New Strategies for Improving Risk-Adjusted Returns

By Richard Westlund

Institutional investors looking for higher risk-adjusted returns are turning to sophisticated factor strategies that provide different exposures to the global equities markets. It’s a powerful approach, based on academic research, that can help align portfolios with investment objectives.

“Meaningful factor exposure can provide positive returns with a better risk profile than other strategies,” says Matt Peron, head of Global Equity, Northern Trust Asset Management. “Rather than selecting managers in the hope that they can add alpha, investors are analyzing factor exposures in their plans to see if portfolios can be tilted more toward compensated risks.”

For more than 40 years, investment researchers have studied factors like volatility, momentum and size that can help explain risks and returns in the equity market. By tapping the expertise of managers who can put those findings into practice, investors can gain direct exposure to those factors, without taking on additional risks.

For example, a pension fund seeking stable returns might load up on utility stocks to reduce swings in the equities market, Peron says. However, that could increase other risks, such as over-concentration in one market sector. In contrast, a low-volatility factor strategy could be constructed to avoid exposure to untargeted risks.

On the other hand, if a portfolio analysis shows that some exposures are missing, an investor might add risk factors to the current holdings.

“Through factor investing, investors can avoid risks that don’t reward them with returns,” says Joop Huij, head of Factor Investing Research with Robeco in Rotterdam. “As more and more investors realize the advantages of factor investing, we should expect to see them implement its lessons not just as an afterthought but as a top-down matter of overall investment strategy.”

Eric Shirbini, global product specialist with ERI Scientific Beta in London, says there are only a limited number of factors with sufficient academic evidence to support their use in a portfolio. “The traditional factors are value, momentum, size and low-volatility,” says Shirbini, whose firm is part of the EDHEC-Risk Institute in Nice, France. Now, the evidence suggests two new risk factors: high profitability (companies with a high return on assets) and low investment (relative to the asset base), he adds.
Factor investing is attracting increasing attention as an effective investment model. “It’s good to start with terminology,” says Joop Huij, Head of Factor Investing Research at Robeco in Rotterdam. Multiple terminologies, such as smart beta, advanced beta or risk-based investing, are often used to refer to similar strategies. Research has found that as much as two-thirds of outperformance could be attributed to the market anomalies that we now call factors. The most common ones are value, momentum and low-volatility. Therefore, factor investing is an approach that takes advantage of how factors affect performance, and allocates towards them from the outset.

Factor investing involves taking these known factors and using them intelligently and collectively in an investment strategy. And, given the wealth of academic literature that is available to demonstrate that factors exist, attempts to incorporate them intelligently in an investment process are surprisingly recent developments.

Robeco has a distinctive philosophy. “The question is how to bridge the gap between this theory and the reality of setting up investment vehicles,” says Huij. For example, we can look closely at value. The idea that cheap stocks, with lower-than-average price-earnings ratios, will be rewarded with above-market returns is popular. Many believe that risk is the only determinant that drives a return, and that they simply should buy stocks that are cheap, without asking why and how it might affect future performance. By contrast, Robeco’s quantitative research team has tested for causality, rather than correlation, and found taking high risk into the portfolio is not necessary to earn that value premium. “That is what we think investors should consider when implementing a value strategy,” he says.

Robeco has taken a similar approach to other key factors, such as momentum and low-volatility. “We found that half of the risk intrinsic to a momentum strategy does not contribute to its return, and it can be stripped out,” he says. For a low-volatility strategy, built on the idea that low-risk stocks have higher risk-adjusted returns, “Robeco found that is important to not only rely on backward looking risk measures but also forward looking risk measures”.

Robeco has looked at different combinations of factors which result in different performance characteristics in terms of expected return, volatility, tracking error and potential drawdowns. An equally weighted factor allocation, for example, would allocate one-third into a value, momentum and low-volatility strategy each. A maximum return objective would forego low-volatility and split the allocation between value and momentum. A risk-weighted factor allocation could be 30 percent in value and momentum each, and 40 percent in low-volatility.

Factor investing is beneficial to many types of investors and to help achieve many different kinds of objectives. “It comes down to implementing the solution that fits best,” he says. “There is a great deal of opportunity for investors to benefit from this rigorous investment approach.” There is considerable evidence that factors work. Now, this research is being accompanied by investment strategies that are easy to implement, at a relatively low cost.

About Robeco
Robeco is a Rotterdam, Netherlands-based global asset manager that offers a wide range of investment products and solutions to institutions and individual investors. Robeco believes in quantitative research, sustainability and adding value for clients through constant innovation. Robeco has offices in 13 countries across Europe, the US, Middle East and Asia Pacific with key investment centers located in Rotterdam, Zurich, Boston, New York and Hong Kong. As of December 31, 2014 Robeco manages over €245 billion.

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In the past, investors obtained factor exposures through active managers. Now, investors now can access these risk exposures passively through the use of factor indexes. Since factor indexes differ in many ways, they exhibit low correlations with each other over time. While factor index performance can be cyclical, and investors have experienced periods of underperformance, longer-term data reveal significant outperformance.

“We have been building factor-based strategies for 20 years, there has been a notable pickup in interest in the past three years,” says Peron. “Clients have asked us to educate them on this approach, and now they are turning the corner and moving into the implementation phase. They like the idea of a middle way - an approach that provides the best of active and passive strategies so you can target your objectives systematically.”

Why use factors?
Investors use factor strategies for many reasons, such as offsetting risk exposures, complementing active strategies or beating a policy benchmark. For example, a defined benefits (DB) plan might implement a low-volatility factor strategy designed to lock in its funding status and match its long-term liabilities. On the other hand, an endowment looking for absolute returns might use a strategic value strategy to improve potential returns over the long term, regardless of short-term volatility.

“We don’t believe there is one optimal solution or allocation for all investors,” says Huij. “Instead, we think two things should be taken into account when constructing a factor solution.”

Huij says the first consideration involves the preferences of the individual investor. For example, there are big differences between the preferences of pension funds and sovereign wealth funds, he says. “Pension funds are worried about coverage ratios, liabilities, and have a relatively shorter time horizon; sovereign wealth funds have different risks to worry about, such as inflation,” he adds.

The second consideration is knowing what’s already in the investor’s holdings. “Something that’s often ignored is the exposure an investor already has in his or her portfolio,” says Huij. “If a sovereign wealth fund already has exposure to value, why add value investing in the solution you create for an investor?”

“We don’t advocate factor timing, but there are some general rules of thumb to consider as we move through the business cycle,” says Peron. “During a period of rate hikes, we typically see quality and low-volatility strategies doing very well, along with value and dividend-yield strategies. In the early stages of the cycle, small caps tend to be leaders.”

But we think the way to look at factor selection is more strategic, selecting factors based on your priorities or objectives.”

Constructing a strategy
Diversification is a key issue in constructing a factor strategy, says Shirbini. “Exposure to a single risk factor might work in your favor in some market conditions, but not in others,” he says. “A combination of factors can help smooth your portfolio performance over time, with potential benefits in all market conditions.”

Shirbini’s firm calculates a wide range of “smart beta” indices to give investors a choice of factor strategies. “We believe in providing efficient access to a particular factor (through diversification) as well as by replicating a smart beta index using an asset manager with low execution cost,” he says. “The index construction process allows the investor to see exactly how the strategy has been constructed.”

Peron adds that there is an ongoing debate on whether factor strategies are active or passive, since a manager typically takes a certain position and then implements the strategy through an index fund or exchange-traded fund (ETF). “We recommend choosing a factor strategy with thoughtful portfolio construction to avoid uncompensated risks,” he adds.

Huij says the evidence suggests that factor investing is more effective than just active or passive management. “But it is not enough to be aware that this statistical preference exists,” he adds. “It is even more important to incorporate these insights into the investment process. If you really understand what you are doing, this can help you to get more efficient exposure to factors, and to result in a better investment product.”

For example, when investors implement a value strategy – such as buying bargain-priced stocks – it’s not necessary to take a lot of risk to earn that value premium, adds Huij. “I like to refer to it as efficiently harvesting factor premiums.”

For institutional investors and their consultants, there are three fundamental issues to consider in selecting a factor strategy, according to Shirbini. “Investors should look closely at the costs, transparency and robustness,” he says, adding that it can be a mistake to rely on a back test for evaluating robustness. It may show “fantastic results,” but you need to understand how a strategy will work going forward.

As a growing number of investors have found, a factor strategy that aligns with long-term objectives can provide important diversification benefits. As Shirbini says, “A low-cost, transparent and robust strategy is ideal because it does not expose you to unrewarded risk.”
Be smart with your factors

Many investors are seeking to invest today by allocating to risk factors, such as Value, Momentum, Size or Low Volatility, that are well-rewarded over the long term.

By offering indices, as part of the Smart Beta 2.0 approach, that have well-controlled factor exposures and whose good diversification enables specific and unrewarded risks to be reduced, ERI Scientific Beta offers some of the best-performing smart factor indices on the market.

With an average excess return of 2.33% and a 43% improvement in risk-adjusted performance observed over the long run* in comparison with traditional factor indices, ERI Scientific Beta’s smart factor indices are the essential building blocks for efficient risk factor allocation.

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*Average of the differences in Sharpe ratio and differences in annualised excess returns observed between December 31, 1974 and December 31, 2014 (40 years) for all long-term track record multi-strategy factor indices and their cap-weighted factor equivalents calculated on a universe of the 500 largest-capitalisation US stocks. All the details on the calculations and the indices are available on the www.scientificbeta.com website.

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