The brass tacks of factor investing through ETFs

by Leo Almazora
16 May 2019

A growing body of research indicates that rather than asset allocation, investors looking for returns over time should focus on factor-based allocation. That job is made easier by the existence of factor-focused ETFs — although the variety of options in the market could end up confusing more than
For that reason, building an effective factor-based portfolio requires a systematic approach. According to a recent article on Barron’s, the first step is to find the factors with real-world track records and significant academic support. A paper titled Alice’s Adventures in Factorland by Campbell Harvey, a partner at Research Affiliates, tracks the historical origins and efficacy of key factors. The value factor’s academic history dates back to the well-recognized “three factor model” paper published by Eugene Fama and Kenneth French in 1992.

There are other factors with respectable track records of success. The size, or small-cap, factor was identified in 1975, though academic studies released since then suggest that its success comes from a composite of value and illiquidity. The low-volatility factor, which Harvey refers to as “low beta,” goes back to 1966; with a history of equalling market performance rather than beating it, it’s ideal for conservative investors with an eye on risk-adjusted returns.

High operating profitability has been among the few factors to work well since 2008, though results prior to 2013 are back-tested. And while high-quality stocks have also performed, the factor’s history extends only up to 2003.

After choosing factors, investors must consider how to gain exposure to them. For instance, those who seek value but want close-to-market performance — which minimizes the risk of underperformance — may consider a market-cap-weighted factor index ETF. But since the largest value stock may not be the cheapest one, some investors may prefer an ETF that weights stocks based on how purely they express the value factor. That involves some risk, however, as high factor concentrations tend to come with higher-than-market-level volatility.
The last decision, how much to allocate to factors, is the most difficult to answer. Some professionals, including Harvey, may favour making tactical shifts to factors based on prevailing macroeconomic winds and whether a certain factor has recently underperformed its way into “cheap” territory.

But Gerstein Fisher founder Gregg Fisher argues that such an approach, like traditional market timing, is extremely hard to get right. Therefore, investors who want factor exposures but don’t want to worry about the allocations themselves may buy a multifactor ETF, while taking care to examine its underlying components.

Citing a 2018 paper by Fisher, Barrons said factor allocation could follow a customized “life cycle” approach based on an investor’s age and risk tolerance. The paper found that transitioning over time from the most volatile factor strategies — such as small-cap value, which combines size and value factors — to the least volatile quality factor produced the best results.

Follow WP on Facebook, LinkedIn and Twitter

Related stories:
Addressing the ETF factor-based investing dilemma
The quant ETF that promises smooth performance and ‘airbag’ protection
Important Update

When you log in with Disqus, we process personal data to facilitate your authentication and posting of comments. We also store the comments you post and those comments are immediately viewable and searchable by anyone around the world.

Please access our Privacy Policy to learn what personal data Disqus collects and your choices about how it is used. All users of our service are also subject to our Terms of Service.

Proceed