FACTOR INVESTING IS A FAD

By: George Douglas, CFA, Chief Investment Officer

Applying a new name to an old idea and calling it "factor investing", "smart beta" or, worse yet, "alternative risk premium", with the hope of generating a different outcome is the height of folly and the definition of insanity.

The notion of "factor investing" in equities has gained popularity in recent years. In our opinion, it is largely a fad with a flawed foundation and a future of disappointment for most investors. "Factor Investing" is a repackaging and relabeling of ideas that have been around for decades, and have collectively generated mediocre results. Applying a new name to an old idea and calling it "factor investing", "smart beta" or, worse yet, "alternative risk premium", with the hope of generating a different outcome is the height of folly and the definition of insanity.

Active quantitative equity investing based on factor models has been around for decades, and many, many products have been introduced into the marketplace. Claims are made that some market "factors" have generated alpha over periods spanning decades. If so, where are the funds that have exploited these anomalies, and what are their long term records? Very few examples of such products come to mind.

Economic and Industry Exposures

The first problem with "factor investing" is *misattribution*. The "factors" used in models almost always exhibit strong correlation with economic and industry exposures. Consider, as an example, the recent fad of investing in "low volatility" equity portfolios. The investor is told the products are exploiting a "low volatility" market anomaly, but in reality are almost always invested in a portfolio with sharp sector over-weighting in Utilities, REITS, and mega-cap consumer stocks, along with consistent under-weightings in Technology and Energy stocks.

The following page shows representative sector exposures for three "low volatility" mutual funds:

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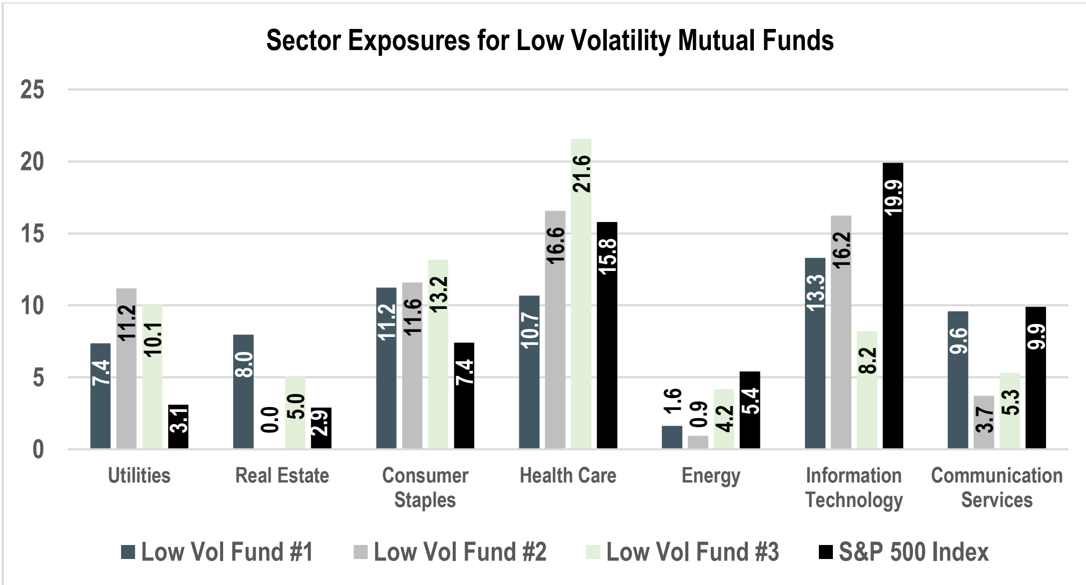

Source: Bloomberg PORT (Portfolio & Risk Analytics) as of 12/4/2018

Why would a rational investor expect particular economic sectors to generate consistently higher or lower risk adjusted returns over very long periods of time? Are market participants really that irrational? If this were so, why doesn't long term data on economic sector returns support such outcomes?

This is not to say that an investment manager with superior skill in forecasting economic conditions cannot successfully manage active exposure to economically sensitive and economically defensive sectors of the equity market, and generate alpha for investors. We instead argue that the relative performance of specific market sectors and industries is much more a function of economic performance of companies within each sector, not an ethereal anomaly such as the "low volatility factor." This relative performance will change over time and throughout economic cycles. As the economic cycle progresses, these portfolios will move from periods of outperformance to underperformance.

Markets and Investor Behavior

The second problem is *the assumption of stationary market and investor behavior*. Markets are competitive, market structures change over time, and the mix of market participants changes and evolves. Consider that today several trillion dollars are invested in hedge funds, a market segment that didn't even exist to a meaningful degree 50 years ago. Will a study of "factor returns" over a span of 60 or 70 years produce results that successfully predict future market behavior? The evidence strongly suggests not. A long list of quants have tried investment strategies that relied on "back-tested studies", many of which represent nothing more than data mining, and few if any are around today who can point to long term success in the generation of "alpha" from such efforts.

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Risk Premia

The term “alternative risk premium” has gained popularity as a description of supposed market anomalies that have exhibited persistence over very long periods of time, and are, therefore, “permanent.” Economic risk premium represents compensation for risk-taking, and is supported by economic theory and practice. Market anomalies, such as “momentum” and “carry”, do not fit the definition of economic risk premium, and the use of the term is misleading and confusing to investors. This is perhaps the most egregious mislabeling we have seen.

More recently, the notion of “big data” has come in to play. A few managers will certainly profit from “big data.” At the same time, exploitation of “big data” constitutes an arms race. Predicting security price behavior amounts to predicting the behavior of market participants. As more market participants utilize an expanding and changing multitude of trading algorithms and paradigms, the more difficult it becomes to predict what the algorithms will do and how prices will move. Security returns become less, not more, predictable. It may be a winning framework for a few, but it is a losing game for most.

Conclusion

While we do not reject the existence of a small subset of investment managers who are capable of consistently profiting from “factor investing” or similar quantitative strategies, the question for institutional investors is whether they can successfully identify and invest with this elite group? Research has shown that most institutional investors, and their consultants, have been unsuccessful in identifying traditional equity managers who generate meaningful and consistent “alpha”. Why should a different outcome be expected from “factor investing”?

We suspect that many of the folks offering “factor investing” strategies will take issue with what we write here. They will see themselves as among the select few on the leading edge, ahead of the pack, and able to generate consistent alpha for their clients. We have no doubt that some will fit that description, and we wish them the best. At the same time, we think that most of these strategies will end up on the same junk-heap as past fads, such as “portfolio insurance” or “130/30” portfolios. It is buyer beware.

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