Factor-based investing: The basics

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What is factor-based investing?

Factors are the DNA of investments. They are the underlying attributes that influence how an investment behaves. By targeting these attributes, factor-based investments attempt to deliver an investment premium, such as market outperformance or reduced volatility.

Every investment is influenced by underlying factors that help explain its risks and returns. For instance, value is a well-known factor.

Traditionally, a value-focused investment seeks to deliver excess returns from stocks that appear inexpensive compared with a company's value.

An investor who buys value stocks is willing to take on certain risks in order to earn a return premium compared with what the broad market can deliver.

Researchers have identified hundreds of factors. Some have earned historical return premiums, while others have produced premiums in the form of lower volatility.

Exposure to factors can be achieved through a variety of investment options, including style index funds, low-cost active funds, or factor funds and ETFs.

Here are five common factors and the basis for their respective premiums:

Value	Relatively inexpensive stocks from undervalued companies historically have earned higher returns than expensive stocks.
Momentum	Stocks with strong recent performance historically have earned higher returns going forward than those with weak recent performance.
Quality	Well-established companies with strong earnings and strong balance sheet quality historically have outperformed companies with weak earnings.
Liquidity	Stocks that are less frequently traded historically have earned higher returns than more liquid stocks.
Volatility	Stocks with low volatility historically have achieved higher risk-adjusted returns than those with higher volatility.

Factor-based investing is a form of active management

Regardless of whether factor-based investment products get their factor exposure by following a published index or through the decisions of an active manager, it's important to understand that factor-based investing is an active management strategy because it involves making a decision to tilt a portfolio away from traditional market-capitalisation weightings. As a result, with factor-based investing, you should expect a different risk and return profile than that of the broad market.

Enjoy transparency and control

Investors often have a range of factor exposures in their portfolios, whether explicitly through very deliberate decisions or implicitly because of an investment process.

By deliberately focusing on factor exposures as part of the portfolio construction process, investors know what they own and get a clearer view of the potential drivers of portfolio returns. Factor-based investing is also a practical option for those looking to have significant control over their portfolios' factor exposures.

In fact, with factor-based investing, you can choose to target the exposure of a single factor or employ a multifactor strategy that harnesses the diversification benefits of multiple factors.

Patience is the key

It's important to stress that while factor-based investing can be a lower-cost, more transparent alternative to traditional active investing, it requires you to be patient and stay the course during periods of underperformance.

Understand the risks

Historically, factor-based investments have experienced sustained periods of underperformance. In addition, factor-timing is extremely difficult. Strategies that attempt to time factor returns are ill-advised and investors should consider factor investing a long-term strategy.

Making the factor-based investing decision

Factor-based investing represents a dynamic tool designed to help you achieve specific investment goals. Direct targeting of factors through factor-based mutual funds and ETFs can offer the many benefits of traditional active mutual fund investing but at a lower cost and with less manager risk.

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