Benefits and Pensions MONITOR Meetings & Events WEBINAR

BMO | Exchange Traded Funds

How Can Factor *Beta* Be Integrated into Portfolio Construction?

Low volatility or value? Factors offering exposure to diverse investment styles

ETFs that focus on specific factors have gained considerable traction with investors. That being said, these factor ETFs will have different risk profiles compared to the broader stock market. Many advocate for a long-term perspective when it comes to factor investing, asserting that it's most appropriate for those investors who possess the patience to weather various market cycles.

In conversation with Benefits and Pension Monitor, Mark Webster Director of Institutional and Advisory, leads the esteemed panel of speakers to delve into the intricacies of factor beta and its integration into portfolio construction. The panel includes Chris Heakes, Head, Disciplined Equity, Portfolio Manager from Bank of Montreal Exchange Traded Funds; Mark Carver, Managing Director and Global Head of Equity Factors at MSCI, and Jon Spinney, VP & Chief Investment Officer at Vestcor.

Understanding Factor Beta

Factors account for approximately 75 to 80% of what is referred to as alpha, which is the excess return on an investment relative to the return of a benchmark index.

With the advent of greater computing power and in-depth analysis, factors emerged as the key determinants of alpha. There are different Factors providing consistent exposures, backed by extensive data sets, offering an evidence-based methodology.

For those with a preference for active investment, factors can provide a concentrated conviction portfolio, high active share, and the opportunity to capture alpha. In other words, factors can offer many of the same benefits as active mandates, but with a more focused and consistent approach.

Webster: What defines or distinguishes a factor from an active investment discipline?

Carver: What we frequently observe is that the use cases for factor indexes differ from those of style indexes. The latter is commonly employed as a benchmark and, at times, serves as an investment universe from which active managers make their selections.

Factor indexes act as an improved benchmark for true active funds. Within the asset owner community, there's an increasing trend of utilizing factor indexes to gain investment exposure typically through ETFs or separate accounts.

Heakes: Factors can be thought of as the essential nutrients in investing. When you focus solely on the style universe, you limit yourself to just two nutrients—it's akin to cooking with only two ingredients. However, as we know, there are many more ingredients available.

Just as a chef can create a more delectable dish with a greater variety of ingredients, the same principle applies to investing. The more factors you have at your disposal, the better your investment 'dish' can potentially be.

Webster: The valuation argument has intuitive appeal because investors are always careful when allocating capital. Are there any critiques we can make about depending too much on a valuation perspective when evaluating factor suitability?

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>
> -Chris Heakes

Heakes: The yield factor is closely connected to value, especially when considering dividend yield, as there is a natural correlation between the two. When dividend yields are higher, this often means that the price is lower, creating a higher yield and, generally, better value characteristics.

However, this relationship doesn't necessarily hold true for other factors. Take the low volatility factor in Canada, for example. Our ETF ticker, ZLB, typically trades at a slight premium in terms of price to earnings compared to the broader market. Over the 12 years we've run the low volatility strategy, we've consistently observed this premium. Notwithstanding the premium, the performance has been superior to the broad Beta index, nullifying the valuation concern[1].

Additionally, we see a slightly higher return on equity (ROE) and return on assets (ROA), as well as a lower debt-to-equity ratio compared to the broader market. When we look at the risk-adjusted returns this factor has delivered over time, including back-testing from 1995 to 2010 before we launched the strategy in 2011, it suggests that the premium may be worth it.

While low volatility tends to trade at a premium, value is often trading at a discount compared to the broader benchmark, even after a bit of a rebound in value over the past couple of years.

Webster: There is clear evidence that factors display different return profiles as we move through an economic cycle. How important is this, given that investors seek to compound returns across a cycle?

Carver: In our study, we analyzed over 40 years of data, encompassing multiple market cycles, to understand average outcomes. We found that investors are increasingly using a macro lens to size their factor positions, a decision that pertains to asset allocation rather than timing.

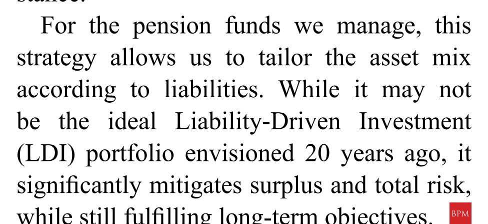
We assessed the probability of a factor index outperforming its cap-weighted parent index over various timeframes—1, 3, 5, 10 years, etc.—based on 40+ years of data. Our results showed that the longer you hold a factor, the greater the probability of outperformance. For many factor indexes in our study, the probability of outperformance over a 20-year period was close to 100%. This was not based on one 20-year period, but on rolling 20-year periods over 40 years.

Interestingly, even minimum volatility indexes, which are traditionally seen as less risky, showed a greater probability of outperforming their parent index over longer holding periods. This contrasts with factors like yield, value, and size, which tended to be more risky or volatile than their parent index over different time horizons. This supports the idea that the rewards earned from these factors are due to their associated risks, while factors like minimum volatility and quality are consistently less risky over time.

Rather than trying to time when to add or to subtract to a factor, institutions may want to consider overweighting or underweighting a factor, in response to macroeconomic indicators.

Webster: Should Factors be evaluated according to their alignment with long-term risk & return requirements for pension plans, taking into account their variables in pension considerations?

Spinney: By utilizing factor investing, we shifted our equity portfolio's risk profile and achieved a balanced 50/50 bond-stock exposure with a 35/65 risk level. This was accomplished through substantial allocations to low-volatility factors, supplemented by other factors relevant to local data. This approach resulted in a more efficient long-term portfolio with desired drawdown characteristics to maintain a defensive stance.



For the pension funds we manage, this strategy allows us to tailor the asset mix according to liabilities. While it may not be the ideal Liability-Driven Investment (LDI) portfolio envisioned 20 years ago, it significantly mitigates surplus and total risk, while still fulfilling long-term objectives. BPM

Source: [1] BMO Funds, October 2023, https://me-qr.com/mobile/pdf/18967068, https://me-qr.com/mobile/pdf/18967092

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