is familiar to most investors as describing Warren Buffet’s approach: “buy low, sell high.” As Treussard put it, “If you can find a disciplined way to find assets at a lower price, they tend to be better investments over the longer term. Good value for money spent makes just about as much sense in investing as in real life.”

As MarketWatch has observed, momentum might be quickly, if crudely, described as “buy high, sell higher.” If that sounds expensive, consider this: If there’s a “stock that everyone’s talking about at the cocktail party,” it’s probably not a great value play — but if all the big players in the market are buying it, it’s going to go up.
Value and momentum may be the yin and yang of investment strategies: “Value is a long-term trade,” Treussard said. “It's cheap to implement but expensive from an emotional standpoint.” Conversely, he said, momentum is expensive because it necessitates a lot of trading, “ongoing repositioning of your positions, last month's hot stocks to this month’s.”

Factors are concepts that ring true, but are also quantifiable. The value and momentum factors are market-based: Have enough investors piled into a stock to give it momentum? In contrast, the two other biggies are more fundamental, speaking to the characteristics of a company.

The low-volatility factor is easy to grasp but more mysterious to account for. Several decades of research show that less-volatile stocks outperform the broader market. It may simply be that if investors glom onto higher-flying stocks, then less-risky ones may become value plays.

Quality refers not just to a company’s management and governance but also to its results: Does it reliably produce strong earnings and maintain a healthy balance sheet? That also sounds intuitive, but, Treussard cautioned, it can get murky. Among other things, “being highly profitable is both a blessing and a curse. Company management may not be fully aligned with shareholders and may make disappointing decisions,” such as enriching themselves, expanding too fast or going into riskier ventures, he said.

Many analysts place a fifth factor, size, among the primary themes, but, thanks to some recent research and advocacy among market leaders, it — like Pluto among the planets — has been rebooted. While there is an obvious logic to the narrative that smaller companies are more likely to be undervalued, some of the initial research that supported the idea has been disproven. “We are size skeptics,” Treussard said. Also worth remembering: Smaller companies are more likely to be more volatile.

Treussard argued that it’s important for investors to understand the narrative behind each factor. “You have to come up with a rationale or a belief that you have to truly adhere to that a particular factor is robust enough to trust,” he told MarketWatch.

Still, because of the rules that underpin the approach, it’s a strategy that’s nearly impossible for most investors to do casually, and not really appropriate for applying to single securities. Curious investors may want to check out a neat interactive tool for judging various factors that Research Affiliates makes available for free.

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