The essentials of factor investing with Stephen Quance

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Having recently joined Invesco as the Director of Factor Based Investing for Asia-Pacific, Stephen Quance is passionate about demystifying and educating investors on this evolving area. A seasoned communicator and previous portfolio manager, he has worked with organizations across the region aiding research, setting strategy, refining operations and increasing knowledge of factor investing for over a decade.

Stephen answers some common questions including the basics of factor investing and how it is being adopted in Asia.

1. What is factor investing?

Unlike traditional stock picking, factor investing seeks exposure to a group of assets that share similar factors rather than focusing on sectors, geographies or investment styles. In recent years, I have had countless conversations with Asian investors about this approach as they increasingly seek precise and systematic solutions to achieve their investment objectives.

Factors - such as value, quality and momentum - are quantifiable characteristics of a financial asset that meaningfully explain its risk-return profile. Invesco considers dozens of new factors proposed each year, so we must provide education about what research has merit versus a repackaging of what's already known, or worse, not reliable. The ones that measure up have been scrutinized and empirically studied, giving investors material exposure to areas that have historically delivered a premium over long periods of time. Factor investing is about data; it is fueled by rigorous research and technological advances over time.

Stephen Quance
Director, Factor Based
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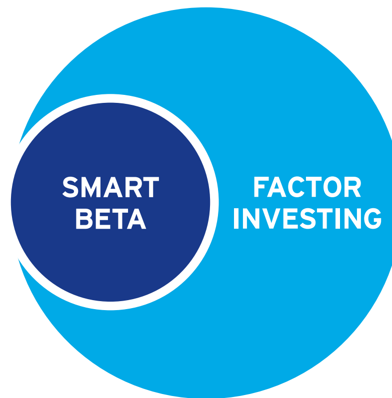
2. Is smart beta the same as factor investing?

There isn't yet a standard definition of smart beta, which is a source of confusion for investors. Most commonly, the term is used to refer to a large subset of factor investing; meaning all smart beta is factor investing, but not necessarily vice versa. A smart beta strategy usually means passive exposure to an exchange traded fund (ETF), tracking an index which screens and weights its constituents through one or more factors like high dividend or low volatility. Differing from traditional ETFs structured according to market capitalization, smart beta ETFs are designed to provide favorable risk-adjusted returns in diverse market environments.

Factor investing can also be deployed through a more dynamic approach where we seek to generate desired return streams using the latest advancements in factor techniques. Markets are not static and neither is the body of knowledge and experience we utilize in factor strategies. We may find new factors, for example, or a more effective way to capture an existing factor. Investors often see value in customizing a factor approach to meet their particular needs. By comparison, smart beta strategies may not be able to adapt or meet unique objectives as easily.

Factor investing best practices have advanced significantly compared to what was possible just a few years ago. The "best strategy" depends on what the investor would like to accomplish.



3. Is factor investing asset-class specific?

The basis for factor investing originated with equities more than 50 years ago, but it exists today as a widely used approach for publicly traded securities across asset classes. In fact, it is intuitive to me that certain factors should be seen across asset classes. There is both a strong rationale and empirical support of a value factor in equities, bonds and even foreign exchange, for instance.

In the fixed income space, Invesco looks at both macro factors like GDP growth and inflation as well as style factors like liquidity and credit quality, which gives insight into how particular securities may change in value during different stages of the economic cycle. Together, these factor groupings can be extensively back tested, providing clarity into the risk and return profile of an investor's fixed income portfolio.

4. How is it different from other quantitative strategies?

All factor investing is quantitative but not all quantitative investing is factor-based. The traditional quantitative approach is really focused on gaining alpha and trying to beat the market by targeting proprietary information or exploiting a skill. High-frequency trading, for example, uses complex, closely-guarded algorithms to take advantage of supposed information advantage over an infinitesimal timeframe. History has shown these approaches are not always able to achieve sustainable alphas particularly when deploying large amounts of assets.

Factor investing, on the other hand, is process driven so we can be more transparent and explain to investors what factors we plan to pursue and how we are going to pursue them. We can also pursue excess return and do it in a very scalable way because it doesn't require us as a manager to meet a CEO or site-check a factory, for example. In this way, factor investing blends attractive elements of both active and passive.

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5. How can factors benefit investors in Asia?

There's a lot of evidence to suggest factor investing not only has the potential to outperform market-cap-weighted benchmarks in the long run, but also with a greater risk-adjusted trade-off. Investors can also use factors to analyze their positioning at the portfolio level, even if they are not using an explicit factor approach to manage their assets. This is often an eye-opening experience because investors can review their investment strategy from a new vantage point and pinpoint the degree to which each component contributes to overall performance.

Factor investing in many ways is like a new technology. In Asia, so far most of the early adopters are large, sophisticated sovereign wealth funds and insurers. Many more entities are already considering factor investing, and it will develop into a mainstream approach as understanding and awareness continues to grow. In this way, factor investing is likely a permanent change in the way assets are managed, with the potential of real benefits for end investors.

6. How do you choose which factors to use?

We need a robust process to screen through all potential factors to ensure the ones we deploy in live strategies have merit. This is particularly important as factor approaches gain popularity and increasingly more people sift through security data looking for exploitable premiums. Every year Invesco screens factor ideas for consideration from academia, colleagues, clients and prospects. Since the highest quality research is almost always in the public domain, we can rigorously examine any new proposal and determine which factors have a solid rationale that merits inclusion in a portfolio. Being independent of thought and philosophy frees us to go where research breakthroughs occur, even if it is from an unexpected source.

Continually evaluating factors is also critical to ensure that our strategies stay current in the changing market environment. This enables us to enhance the rules behind factors that add value and adjust them for the ones that may not perform as well as before. I also believe that the entire investment process needs to be regularly examined and improved in order to ensure we help clients achieve their objectives as efficiently as possible.

7. Why should investors in Asia consider factor investing now?

I see factor investing as the third pillar of investing alongside traditional alpha sources and market cap weighted indexing. Due to the systematic, data driven processes of factor investing, it complements other investment options in compelling ways. At its core, it represents a breakthrough in fundamental elements of investing, like price discovery and risk and return. There is no reason investors in Asia should not benefit from this new knowledge. I believe it will mark a permanent shift in asset management both globally and in this region as well.

8. How can investors implement factor investing?

Factor investing can exist as either a standalone strategy or a complementary component of an existing portfolio. In reality, investors already have exposure to one or more factors, but unless they employed a rigorous factor approach, their portfolios might demonstrate a very different risk and return profile from what was intended. There are several techniques available to rebalance a portfolio and optimize factor exposures.

Depending on investor needs, they can implement an active or a passive factor approach, based on a single-factor or a multi-factor strategy. Regardless of the implementation selected, a factor-based portfolio potentially offers access to more stable returns and very specific outcomes. Factor investing will be an increasingly mainstream investment approach in Asia, so I am focused on providing investors in this region with more education so they can learn how it can help them meet their objectives.

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