



# How to evaluate equity factor products

Once you have decided that employing one or more factors may help achieve your intended investment objective, you may be ready to begin sorting through the many factor-based products available in the marketplace. But where to start?

Factor products may perform differently even if they are rules-based, tracking an index and have similar names that cite a particular factor (e.g. value, momentum, quality).

To help you conduct your due diligence, below is a sample list of product-related questions you should consider to help guide you through the investment selection process.

## Single or multifactor product

### Portfolio construction methodology

The design of factor products involves many conscious decisions by either an index provider or an asset manager. There is no industry consensus on how to build factor strategies, and current products can vary considerably. These questions can help you understand the rationale for different portfolio construction decisions.

(1) What are the research capabilities of the asset manager and/or the index provider constructing the strategy?

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(2) What is the eligible universe for securities selection (e.g. US large-capitalisation equity, international developed markets equity)?

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(3) Constituent selection: What characteristics are used to screen stocks, and why?

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Review the supporting theory and evidence for the chosen filter metrics. Were the metrics:

- Used in leading academic journals? \_\_\_\_\_
- Tested by independent third parties? \_\_\_\_\_
- Developed with sufficient out-of-sample data? \_\_\_\_\_
- Screened for potential back-testing biases? \_\_\_\_\_

(4) What is the weighting scheme (e.g. factor/score, blended factor/capitalisation, equal)?

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(5) What is the methodology for rebalancing?

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(6) Are there constraints on the degree of concentration (e.g. stock, sector, turnover, country, market cap)?

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What portion of the eligible universe is screened out?

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(7) How much and how consistent are the targeted and incidental factor exposures?

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## Implementation

Investors care about returns after all costs are considered. These questions can help you assess how decisions about implementing a factor strategy may affect investment outcomes.

- (1) Does the asset manager have experience with scalable, rules-based trading strategies?  
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- (2) Is there a degree of trading flexibility? \_\_\_\_\_
- (3) What is the expected turnover? \_\_\_\_\_
- (4) Determine the total cost of ownership.<sup>1</sup>
  - What are the ongoing costs, such as expense ratio and taxes (if the vehicle is held in a taxable account)?  
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  - What are the transaction costs, such as bid-ask spreads, entry or exit fees, and premiums/discounts?  
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- (5) What is the securities-lending policy?<sup>2</sup>  
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## Multifactor products only

These products require additional due diligence, given that more active decisions occur when considering multiple factors in the same strategy.

- (1) What is the strategic objective (e.g. excess return, risk-adjusted return, reduced risk)?  
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- (2) Which factors are considered, and why?  
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- (3) What is the weighting scheme among the factors?  
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  - How are the weights for each factor chosen?
  - If dynamic or tactical, what is the theory and evidence that support the time-varying strategy, and how might it affect diversification and all-in costs?  
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Is the strategy constructed using a top-down or bottom-up approach and why?

  - Top-down: Single-factor strategies are combined.
  - Bottom-up: Each stock's exposure to all targeted factors is included in the formula that determines whether to buy or sell.

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- (4) What are the factor exposures when blended?  
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For more information on factor investments and portfolio construction techniques, see Douglas M. Grim, Scott N. Pappas, Ravi G. Tolani and Savas Kesidis, 2017. *Equity factor-based investing: A practitioner's guide*. Valley Forge, Pa.: The Vanguard Group.

<sup>1</sup> Joel M. Dickson, David T. Kwon and James J. Rowley Jr., 2015. *Choosing between ETFs and mutual funds: Strategy, then structure*. Valley Forge, Pa.: The Vanguard Group..

<sup>2</sup> Andrew S. Clarke, 2016. *Securities lending: Key considerations*. Valley Forge, Pa.: The Vanguard Group.

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