HOW TO MULTIFACTOR: DIVERSIFYING EXPOSURE ACROSS ALL FACTORS AT ALL TIMES

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Currently, there is significant research being conducted around how to best invest in factors—which, simply put, represent certain equity attributes that may be associated with higher returns. As we discussed in our previous blog "[The factors that drive performance]", there are five main factors academics agree upon: value, quality, size, momentum and low volatility.

There are many ways to gain exposure to these factors individually, such as using Exchange Traded Funds (ETFs), but as the existence and benefits of factors becomes more accepted, multifactor strategies have become the next logical step. In our view, the benefit of a multifactor strategies lies in the fact that no single factor continues to outperform all markets at all times. As different factors come into and out of favour, maintaining multifactor exposure could mitigate the risk associated with trying to time factors, thereby landing in the worst-performing factor at the worst time.

Multifactor diversification may help reduce risk and regret

Different factors perform at different times. As the chart below demonstrates, none of the factors outperformed during every single calendar year. Since it is a practical impossibility to consistently know ahead of time which factors will be the best (or worst) performing, we believe a multifactor approach makes sense.

Figure 1: Calendar year returns show factor performance ebbs & flows

Year	Value	Low Volatility	Momentum	Quality	Size	MSCI USA Index
1998	18.1%	23.0%	49.0%	45.5%	10.5%	30.1%
1999	8.1%	7.2%	40.3%	19.8%	3.0%	21.9%
2000	3.2%	2.3%	-9.6%	-9.7%	13.0%	-12.8%
2001	1.1%	-8.4%	-17.6%	-9.8%	-1.0%	-12.4%
2002	-16.4%	-15.9%	-12.6%	-19.8%	-14.7%	-23.1%
2003	32.2%	19.1%	25.6%	19.6%	28.9%	28.4%
2004	19.2%	13.8%	16.4%	9.6%	17.1%	10.1%
2005	12.5%	5.9%	18.8%	2.0%	7.0%	5.1%
2006	19.0%	14.2%	10.4%	11.4%	16.7%	14.7%
2007	0.5%	3.6%	17.4%	10.1%	0.4%	5.4%
2008	-37.5%	-26.2%	-41.1%	-30.6%	-34.5%	-37.6%
2009	37.9%	17.5%	17.1%	31.0%	30.4%	26.3%
2010	12.1%	13.8%	17.8%	11.9%	18.3%	14.8%
2011	-3.3%	11.9%	5.5%	7.7%	5.6%	1.4%
2012	16.0%	10.2%	14.3%	13.3%	14.2%	15.3%
2013	42.3%	24.4%	34.0%	32.8%	30.7%	31.8%
2014	17.0%	15.8%	14.2%	11.2%	15.2%	12.7%
2015	-7.0%	4.9%	8.7%	6.5%	-0.2%	0.7%
2016	15.0%	9.8%	4.6%	7.3%	12.8%	10.9%
2017	21.3%	18.4%	37.2%	25.3%	18.4%	21.2%
2018 YTD	6.4%	9.3%	16.2%	12.5%	6.5%	10.2%
Full Period	8.9%	7.6%	10.7%	8.6%	8.4%	6.8%

Sources: Bloomberg, Factset, MSCI. Period is from 31 December 1997 to 30 September 2018. You cannot invest

directly in an Index.

The MSCI Factor strategies do represent underlying indexes and do include backtested returns. Value: MSCI USA Enhanced Value Index, which began live calculation on 12 Dec. 2014. Minimum Volatility: MSCI USA Minimum Volatility Index, which began live calculation on 2 June 2008. Momentum: MSCI USA Momentum Index, which began live calculation on 15 Feb. 2013. Size: MSCI USA Risk-Weighted Index, which began live calculation on 28 June 2011. Quality: MSCI USA Quality Index, which began live calculation on 18 December 2012. Returns are calculated net of tax withholdings. Historical performance is not an indication of future performance and any investments may go down in value.

A new breed of active management?

Multifactor and active approaches through ETFs are plentiful, but they are not created equally. In our view, as these approaches are investigated, it is important to consider the following elements:

- **Which factors are utilized?** Even if the widely accepted factors are size, value, momentum, quality and low volatility, not every multifactor strategy follows these factors in the exact same proportions. Confirming which factors are touched upon could be an important step in a due diligence process.
- **How are the factors balanced?** Some approaches may take existing single factor indices and blend them together. Other approaches may screen each stock across a spectrum of factors, thereby staking index inclusion more on a stock's capability to be well-rounded rather than excellent with respect to a single factor alone. Rebalancing frequencies for indices are also important to consider here.
- **Number of stocks?** Some strategies are very selective, leading to smaller overall numbers of constituents. Other approaches tend towards broader exposures with greater numbers of stocks. The number of stocks is important because, as the number drops, the approach becomes more selective and therefore places a greater risk on any singular equity position, as well as creating more sources of differentiation against market capitalization-weighted benchmarks. It is these sources of differentiation that create the potential for tracking error.

Because different factors perform at different times, we believe a carefully considered multifactor approach could help drive portfolio performance in almost any market.

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