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Mixed reaction to 'new dawn' of factor investing

Is factor investing the new dawn managers have been waiting for? ***Tim Cooper*** investigates

Academics have hailed developments in factor investing as ushering in a 'new dawn' for fixed income investors. Wealth managers welcomed the news cautiously, but say more research is needed.

Factor investing is a systematic approach to investing that focuses on the specific drivers of returns in and across asset classes. Investors have adopted it widely in the equity space since the financial crisis of 2008, and institutional investors now use it routinely as an alternative to active management.

In bond markets, factor investing has been slower to catch on and investors still mostly turn to active management to control interest and credit risk exposures.

But, according to Edhec Institute, which has been researching this area, the steady decrease in interest rates in recent years has led investors to question whether active skills in this asset class are still effective.

Some asset managers – including AQR, Robeco and BlackRock - have begun to offer products that focus on harvesting returns from fixed income factors efficiently.

Factor investing aims to allow clearer risk control, and cheaper, more liquid and more transparent access to the underlying sources of returns. This could be especially attractive in those markets where traditional active investment vehicles may have been found wanting.

However, factor investing poses two major challenge – identifying the rewarded factors and constructing the investable proxies for those factors. In equity markets, there is a consensus around which factors are most effective - value, size, momentum, and profitability. Many funds exist to harvest returns from these factors.

There is no similar consensus in fixed income, although this is where the most exciting research is happening.

Players such as AQR and Robeco have highlighted the existence of risk factors in the US corporate bond universe such as momentum, value, carry, or size; and developed funds aiming to capture the associated rewards.

Edhec has also provided a first detailed, security-level analysis on two factors - value and momentum - that explain a large fraction of the differences in the cross-section of bond returns, using proxies for these attributes.

The institute said much research is still needed before risk premia can be extracted in fixed income as efficiently as in the equity space.

But some important differences are already emerging. Equity factor approaches have been mainly cross-sectional - playing one set of equity stock against another. But there is ample empirical evidence that directional predictability, or timing the market, in fixed income is a much stronger factor compared to equity markets. In addition, the traditional cross-sectional strategies also seem to be effective in fixed income.

It also warned against the dangers of data mining and overzealous factor hunting, and said it is necessary to combine academic research with the market experience of established managers.

Much more work needs doing, but we are witnessing a new dawn in fixed-income investing, said Edhec.

TRUE ALPHA

Wealth manager Parmenion already has some exposure to factor based fixed income funds.

Andrew Gilbert, senior investment manager at the firm, said these funds have been largely successful in targeting the point of the yield curve that offers the best risk/return reward. But this has also led to high turnover at certain points in the market cycle. Also their defensive approach to credit and duration has led to underperformance versus traditional bond market indices.

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ANDREW GILBERT
Senior investment manager, Parmenion

'Different factors work best during different market scenarios and cycles,' said Gilbert. 'As such, a combination of multiple factors that are empirically tested to add value over a reasonable period; and that have a sound economic rationale for likely persistence in the future, is typically the best approach.'

Gilbert noted that there is still little exposure to factor investing in the bond market with retail clients, and the existing strategies focus predominantly on the credit aspects, individual yield and yield curve shape. When academics test other approaches, fund providers and clients will be equally interested and open to the results, he said.

'Factor investing can help avoid individual bias or fund managers taking strong qualitative views that later impact future risk and returns versus client expectations. However the industry hasn't yet reached critical mass where the fees are substantially more attractive than an active approach. Academic evidence of "true alpha" or value in this space needs further development.'

Regarding Edhec's claim that 'timing factor exposures in fixed income is far more promising than in equities', Gilbert said: 'We are open minded and will examine the evidence before reaching a conclusion. Fixed income markets are more illiquid and often have a higher cost of trading, so this will have to be considered within any timing decisions. But this area is of significant interest to retail investors. We anticipate much more choice of products soon.'

COMPELLING ARGUMENTS

Metis Wealth is following fixed income factor investments closely and considering them for certain clients but has not yet taken the plunge.

Michael Smits, chartered financial planner at the firm, said: 'We continue to monitor this type of strategy as it is less established than its equity counterparts. We have reviewed a core fixed income holding using macro factors to match interest rate and credit risk.

'This approach has been shown to produce a portfolio that lowers duration and increases yield, thereby enhancing risk-adjusted returns. The research is all interesting and if it ultimately leads to better outcomes for clients, we welcome its continuation.'

Smits said Edhec's arguments are compelling – 'however, we're not getting too carried away at this stage. We advocate a balanced approach to asset allocating client money and there is plenty more research to be done before we become converts to factor investing.'

Charteris Treasury Portfolio Managers has not used factor investing in its private client wealth management division. Director Mark Williams, said it generally favours active management.

'We see lots of asymmetric risk in fixed income markets, so we only invest in short dated UK conventional gilts or AAA short-dated supranational floating rate notes for reasons of security and liquidity,' he said.

'Edhec talks about being creative in fixed income markets, especially in an era of quantitative easing and negative interest rates. Our bond strategy is specific in offering investors a haven in the event of a bond crash. [So Edhec's] process and modelling would not suit what we do.

'Research, reports and outside the box thinking are always welcome in this industry, but no modelling in the world will substitute the reality of decision making.'

Williams highlighted that active management does not involve a single strategy, it can be a wider combination of fundamental analysis, analytical research across many points of reference, and the manager's judgement and experience.

'Clients put their money and faith into individual investment managers based on their understanding of market mechanics and their decisions on markets,' he said. 'To leave the fate of a clients' money solely to factor investing could be a lot riskier than entrusting a manager.'

Williams agreed that bonds are more likely to mean revert than equities and this leads to many types of market anomalies that can be exploited.

'However, none of them are new, many are old as the hills,' he said. 'So the idea that this represents a "new dawn" in fixed income is a fallacy.'

Whether it offers a false dawn or promising sunrise, wealth managers are sure to keep watching developments on the factor investing horizon with interest.

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MARK WILLIAMS
Director, Charteris Treasury Portfolio Managers

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