Factor Investing: Finding Balance between Active and Passive

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Snapshot

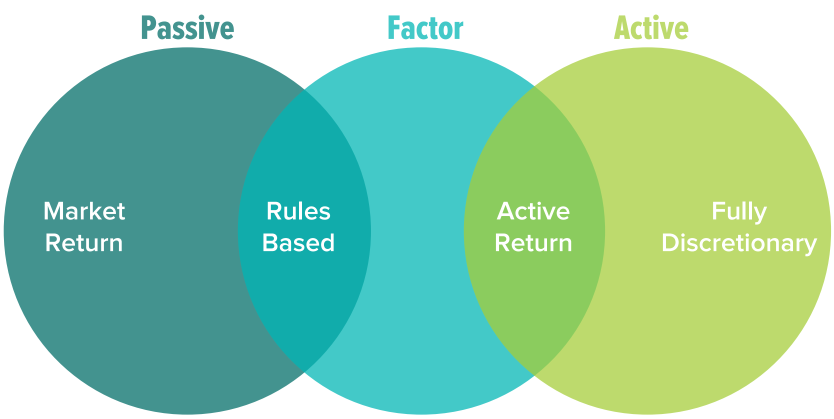
- Factor investment strategies employ a transparent rules-based approach to portfolio construction that provides systematic exposure to known market inefficiencies.
- These inefficiencies have demonstrated long-term persistence and offer opportunities for investors to generate excess returns or reduce risks.
- At SEI, we believe that incorporating factor investment strategies into traditional equity implementations could improve long-term risk-adjusted returns.

During the epic bull market that finally ended its record-long run in early 2020, there was a proliferation of index-tracking products—which left investors to navigate newly abundant information about the relative merits of active and passive investment strategies. At SEI, we allocate to both approaches in order to gain exposure to their respective benefits while offsetting their distinct limitations, in pursuit of improved risk-adjusted returns. Factor investment strategies fall between active and passive on the risk/return spectrum—transcending the pitfalls of each approach while reconciling their advantages.

Bridging the divide

Factor investment strategies employ a transparent, rules-based approach to portfolio construction that provides systematic exposure to factors, that is, characteristics historically associated with excess risk-adjusted returns.[1] This means factor investing possesses beneficial attributes of both active (potential excess returns) and passive strategies (rules-based simplicity and lower costs). Exhibit 1 shows the areas in which these three approaches overlap.

Exhibit 1: Shared Qualities

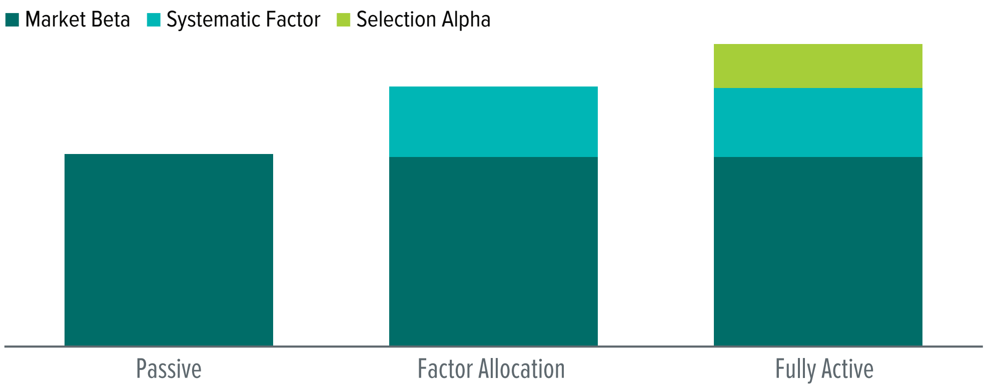


Source: Concept courtesy of MSCI

1 "The Asset Manager's Dilemma: How Smart Beta is Disrupting the Investment Management Industry." Kahn, R., Lemmon,. 2016. Financial Analysts Journal, Volume 72 Issue 1.

Exhibit 2 depicts a breakdown of total returns across these three approaches. We see that the return of passive strategies can be fully explained by market performance, or beta. Factor investing builds on this base by deriving potential excess return from systematic exposure to structural market inefficiencies. Active strategies build further still, also seeking potential excess returns, via both factor exposure as well as security selection.

Exhibit 2: Decomposing Total Return



Source: SEI. For illustrative purposes only. Not intended to imply performance of any investment strategy.

Behaviour: Motivating factors

Where do factors originate? Behavioural finance theory posits that investors make decisions that tend to reflect concerns about fear and greed. Such behavioural biases, in aggregate, create inefficiencies at the overall market level, which can create opportunities for other investors to generate excess returns. These inefficiencies can be volatile over the short-term and are sensitive to cyclicality, but have also demonstrated historical long-term persistence.

SEI categorises these factors into three primary families that have been empirically identified, along with the **behavioural anomalies** that drive their persistence:

- **Value:** Designed to exploit **mean reversion.** Investors tend to overreact to the low chance of a high-loss event **(loss aversion)**. Longer-term investors can exploit this risk premium. Value factors help identify company stocks that are priced cheaply due to investors being **overly cautious** about recent market conditions.[2]

- **Momentum:** Designed to exploit investor **anchoring** and **adjustment bias**—two behaviours that typically result in medium-horizon trends. We seek to capitalise on this anomaly by measuring a variety of trends such as earnings growth and share-price performance.[3]

- **Stability:** Designed to exploit investors' tendency to **underestimate** the compound-return benefits of investments that provide stable earnings over the long-term. These stocks are also often unloved and considered boring as short-term investors seek more immediate stock-market outperformance. We identify higher-quality business models, income statements and balance sheets, with strong interest-rate coverage and generally high solvency.[4]

2 "Myopic Loss Aversion and the Equity Premium Puzzle." Benartzi, S. and Thaler, R.. 1995. The Quarterly Journal of Economics.
3 "The 52-Week High and Momentum Investing." George, Thomas J. and Hwang, Chuan-Yang. 2004. Journal of Finance.
4 "The Low-Volatility Anomaly: Market Evidence on Systematic Risk vs. Mispricing." Li, Xi, Sullivan, Rodney N., and Garcia-Feijóo, Luis. 2016. Financial Analysts Journal, Volume 72 Issue 1.

Each primary factor family represents a set of more narrowly-defined factors, or sub-factors, that we combine into factor composites. We measure the presence of these factors in the stocks that make up our investment universe by using a series of corresponding metrics. Exhibit 3 connects the primary factors with their causal behaviours, linking both to the composites and metrics we employ to systematise our strategy.

Exhibit 3: A Modular Perspective on Factor Investing

Traditional Style	SEI Equity Alpha Source Group	Behavioral Foundation	Factor Composites	Measurable Opportunity	Examples of Metrics
Value	Value	**Mean reversion** in prices due to investor overreaction as a result of **loss aversion** or **liquidity preference**	Cyclical value	Undervaluation due to investors overestimating the likelihood and/ or severity of poor outcomes for economically sensitive companies	Price-to-book, Price-to-sales Price-to-NAV, Price-to-reserves Forward price-to-earnings
			Stable value	Undervaluation due to less investor exuberance for the steady, but low-growth earnings of mature businesses	Enterprise yield, Dividend yield Price-to-earnings, Cash flow-to-price
Size			Illiquidity (diversity)	Undervaluation due to low investor attention, benchmark concentration, or forced sellers	Underweighting largest constituents, Short-term rebalancing,Equal weighting
Growth	Momentum	**Trend** in prices due to investor under-reaction as a result of **anchoring**	Price momentum	Underestimation of price-trend persistency, typically over a 1-to-12 month horizon	1-to-12 month outperformance
			Earnings revisions	Underestimation of fundamental improvement, typically reflected in trending earnings or sales estimate changes on a 1-to-6 month horizon	Upgrades-to-downgrades, Change in median forecast, Standardized unexpected earnings, Pricet target change
	Stability	**Stable** compounding of prices due to investor preference to overpay for **lottery-like** outcomes	Quality	Under-appreciation of superior profitability via a sustainable competitive advantage (“moat”)	Return on invested capital, Margins, Default risk
Low Volatility			Low volatility	Under-appreciation of long-term compounding via stable and predictable, but not necessarily high or growing earnings	Standard deviation of returns Beta
Selection	Selection	**Idiosyncratic opportunities** through individual security, country or sector selection	Idiosyncratic (analytical)	Not applicable	Not applicable

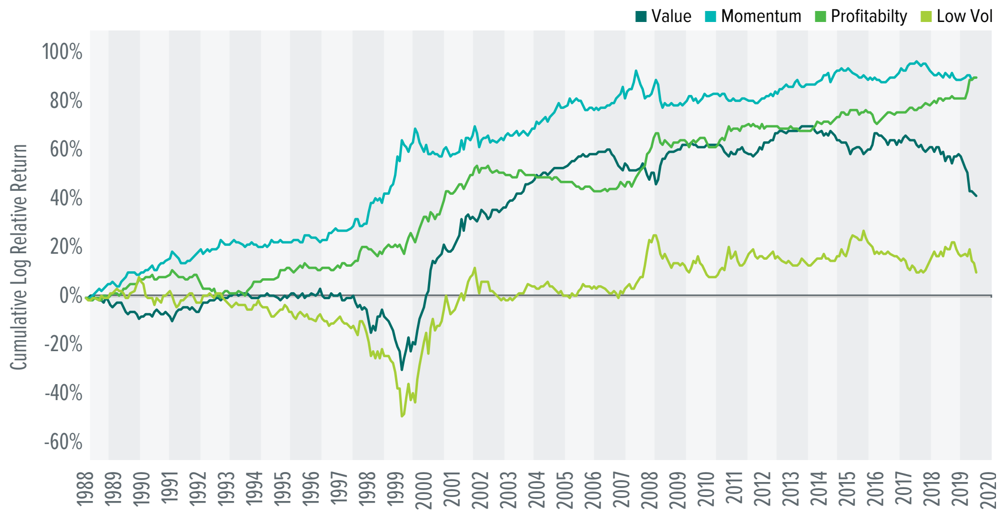
Source: SEI based on “Myopic Loss Aversion and the Equity Premium Puzzle;” “The 52-Week High and Momentum Investing;” “The Low-Volatility Anomaly: Market Evidence on Systematic Risk vs. Mispricing;” among others.

A globally diversified approach to factor investing

Factor performance is sensitive to market developments and cyclical pressures because of its exposure to varying macro and behavioural forces. For example, between 2000 and 2007, value’s market sensitivity (beta) shifted from defensive (low beta) to highly cyclical (high beta). By the end of this period, investor performance-chasing attracted so much attention to value-oriented strategies that the expected compensation for taking additional cyclical exposure eroded—right before the bear market began in 2008. In the later years of the recent bull market, investors were directing their tendency to chase performance toward stability- and momentum-oriented strategies, again without consideration of the potential consequences.

Exhibit 4 depicts the changing favourability of the primary factor families across major developed equity markets over time. This volatility reinforces the merits of global diversification, which remains as integral to successful outcomes in factor investment strategies as it does in traditional approaches. SEI believes a well-constructed factor investment strategy should seek to balance the contributions to expected returns from each factor so that they are approximately equal.

Exhibit 4: Factor Payoffs Over Time



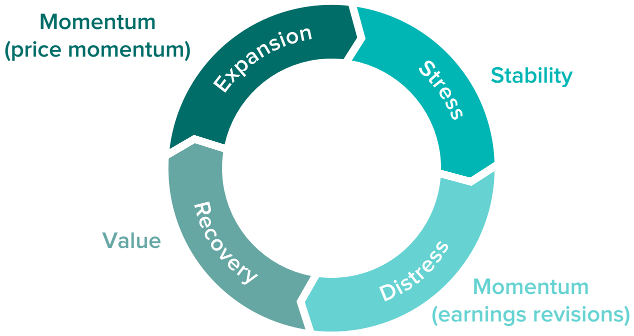
Source: SEI, using data from Russell, Axioma and FactSet. Data is for US equities, based from the Russell 1000 Index. Factor portfolios are constructed using the top one-third of the liquidity-weighted index, grouped by the respective factor style and rebalanced quarterly. The metrics are composites of underlying ratios that SEI has determined to be the appropriate measure of each factor. Factor performance is shown relative to capitalisation-weighted market. Factor and index performance do not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Data refer to past performance; past performance is not a reliable indicator of future results. Updated to 30 June 2020, using SEI's most recent composite methodology.

SEI's approach to factor investing and our competitive strengths

Assessing the investment universe through a factor-based framework is familiar territory for SEI. Factors have been a core component of our active investment-manager evaluation structure for more than 25 years. This has provided us with a broad foundation for understanding how to effectively identify and manage factor exposures in a portfolio. In fact, our views on factor positioning are essentially identical across directly-managed and multi-manager implementations.

Exhibit 5 provides a high-level reference for changes in factor favourability as the economic cycle progresses through different stages. We believe forward-looking investment strategies that shift portfolio weights dynamically among factors provide the framework necessary to capitalise on the available opportunity-set. SEI conducts factor-specific scenario analyses to measure performance across economic cycles, which helps inform the timing and sizing of our factor allocation decisions.

Exhibit 5: Shifting Factors along with the Economic Cycle



Source: SEI. For illustrative purposes only.

In 2004, we believe SEI served as a factor-based pioneer when we introduced our managed volatility strategies—the first of their kind, we believe—seeking to capitalise on some of the inefficiencies described above in the stability factor composite. As at 30 June 2020, we oversee more than $3 billion in managed-factor strategies.

Traditional passive products typically rely on market capitalisation to dictate index construction. Factor investing employs a combination of metrics, each tied to a particular sub-factor for which our analysis provides ever-evolving weighting guidance. We recognise the appeal of systematic, rules-based strategies to investors who prefer passive implementations, as they provide transparency and typically come with lower costs than active strategies. Factor investing offers both features, while also retaining the potential for excess returns.

With these benefits in mind, SEI believes incorporating factor investment strategies into traditional equity implementations could help improve long-term risk-adjusted returns.

Global Equity Factor Allocation at a Glance

(as at 30 June 2020)

Investment Universe

- Approximately 6,000 global stocks
- Benchmark = MSCI World Index

Multi-Factor Scoring

- Employs multiple measures to assess value, stability and momentum
- Weighted strategically in accordance with the strategy's long-term risk-return profile

Active Allocation

- Factor allocations are adjusted dynamically in an effort to capitalize on current market environment

Portfolio

- Approximately 300 to 600 stocks
- No large single-stock holdings
- Customised risk models
- Designed to complement other investment approaches
- Implemented efficiently

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