



FactorFlex

Portfolio Model



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Factor investing is a popular investment approach that aims to identify and exploit specific risk factors that drive returns in financial markets. It is based on the belief that certain characteristics or factors, can explain a significant portion of the variability in asset returns. These factors can include things like a company's quality, value, profitability, volatility, and momentum. By targeting these factors, investors can potentially achieve higher returns and better risk-adjusted performance than traditional market-cap-weighted strategies.

Factor investing can be applied to various asset classes, including equity and fixed income. In equity markets, for example, investors can use factor-based strategies to tilt their portfolios towards stocks with specific characteristics, such as those that are undervalued, have positive momentum, or exhibit low volatility. In fixed-income markets, factor investing can be used to target specific risk factors, such as credit risk, interest rate risk, and quality risk.

The practice of factor investing has its origins in the modern portfolio theory proposed by Harry Markowitz in the 1950s, which suggested that risk could be reduced by diversifying investments across assets with different returns.

Researchers then developed models that aimed to identify the factors that influenced returns, such as the Capital Asset Pricing Model (CAPM) in the 1960s.

The Fama-French three-factor model, developed by Eugene Fama and Kenneth French in the early 1990s, further expanded on the notion that returns are based on the market risk premium, size premium, and value premium. Since then, researchers have found more factors that can affect returns, like momentum, quality, and low volatility. Consequently, factor investing is a popular form of portfolio construction, with investors attempting to tilt towards factors that are likely to outperform in the long run.



Helpful Analogy

Factor investing can be explained using the analogy of a chef preparing a meal.

A traditional investment strategy can be like a chef using a limited set of ingredients to prepare a dish without considering the specific flavors or nutritional value of each ingredient. In the same way, a traditional investment strategy may not consider specific characteristics or factors of the companies or assets being invested in.

On the other hand, factor investing is like a chef carefully selecting and combining specific ingredients to create a balanced and flavorful meal. Similarly, factor investing involves carefully selecting and combining specific characteristics or factors of companies or assets to create a diversified and potentially higher-performing portfolio.

Just like a chef, a factor investor will carefully choose what factors to focus on, such as value, momentum, profitability, quality, and volatility. We use regression analysis to find investments that stand out in the factors we are looking for.

It's important to note that just like a chef, the factor investor needs to be well-versed in the markets and the factors at play and continuously monitor the portfolio and make adjustments as necessary.

Understanding Benefits

Potential Benefits

Factor investing offers several potential benefits for investors:

Improved risk-adjusted returns: By targeting specific factors that are expected to outperform over the long term, factor investing can potentially generate higher risk-adjusted returns than a traditional market-cap-weighted index. This is because the targeted factors can provide excess returns beyond what can be obtained through broad market exposure.

Diversification: Factor investing can provide investors with additional diversification benefits beyond traditional asset class diversification. This is because factors have historically exhibited low correlations with each other, and targeting multiple factors can potentially lead to a more diversified portfolio.

Systematic approach: Factor investing is based on a systematic and rules-based approach to portfolio construction, which can help investors avoid behavioral biases and emotions that can often lead to poor investment decisions.

Overall, factor investing can provide investors with a potentially more efficient and effective way to capture market returns, improve risk-adjusted returns, and achieve their investment goals. However, it's important to note that factor investing strategies may also involve higher costs, increased tracking error, and the risk of underperformance, so investors should carefully consider their investment objectives and risk tolerance before implementing a factor investing strategy.

Types of factor investing

Equity

- **Quality:** This factor is used to identify companies that have a strong financial position and are likely to be able to weather economic downturns. Quality companies typically have high returns on equity, low debt-to-equity ratios, and stable earnings.
- **Momentum:** This factor is used to identify companies that have been performing well in the recent past and are likely to continue doing so. Companies with high momentum typically have high returns over the past year and are expected to continue to grow.
- **Value:** This factor is used to identify companies that are undervalued by the market. Value companies typically have low price-to-earnings ratios, high dividends, and low price-to-book ratios.
- **Beta:** This factor is used to identify companies that have a high level of volatility. High-beta companies typically have high returns but also high volatility and are more sensitive to market movements.
- **Profitability:** This factor is used to identify companies that are generating high profits. Companies with high profitability typically have high returns on assets and high returns on equity.
- The portfolio would then be constructed by selecting companies that score well on these factors and weighting them accordingly to achieve the desired level of exposure to each factor. The portfolio would be regularly monitored, and rebalanced as needed, in order to maintain the desired factor exposures over time.

Fixed Income

- **Quality:** This factor is used to identify income-generating assets that have a strong financial position and are likely to be able to weather economic downturns. Quality assets typically have high credit ratings, low default rates, and stable income streams.
- **Beta:** This factor is used to identify income-generating assets that have a high level of volatility. High-beta assets typically have higher returns but also higher volatility and are more sensitive to market movements.
- **Long-term rate exposure:** This factor is used to identify income-generating assets that have a high sensitivity to changes in long-term interest rates. Assets with high long-term rate exposure typically have high yields but also a high sensitivity to changes in interest rates.
- **Credit:** This factor is used to identify income-generating assets that have a high level of credit risk. High credit risk assets typically have high yields but also a higher risk of default.
- **High-yield credit risk:** This factor is used to identify income-generating assets that have a high level of risk in the high-yield credit markets. High-yield credit risk assets typically have high yields but also a higher risk of default and a higher sensitivity to changes in economic conditions.
- The portfolio would then be constructed by selecting income-generating assets that score well on these factors and weighting them accordingly to achieve the desired level of exposure to each factor. The portfolio would be regularly monitored, and rebalanced as needed, in order to maintain the desired factor exposures over time.

Factor Investing Strategies



First, we look at long-term technical charts to determine which end of the spectrum for a factor is the right choice. For example, high-quality vs low-quality companies. We then have a proprietary scoring system that we use to determine if we have strong or weak confidence that which end of the spectrum we should be on. Once we have strong confidence, we then use regression analysis to determine which investment returns are statistically being driven by the desired factor. We then use a forward-looking efficiency curve to assign a portfolio weight to each investment. The forward efficiency curve is a graphical depiction of the anticipated excess returns of a financial asset. The forward efficiency curve is commonly used in asset allocation and portfolio management to gauge the predicted risk-adjusted returns of different investment opportunities at varying time horizons.



Smart Beta Process

Equity Factors	Direction	Confidence
High vs Low Quality	High	Weak
High vs Low Momentum	High	Strong
High vs Low Value	High	Weak
High vs Low Beta	Low	Strong
High vs Low Profitability	Low	Weak

Fixed Income Factors	Direction	Confidence
High vs Low Quality	High	Weak
High vs Low Long Term Rate Exposure	High	Strong
High vs Low Credit	High	Weak
High vs Low Beta	Low	Strong
High vs Low High Yield Credit Risk	Low	Weak



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