Breakout session B – Room 3

Thursday, 8 June 2017

Equities – Factor Investing

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Agenda

- What is Factor Investing?
- Why is Factor Investing becoming increasingly Topical?
- How does Active Management compare to Factor Strategies?
- What is Smart Beta and how different to Factor Investing?
- Frontier client experience
- Cbus experience and vision in this area
- Summary

What is Factor Investing?

- Investopedia Definition
  - Factor investing is an investment strategy in which securities are chosen based on attributes that are associated with higher returns
  - This definition seems too narrow in our view. Some factors such as Low Volatility have attributes associated with lower risk or less drawdowns
- Common “Factors” referenced include:
  - Value, Momentum, Low Volatility, Quality, Small Cap
  - A more robust factor has data support and academic literature on the factor
- What is a “Smart Beta”?
  - Occasionally a term used interchangeably with a Factor

Why is Factor Investing increasingly Topical?

- For Risk Reduction
  - Some factors can deliver a better drawdown profile (eg. Low volatility)
- For Return Enhancement
  - While more costly than passive management, a low cost factor can be expected to deliver a superior return
  - The payoff from active management appears to be on the decline
  - Some alpha from active management has been shown to be factor premia dressed up as alpha
- For Cost Savings
  - Factors are cheaper to access than active management
  - Can be part of a fee reduction strategy
- To Provide a Specific Portfolio Exposure
  - Add an exposure that complements the existing portfolio

- It has been heavily promoted and structured into products

How has active management fared in the past decade?

- The following are Manager Excess Returns to 30 April 2017 (pre fees), Source: Mercer Insight
- The results of the past decade are not especially compelling versus active fees
- Active Management in Australian Equities

Versus S&P/ASX 300 Index	3 Years (% p.a.)	5 Years (% p.a.)	10 Years (% p.a.)
Australian Equities (Observations)	87	80	50
Upper Quartile	2.8	2.5	2.0
Median	0.6	1.2	1.4
Lower Quartile	-0.3	0.5	0.6

- Active Management in Global Equities

Versus MSCI ACWI	3 Years (% p.a.)	5 Years (% p.a.)	10 Years (% p.a.)
Global Equities (Observations)	94	74	43
Upper Quartile	2.3	2.0	1.2
Median	0.7	1.0	0.2
Lower Quartile	-1.1	0.2	-0.5

- Active Management in Emerging Markets Equities

Versus MSCI Emerging Markets	3 Years (% p.a.)	5 Years (% p.a.)	10 Years (% p.a.)
Emerging Market Equities (Observations)	37	29	20
Upper Quartile	2.5	2.6	1.8
Median	1.4	1.7	1.1
Lower Quartile	0.7	0.4	0.4

How have factor strategies performed?

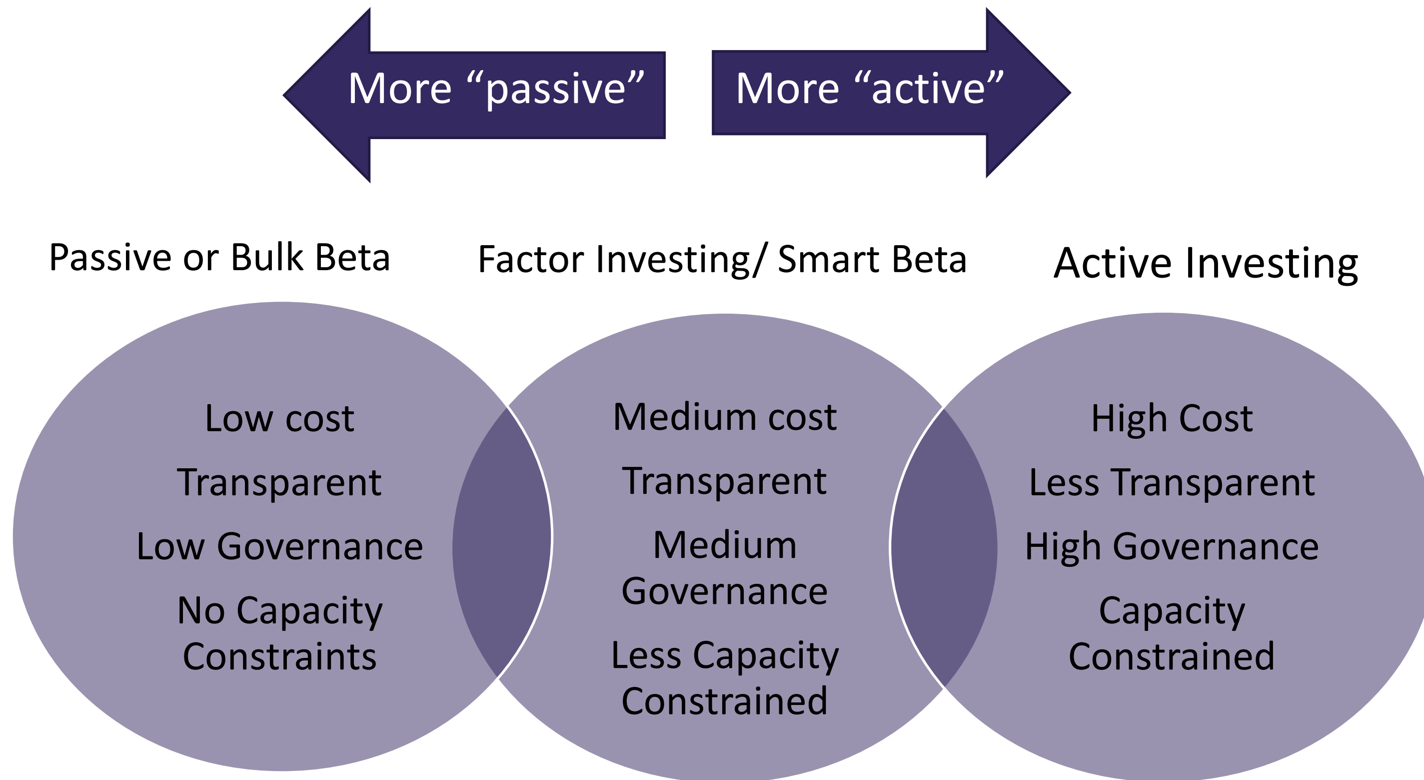
- Objectively, it is hard to answer this questions with high confidence
- Beware of any factor series that you see
  - Many of these have been created retrospectively and lack credibility. These have superb past performance track records and conveniently ignore transaction costs
  - The MSCI World Small Cap series only commenced in 1999 (small caps investment was happening well before then)
  - The MSCI World Minimum Volatility series commenced in 1994 (nobody invested until mid-2000's)
  - The MSCI World Quality series commenced in 1994 (only recently invested and quality defined for a strong backtest)
  - The MSCI World Momentum series commenced in 1994 (actual returns impacted by transaction costs)

How have factor strategies performed?

- The MSCI World Minimum Volatility series has outperformed MSCI World by +1.28% p.a. since 1994
  - Many manager products have outperformed by more in their backtests
- The longest factor series that seems credible is MSCI World Value – 42 years from 1/1/1975 to 30/4/2017
  - This series has outperformed MSCI World by +0.84% p.a. with a tracking error of 3.3% p.a.
  - Note that this particular factor series has underperformed in the past ten years and value/growth have both generated approximately market returns since 1994

Genesis of Factor/Smart Beta Investing

- Challenge to the CAPM and Efficient Markets Hypothesis (EMH)
- Passive market cap portfolios do not discriminate between expensive and cheap stocks
- Alpha not true skill of managers but dressed up as implicit exposures to factors



Naïve Factor versus Smart Beta

- A naïve factor is a widely used or accepted factor
  - Academically documented factor premiums that are rewarded over the longer term
  - Can be systematically harvested in a transparent, repeatable manner
  - Generates higher risk –adjusted returns and offers better diversification than passive investing
  - Five widely accepted factor premiums; value, momentum, quality, low volatility and size
  - Can be implemented using ETFs
  - Issues of crowded trades and front running if using public factor indices

- Smart beta
  - Takes factor investing to the next level
  - Avoids the pitfalls of factor investing with manager overlay
  - Increasing interest for multi factor investing
  - Generally described as "return" or "risk" focused smart beta

Factors/smart betas and Frontier clients

- Frontier's clients have largely implemented smart betas in global equities
  - We think this is the most logical place given the breadth of the sector

- Frontier's clients have tended to add a single factor or additional factors over time
  - Low volatility has been the most common factor added
  - Value has been the other factor generating most interest
  - Separate providers have often been added for different factors – this may ensure a suitable providers, but it may not be the most efficient implementation

- This has occurred for a variety of reasons
  - For protection against drawdowns
  - To fill portfolio gaps with a factor
  - To reduce fees
  - To replace active management that has not worked well

The Cbus experience

- How?
  - Global Equities – fundamental indexation and low volatility exposure
  - Emerging Markets – value momentum
  - ESG considerations

- Why?
  - Complementary to existing manager line-up and improved diversification of global equities portfolio
  - Risk reduction and return enhancement
  - Cost savings

- Important to note
  - Investment decisions should be based on own investment beliefs
  - Implementation route is crucial to avoid unrewarded risks
  - Setting right expectations and benchmarks key
  - Smart beta valuations can get “expensive” so be wary of timing

Summary

- Factor Investing in Equities offers the potential for different and potentially superior return streams to a market cap index
- There are naïve and sophisticated Factors and these have scope for different outcomes
- Be wary about historical data and realistic about what can be achieved with Factor Investing
- Factor Investing should be designed to suit your fund
- Consider Factor Investing alongside active management
- Be cautious about the entry point when looking at a smart beta/factor

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Matters to consider if setting up a Factor Investing Program in Equities

- Ideally plan a program for the future
  - A designed and planned factor investing program will usually be more efficient and effective than adding factors incrementally
- Be discerning and realistic
  - Be selective on factors and whether they truly offer a return premium or risk benefit
  - Consider a factor's relevance and scope to be additive to your equities portfolio
  - Adopt conservative factor return forecasts and know the difference between naïve and sophisticated
  - Consider the factors valuation before implementation. An expensively priced factor will have a lower expected return
  - Do not expect a factor strategy to match an active manager with skill
  - Take a long term perspective – a factor is most likely to deliver superior returns to the index over the long-term

Matters to consider if setting up a Factor Investing Program in Equities

- Balance the level of Factor Investing and active management
  - Factors capture only a return premium
  - An active manager can generate excess returns through taking on idiosyncratic risk
- Consider the Factor Investing allocation based on objectives and budgets
  - Fee budgets
  - Sector outperformance objectives
  - Downside protection objectives
- Consider the merits of a single provider delivering multiple factors
  - There can be portfolio management efficiencies if performed by a single manager, rather than multiple providers
  - There can be fee benefits too
- Carefully consider whether to time factors
  - There is increasing enthusiasm to do this, but many active managers have tried and failed historically
  - Be wary of those that believe to have this timing expertise – this is difficult
  - Factor timing is likely to be most plausible at extremes

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