Q&A

The X-Factor

Heidi Ridley
CEO, AXA IM Rosenberg Equities

Smart beta is getting smarter. But not all strategies are keeping up. Heidi Ridley, CEO of AXA IM Rosenberg Equities, discusses the qualities that today's factor investing strategies must offer to feature in an institutional investor's long-term line up.

As the active versus passive debate continues to rage, smart beta strategies have been steadily evolving to offer investors a *true* alternative to traditional equity approaches.

What are the limitations of investing passively using traditional market cap weighted indices?

Heidi Ridley: There are a number of downsides to market cap weighted index investing. The main one being that it concentrates investor capital in stocks that may have already run up in price and as such investors could be more acutely exposed to the boom and bust cycles of the equity market.

This potential combination of overexposure to expensive names and heightened volatility led many to conclude that there is simply a more efficient way of accessing the equity risk premium, and producing sustainable long-term returns.

So what is smart beta?

HR: The term 'smart beta' first emerged almost 10 years ago to describe investment strategies that rejected the market capitalisation weighting approach in a bid to get away from some of the more unattractive features of this method.

Yet the smart beta term has, to some extent, become a victim of its own success. It has been used to describe a huge variety of investment approaches and outcomes, causing much frustration and confusion for investors.

How can smart beta be improved?

HR: At AXA IM Rosenberg Equities, we see the type of investing generally referred to as smart beta as rightly part of what is called factor investing. Our interest in factor investing, and what has drawn many to smart beta generally, is investing in proven risk premia ideas to generate better risk-adjusted returns than the cap-weighted market.

Factors are specific investment characteristics that are long established and persistent drivers

AXA INVESTMENT MANAGERS

21190_UK 02/2017 Design & Production: AXA IM London Corporate Communications. Produced using stock that is FSC certified.

www.axa-im.co.uk

AXA INVESTMENT MANAGERS

of equity returns, and which are generally linked to fundamentals.

We consider the four key equity factors to be: Low Volatility, Quality, Value and Momentum. Each of these factors is used to determine why a stock is included in the portfolio and the expected outcome for the investment. For example, a Low Volatility factor will be made up of lower-risk securities and should deliver an investment outcome expected to outperform a traditional market-cap index when markets fall.

“Factors offer different risk and return outcomes, allowing asset managers and advisers to focus on those factors that best meet investors’ goals.”

How can factor investing provide better outcomes?

HR: Rather than targeting outperformance of an index in the traditional way, factors offer different risk and return outcomes, allowing asset managers and advisers to focus on those factors that best meet investors’ goals. Assets managers may opt to focus on individual factors or combine more than one factor to further enhance the investment outcome.

An example of how blending factors may improve investment outcomes is AXA IM’s Sustainable Equity Strategy, which combines the Low Volatility and Quality factors with the dual aim of minimising drawdowns when markets fall and offering improved long-term returns.

Isn’t factor investing just passive management?

HR: Since factor investing is about explicitly biasing allocations away from standard cap-weighted indices, it should not be considered passive management. There are no standard definitions for individual factors; index providers and asset managers alike make active choices when deciding how to capture factors, which can impact investment outcomes.

A recent Rosenberg Equities’ study of a range of global Momentum factor funds[1], including ETFs, revealed a significant disparity of returns delivered over the last four years. The five best-performing Momentum approaches outperformed the market by 10% or more while the worst five underperformed the market by 5% or more (on a cumulative basis). Such disparities occur as a result of active choices made during construction of a factor. For something as seemingly simple as price momentum, decisions on to how to handle currency impact, country and sector limits all ultimately affect investment outcomes.

“Typically, ETFs adopt the ‘set and forget’ approach, which does little to serve long-term investment interests.”

What’s the difference between using an asset manager or an ETF for factor investing?

HR: As factor strategies are not passive, we believe they should be managed by an active asset manager. Asset managers have extensive experience with a wide range of market environments and typically use more proprietary versions of factors with built-in controls to manage undesirable side effects. There is a benefit from their ongoing research and development, which allows for the investment to evolve. Importantly, there is direct accountability for a strategy’s success from design through to execution.

Typically, ETFs adopt the ‘set and forget’ approach, which does little to serve long-term investment interests. Simple factor ETFs tend to rely on simplified metrics that may be easier to replicate but do not consider specific investment goals. With many simple factor ETFs, design and implementation are often handled by separate parties, which can create a fiduciary grey area with respect to who is responsible for the investment outcome.

[1] Source: AXA IM, August 2013-May 2017, based on a representative sample of 20 funds (both ETF and active long-only funds) investing in global, developed markets, with a singular focus on the momentum factor. For illustrative purposes only. Past performance is not a guide to future returns.

What are the latest innovations in factor investing?

HR: The factors on which a strategy is based are only as good as the manager’s ability to analyse and react to them. The latest technology means well-resourced managers can really dig into fundamental data and make educated decisions on the best stocks to include.

For example, Rosenberg Equities’ research found that the investment outcome for our proprietary measure of Quality, called Earnings Sustainability, could be improved by incorporating analysis of balance sheet fundamentals to predict likely changes in the level of Quality in the future.

We are also aware of the increasing importance of environmental, social and governance (ESG) factors in determining a company’s long-term profitability. We have incorporated ESG issues into factor-based strategies to look beyond traditional financial metrics to gain a clearer perspective of the risks and opportunities that lie ahead, and potentially enhance the long-term investment outcomes.

“We have incorporated ESG issues into factor-based strategies to look beyond traditional financial metrics to gain a clearer perspective of the risks and opportunities that lie ahead.”

Technology plays an important role in developing strategies to better meet investors’ needs for tomorrow. We, for instance, are actively exploring how big data and machine learning can be successfully integrated into our investment strategies. And, in our factor portfolios, we now integrate machine learning techniques to improve our understanding of tail risk in portfolios.

While technological advances have been positive for factor strategies, there is a danger that processes are hidden inside computers rather than readily accessible to investors. Recognising the importance of transparency, we have built software to demonstrate the process and resulting portfolio construction for our clients. Our ‘visualisation tool’ maps the entire investment universe according to proprietary measures of factor exposure and ESG characteristics, and each stage of the investment process can be demonstrated on a step-by-step basis to reveal how stocks are measured and weighted within the final portfolio.

What is the future for factor investing?

HR: Factor investing has the potential to respond to a wide variety of investment objectives across a range of economic conditions. As investors’ circumstances change and market environments shift, the emphasis on a particular factor or combination of factors should respond accordingly.

Improvements in technology will continue to drive innovation in this space. And, as factor investing develops, it will become ever more important to select active managers with the X-factor: a proven track record, transparent systems and robust processes that can help investors meet their unique investment outcomes over the long term.