Factor investing roundtable

CHAIR

Chair for the day: Andy Cheseldine, Client Director, Capital Cranfield
Andy joined Capital Cranfield in 2017. Before joining Capital Cranfield, Andy acted as an adviser to trustees and employers at Watson Wyatt, Hewitt Bacon & Woodrow and latterly as a partner at LCP. Using his experience of over 30 years in consulting on both DC and DB pension arrangements and liaising with regulators throughout the pension and financial services industry, he is able to use his wide knowledge and understanding for the practical benefit of trustee boards. He has served on the PLSA DC Council since 2013.

PANEL

Tom Baird, Vice President, Manager Research, Redington
Tom is a vice president within the manager research team at Redington, where he focuses on equity strategies across the globe, ranging from long-term fundamental approaches to purely quantitative styles. He has worked at Redington since December 2017, before which he spent a number of years in the manager research team at Willis Towers Watson, specialising in public and private equity. Tom is a CFA charterholder.

Marlies van Boven, Managing Director Research & Analytics, FTSE Russell
Dr. Marlies van Boven is a managing director in the research analytics team at FTSE Russell. She is also lead lecturer in alternative investments at Warwick Business School and has taught at Cass Business School. Previously, Marlies was a senior investment consultant with Cambridge Associates’ Middle East & Africa team, working with clients throughout the GCC and wider MENA region, with a focus on hedge funds. Prior to that, Marlies was head of quantitative analysis and portfolio management at Baring Asset Management.

Andrew Cole, Trustee Executive, BESTrustees
Andrew has more than 15 years’ pension experience of both defined benefit and defined contribution schemes, managing one scheme through five valuation cycles. For the past seven years he has also chaired the Investment Sub-Committee of a £650 million portfolio. Andrew joined BESTrustees in April 2019. Prior to joining BESTrustees, Andrew spent over 35 years working in global financial markets working for both American and European investment banks where he held a number of senior roles in capital markets.

Ian Mills, Principal and Senior Investment Consultant, Barnett Waddingham
Ian advises pension trustees and sponsors on investment and risk management strategies. He helps to develop Barnett Waddingham’s investment consulting services to DB pension schemes. He provides clear and actionable advice that helps pension schemes take control of their situation and focusses on the issues that will have the biggest impact. Ian has advised the trustees of one of the UK’s largest DB schemes; and has advised on some of the UK’s largest and most complex insurance buy-in transactions.

Stéphane Vial, Managing Director, Head of Investor Relations EMEA, CFM
Stéphane is managing director, in charge of CFM’s EMEA client base. He joined CFM in 2007 and spent his first two years at CFM’s headquarters in Paris where he was responsible for European client coverage. He then made the move to Tokyo where he was the director of CFM Asia KK, before moving to London in 2013. Stéphane has 20 years of experience in trading capital markets and held previous roles at Chase Manhattan Bank, Renaissance Technologies and Commerzbank across the globe.

Jonathan White, Head of Client Portfolio Management, Rosenberg Equities, AXA Investment Managers
Jonathan is AXA IM’s lead client portfolio manager, responsible for factor-driven investing, having contributed to the development of Rosenberg Equities’ sustainable equity and advanced multi-factor strategies. Now head of Rosenberg Equities’ client portfolio management team, Jonathan joined the firm in 2007 as a client portfolio manager with responsibility for managing clients investing in Rosenberg Equities’ low-volatility equity strategies.
The evolution of factor investing

We look at how factor investing is evolving and whether its place in pension fund portfolios has been truly defined

Chair: What is factor investing and where does it come from?

Vial: For us, factor investing is ultimately an investment framework whereby, rather than defining your asset classes, you define your strategies. Factor investing was talked about in academic literature – I refer to the Fama-French papers from the 1980s, which highlighted the fact that you can isolate persistent plausible strategies that would be reasonably uncorrelated and decide to allocate, as an investor, into these components in any given amount.

For example, in the equity world the size effect would be one of them. The momentum effect, as defined by up minus down, would be another. Value is one of the oldest – whereby you can buy stocks relative to a value metric which relates to the price of the stock with certain fundamental quantities that you can isolate, and this has been in the marketplace for ages.

White: I agree that the factors you’ve mentioned are some of the primary factors, but we think of factor investing a little differently. We simply see factor investing as fundamental investing. These ideas – of value, quality and so on – are simply empirical ways to access ideas around earnings and earnings growth. That’s a really fundamental concept, and ultimately that’s why factors work and why they’ve got a proven long-term track record of delivering better returns than standard indices. For example, quality is a way to access stability of earnings and long-term earnings growth. Momentum or sentiment is a good way to access one-year-ahead earnings growth. These are fundamental concepts, kind of like a forecast about the future.

So, while there are technical definitions, and mathematical definitions, all that factor investing boils down to, in our view, is fundamental investing.

Chair: How confident are we that where we are today is close to the endgame? Will we continue to develop philosophy around factor investing, expanding into different factors, perhaps?

Baird: The main factors that have been in place for a very long time tend to be pretty static in terms of the behavioural biases that are driving them – value, momentum, quality, and so on. What is constantly developing is how you define them, how you harvest those factors. Those factors are based on behavioural biases that are ingrained in humans, and some economic reasons and, even though there are constantly new factors coming out, they can normally be placed into one of these key buckets.

The definitions have evolved, and
how you harvest them has become more complex as the world evolves. There's also more innovation, as people get more comfortable with factor investing. But the broad actual buckets are pretty stable, and even though you can invent new factors all the time, where they actually sit tends to be driven by the behavioural biases that existed 10, 15 years ago; just how you harvest it now has changed.

Mills: I agree. I think the most significant substantial factors have probably been discovered. There are most likely things out there that haven't yet been discovered, but they are possibly less significant, because otherwise they would have been spotted. But we shouldn't stop researching this area; we shouldn't stop thinking about it, because we're all in the business to try and get more efficient returns for our clients.

Van Boven: The reality is that, while there may be 200 or 300 factors out there that some people quote, whenever the academics redo the statistics, they find that they're not significant. Most of them are totally irrelevant and a result of data mining. We have to be very careful that we first define the economic rationale for a factor testing, because otherwise you will find spurious factors, which will not add any alpha to your portfolio.

White: Exactly, and economic rationale is key. It is what you should anchor on. Does the factor have an economic intuition underpinning it? Does it have a link to corporate earnings in some way? A few years ago, when people were talking about hundreds of factors, it was unhelpful and confusing for many investors and clients. It is healthier that we seem to have moved past that now, and the industry is more aligned around a handful of key factors.

Cole: That is an interesting point because, from a trustee's perspective, it is confusing. There are lots of different things out there and we do need to start simplifying things.

Keeping things simple
Chair: When you talk about factor investing to trustees, do they get it?

Cole: I don't want to generalise, but it is quite challenging for most trustee boards to understand. They clearly understand the fundamental investment principles and the asset classes, but when one looks at factor investing, it's a step beyond; so we need to ensure that they are educated appropriately and there is also a degree of simplification that needs to happen alongside this.

Mills: Factor investing is one of the most complicated topics that pension trustees face within their investment strategies. It isn't for everyone. There are some trustees who will want a simpler approach, and will take the view that the additional complexity that this way of investing brings is not for them. I would encourage trustees to spend the time to think about it, because I believe that by introducing some form of factor investing into a portfolio introduces more diversification, more sources of both risk and return, which overall results in a more efficient portfolio.

Chair: How can the adviser help?

Mills: Our job as advisers is to try and make things as simple as possible. I like using analogies wherever I can to try and explain how factor investing works. I also like discussing the psychological aspects – one thing I've done in the past with clients looking at this is to demonstrate to the trustees through some games that actually they have these psychological biases built into them just as other investors do, and that's why some of these things work.

Not all these factors have psychological roots of course. Some of them are rooted in risks, i.e. you're actually buying something that is a little bit riskier, and that obviously has pros and cons.

Baird: The key thing for us when explaining this is to not get too much into the weeds. What is factor investing? It is fundamental investing in a way, just a different way of defining it. When you start off on a high level with the behavioural biases and economic reasons behind their existence, you can actually explain it simply and it makes sense. Sometimes, if you bring in a portfolio manager, they can very quickly get into the detail of the optimisation, the factor construction and how everything works, and it can get very convoluted and confusing for the trustee.

If you step away, keep things at a high level, explain that this is just another way of choosing stocks using a quantitative framework, a factor framework, it can be effective. The danger is when you get too technical too soon.

White: As a portfolio manager,
when I am going out explaining this to people, I find it very helpful to focus on the outcomes. There is a mathematical element to factor investing, of course, but the key question to ask is: what does it give you in terms of an outcome? It's much more helpful to talk about, say, the quality factor in terms of buying stable earnings, buying into companies such as consumer staples, companies that are likely to go on to deliver good earnings growth into the future. That's highly intuitive to an investor – that if I invest in these types of companies, I'm more likely to perform well in an earnings recession, for example. When earnings are under pressure, when earnings are falling, I'm buying companies with good earnings, solid earnings, and predictable earnings.

Vial: The reality is that anyone who buys equities has exposures to factors. So the conversation could start with: What is your equity book? What does it look like? What exposures do you have? Some people may have had a great few years because they have the growth factor embedded into their portfolio, which did very well versus other factors. But it's worthwhile analysing their equity portfolio and explaining to them how much factor exposure they have – then you can start a conversation about whether it's appropriate, whether they ought to have it balanced differently, whether they should have more exposure to certain things that might perform better in the future and so on.

Another way, perhaps, to deal with it, is to disentangle the pure equity premium versus the factors in a market-neutral framework. You can tell people, for example, you've got equity risk, and that's purely equity risk. Now let me give you, in a market-neutral framework, exposures to value, to momentum, and so on, that are not correlated to the market.

So, they will be getting an investment with risk-adjusted objectives that are similar to the stock market, but the outcome will be different. They will make or lose money in a different way than the stock market, and that's where the diversification can play a role.

Size of pension scheme
Cole: Is there a certain size of scheme that tends to buy into this? Where do you see the opportunity for factor investing, given that there are an awful lot of sub-£50 million schemes out there?

Vial: Size-wise, small pension funds tend to be intermediated, and maybe they would buy products that are tailor made to smaller schemes, perhaps comingled with other pensions. The direct conversation with smaller schemes is very different.

Van Boven: Interest in factor investing started off with the larger schemes because they're more sophisticated, and they have large in-house investment teams. We are now seeing it rippling down to the smaller schemes.

In the Netherlands and Scandinavia, they have been doing this for a long time, so they're very familiar with it. In the UK, of course, the whole pensions market is more consultant-driven, so the consultants need to be on board with the strategy first for it to gain traction with the trustees.

We run an annual smart beta survey across the asset owners and, when it comes to interest and even adoption of smart beta, the gap between the larger and the smaller schemes is much less significant than it was, say, six years ago. Today, smaller schemes are at least considering smart beta allocations.

White: That's our experience too. We have seen growing interest in the UK from both DC and DB schemes. Smaller DB schemes tend to want to come into more fund-like approaches with a multi-factor focus. This can be attractive to smaller schemes as it offers a replacement for a pure passive investment, particularly as the fees for factor funds tend to be much lower than traditional active management.

Factor investing has also moved beyond institutional – we are seeing interest from wealth managers and from wholesale advising networks.

Chair: What's the consultant's view?

Mills: It comes down to governance budget. I don't think there's a size for which these factors don't make sense from a pure investment perspective. There are off-the-shelf pooled funds that can be bought at relatively small sizes, even actually at an individual level. You can access these strategies through some of the platforms.

But what really makes the difference on the size of the scheme is the amount of time that the trustees are prepared to spend. If you're a multi-billion-pound scheme, you will spend a lot of time thinking about investments because the marginal benefit of a few more hours in your trustee meeting to think
about a new investment idea is going to be worth it if that idea is a good one; whereas if you're a £10 million scheme, spending some extra time on something which might improve your returns incrementally, marginally overall, at an overall portfolio level, is it worth it? That's a question that genuinely gets asked, and if it isn't worth it then they're not going to invest in it. They're going to have a simpler, more straightforward investment strategy that's easier for them to keep an eye on, easier for them to understand, but still going to do an okay job overall.

**Passive and active**

**Cole:** Do you see factor investing more as a replacement for passive funds, or more as a replacement for active managers?

**Mills:** I’m not sure I even see the distinction between factor investing and active management. You can classify many active managers as factor investors. They may or may not agree with that distinction, but if you talk to an active manager – and we’re talking equities here – they will be able to articulate their strategy, and how they define the stocks that they like. Whether they’re conscious of it or not, you can often correlate that quite closely with some of these factors.

I genuinely think most active strategies are factor strategies of some description.

**White:** And all factor strategies are active strategies.

We wholeheartedly reject the idea that factor-based investing is in any way passive. It’s an active approach, it needs active oversight, and an active mindset.

**Van Boven:** We see quite a few pension funds that have, as their default allocation, a market cap benchmark and, while you do need somebody to drive the discussion on the board of trustees, we do see an interest in switching that to a factor-based strategy – often opting for a balanced multi-factor approach. They are also often interested in including ESG considerations and climate risk in a factor framework to target specific outcomes.

**Baird:** I agree that you shouldn’t think of this as active versus passive. However, what we do see as being fairly useful is, if you can get investors to get over the governance burden of what factor investing is, how it works, etc, then a one-stop multi-factor solution can be a good option if they’re already in passive, but they don’t want to go fully-fledged active in the traditional sense – because otherwise they’d maybe have to hire a value manager, a quality manager, a momentum manager, and so on, to get that smooth return stream.

So, if your governance is a little bit lower and you can’t monitor four to five asset managers, the idea of using a one-stop solution in terms of multi-factor can be a pretty nice outcome, because it is active but it means you only have to monitor one manager, and can dial the risk up or down depending on what’s appropriate.

**Economic and regulatory environment**

**Chair:** Does factor investing suit the current regulatory and economic challenges pension funds are facing?

**Mills:** Whatever regulatory environment pension funds are in, it is a sensible thing to do to try to invest your money in an efficient, diversified way, and factor investing is one of many tools that you have in order to achieve that.

The economic environment at any point in time usually favours one or more of these factors over others. These factors tend to come in and out of favour at different points in the cycle, and to me what’s important in a factor-based strategy is having a diversified approach, so not having all your eggs in one factor, because that could significantly underperform or outperform your expectations, whatever they are, over a relatively short period of time. By having a diversified approach, it should work in pretty much all market environments when given long enough.

I’m not saying that if you diversify your factors, you’re always going to get a positive return, but you should get a smoother return than putting all your eggs in one basket.

**Vial:** If we all agree that in reality there are only five or six truly persistent, plausible factors out there, then it makes sense to diversify and get exposure to them, and not try to time.

**White:** Taking a slightly different
perspective on this, one of the advantages of factor-based investing is the ability for an asset owner to take a step back, think about what it is that they want to achieve. What are they looking for? That, in some scenarios, might lend itself to a factor design that isn’t multi-factor. One that is more focused, say, on quality and low volatility, because they are possibly an asset owner that really cares about downside protection – an insurance company, for example; or maybe they are a more mature scheme, which is in de-risking mode, and therefore lower volatility and downmarket protection makes more sense.

**Baird:** On the economic point, in certain economic environments you perhaps need to make the return part of your portfolio work a bit harder, so looking at something like factor investing could make a lot of sense.

**Chair:** Low volatility has become expensive. Is that a risk?

**White:** We are challenged a lot about the low volatility factor – this factor has performed very well this year and there has been a huge amount of asset flows into low-volatility ETFs, particularly in the US. The result is that, through our lens, some stocks have been bid up to expensive levels. This tells you that factor investing is an active approach. It comes with side effects. You’ve got to monitor those side effects – you’ve got to keep on top of them. When we build a low volatility strategy, we think about a couple of things. First, we can avoid some of the expensive names – we just don’t buy them. There are plenty of other stocks to buy. Also, low volatility is not just about price. It’s about earnings, and buying stable earnings, so we need to be thinking about fundamentals as well.

This is where active management has something to add, compared to index-based approaches, which can potentially have unintentional risks built in. An active manager has more leeway to control these unintended risks.

**Baird:** If you just have a pure low vol approach, which is purely price-based, it can lead you into pockets of the market you don’t necessarily want to be in and give you unintended exposures, so we prefer managers who have a multi-factor model and a low vol overlay.

**Chair:** Is value broken?

**Baird:** It’s a pretty bold statement to say that value’s broken, something that’s worked for over 100 years. We don’t believe that. Saying that, how we define value may be changing. That’s the innovation. That’s what might change over time.

**Looking ahead**

**Chair:** How are things changing?

**Vial:** Ultimately, investors may start to allocate according to factors as opposed to allocating according to asset class. That’s what a good outcome would be – a future where people understand that when they buy a lot of equities, within that portfolio they have exposures to momentum, quality, low vol and so on. Then they can figure out according to the cycle where they are, and whether they want more low vol or less etc. I think the industry’s getting to a point whereby this will be more trackable, and people will be more able to make investment decisions on this basis. I’d also add that we’re talking about equity factors here, but these things can be applied elsewhere, in fixed income and in other places.

**Cole:** The challenge the trustees have is knowing exactly where they are in the cycle because they usually meet just four times a year (more often of course if they have investment committees, so it does depend on the size of the scheme). The challenge then for the people selling to and advising the trustees is identifying where the scheme should be in 6-12 months’ time and whether, on that basis, now would be good time to enter into a momentum factor or whatever it may be.

Also, as trustees, we’re investing for the long term, but that long term seems to be getting shorter because The Pensions Regulator is looking for fuller funding in a shorter period of time.

As a trustee, I’m tending to look five years out rather than 10-15 years out, and therefore market timing is becoming more important. But unfortunately, as a trustee, we tend to be very slow. So, market timing is important, but our decision-making process is slow.

**Education**

**Chair:** Is it challenging to get those
Factor investing roundtable

schemes that are not currently in factor investing to make that breakthrough into factor investing?

Vial: The reality is that they are already in factor investing, but they just don't know how much or of what.

So that's the first step – helping them understand that they have exposure to certain factors already and helping them see what they have and how much. Then you can move on and discuss whether what they have is appropriate, whether it's diversified enough or not and so on.

Van Boven: There's an educational process that is needed here. You have to start by presenting in a very simple way the basics of factor investing; use analytical tools to show the behaviours of different factors, when you combine them what happens and then, often they come to the conclusion that they do not want to time factors, or do not want to switch between factors, but that a diversified approach is more suitable. Then, depending on their stamina or how strong the governance is, they can take more risk or less risk.

Cole: You're 100 per cent right. To me, it's the education process that is key because it will take a long time to get people on board.

Van Boven: You can also, for example, show the difference between the behaviour of cyclical factors like value and momentum, and the defensive factors, like low vol and quality and how, if you combine them, you can improve the relative risk-adjusted performance. When you combine cyclical and defensive factors in a multi-factor index you again get a different risk-return profile. So, if you show that and talk them through, investors will probably come to their own conclusion of what is a suitable risk-return profile. Different investors will address different concerns via a factor approach and require a specific factor allocation in line with the desired investment plan outcome.

Mills: I've advised quite a few clients on these types of investments in the past, and I don't think there's ever been a decision made in the first meeting. But for the schemes that have invested, it's usually a three or four-meeting process – it can take up to a year before they're ready to invest.

Vial: We already have people asking us to analyse their portfolios and tell them what exposures they have in the various factors. I think the industry will reach a point where this will be a service provided by consultants, managers, etc. So, you can start with some real numbers and talk to your trustees and your peers, and explain what there is, and move on from there.

White: Investor education is critical – this is active management. I find it very unhealthy when you get into a scenario where factor investing is considered some form of passive approach and asset owners are told they can relax because it's replicating a benchmark.

Risk

Chair: Most trustees now get concentration risk, but do they understand the factor risk they've got?

Vial: We do regression analysis against commonly accepted factors – so we can show how they are exposed to certain factors. For example, if they are concentrated in BP, that's the growth factor, perhaps. But it would be tremendously useful for trustees to have a better understanding about the risks that are in the portfolio, because typically people forget when things go well, and when things go badly then there's a big
problem.

**Baird:** A holdings-based analysis is another option. You get the whole portfolio in front of them – so, all the portfolio managers they have within the portfolio – and you show, for example, if they’ve got big tilts to quality, and where that’s coming from/which companies, and why maybe they should be worried, because in a market where quality underperforms that’s going to hurt. That’s a nice visualisation for people. People can understand it because it’s not the most complicated calculation.

**Van Boven:** Trustees will hear a lot of pitches – everybody telling them that they have the best approach. But if the factor story’s true, and factors drive performance, two portfolios with the same factor exposure should have the same performance. If the performance is different, the factor exposures are different. So, a better way to look at the difference between alternative factor indexes is to look at the implementation efficiency of the portfolios – how diversified are portfolios to similar factor exposures? What’s the turnover? How much active share do I need to execute the strategy? You’re almost turning the question upside down.

You also need to make sure that the portfolio is delivering the exposures you choose to have exposure to, and it avoids off-target exposures.

**Cole:** One of the challenges as a trustee is that we tend to buy in to different ideas. For example, 10 years ago, a lot of trustees bought into DGFs. You then come to the problem that some of these DGFs become too big and therefore don’t perform.

From a trustee’s perspective, though, it’s quite challenging not to follow the latest trend. Today, for example, everybody’s investing in infrastructure. It’s amazing to me how many investment managers, all of a sudden, have an infrastructure fund. I came from an institution that had been investing in infrastructure for 30-plus years, and you cannot tell me that people who are starting to invest in infrastructure now have the wherewithal to know what to do when things go wrong.

So, from my perspective as a trustee, where I become sensitive is, am I just following a trend?

**White:** My response to that would be that there’s an assumption here that factor investing is a generic, singular concept. If you come back to the very simple notion that factor investing is simply a proxy, a mathematical proxy, to access fundamentals, then I think concerns about it just being a trend that’s somehow going to stop working don’t stack up.

There are risks to certain approaches that could get arbitraged away if you had an overly simplistic way of accessing value, such as price-to-book 20 years ago. It’s probably no longer a good measure of value. It has to evolve, it has to adapt, but the underlying idea here is to buy good fundamentals, and that is something that will remain robust. It’s robust today, and it will be robust into the future.

**ESG**

**Chair:** Where does ESG sit in factor investing?

**White:** The ideas behind ESG are actually very long term – we would see them as economic in nature, just like earnings, just like a balance sheet. Thinking about E, S, and G, and all of the granular components that go underneath them can be analysed alongside traditional fundamentals. Therefore, you’ve got to consider them when you build a portfolio, but perhaps the slight difference with some of them are, they’re quite long horizon, and that is a good thing. To have a long horizon discipline built in alongside other ideas is a healthy way to invest.

**Chair:** Is ESG a factor?

**Van Boven:** It’s too early to call it a factor because we don’t have a lot of historical data to evaluate.

At the moment, we are seeing that clients are looking to engage with companies that fall below the desired ESG score. So, by having a sustainable investment overlay, you can identify companies to work with and try and influence their governance. In addition, an ESG score or overlay allows you to identify those companies that are better prepared for the transition to a low carbon economy, companies you may want to tilt towards. We are seeing less clients ‘divest’ as complete divestment can lead to concentration and negatively affect portfolio dynamics. That said, some clients do choose to divest as by divesting, you’re out of the picture especially if judgement is more values based.

**Cole:** For me, if we separate out the E, S and the G, clearly both social
We are also taking ESG integration a step further by upstreaming ESG information right into the heart of the models that we use to build factors. I'll give you an example. We have a quality model that, for many years, was based on the things you'd expect to go into a quality factor – balance sheet strength, cash on the balance sheet, earnings stability, all those things.

Something we introduced into that model recently was diversity of the boardroom. When you build a diversified factor-based approach you need breadth of data, and this met that criteria. Our research found that there was a strong link between diverse boardrooms from a gender perspective, and the capacity for companies to deliver and protect high profits into the future. So, it's a very fundamental idea. You can upstream that and put it alongside balance sheet and earnings data.

So, that's bringing these ideas right into the heart of these factors and is something we are embracing.

**Baird:** I think ESG comes under other factor umbrellas. For example, governance could be regarded as a quality factor. So, it can be another lens through which to look at quality, essentially.

The key thing with ESG that we're thinking about when it comes to factor investing is, we think it's easier done by a more traditional fundamental manager, who more qualitatively assess ESG characteristics and are more able to engage. It's more difficult for quants because the data's a bit spotty, and not everybody agrees with each other about how you define these things.

It is of course on a lot of quant research agendas. There's a lot of interesting work being done by quants and there's a huge business push by them. But we're spending a lot of time with them, and making sure that when ESG factors are incorporated they've gone through the same robust tests as a more traditional factor, because there is definitely some greenwashing going on in certain areas of the market.

**Van Boven:** We don't incorporate the data in the factors, because every client has different demands in terms of how they want to address ESG, or how much carbon reduction they want to achieve, for example. I like the idea of incorporating it in factors, but with the clients we've worked with so far, they really have very individual needs.

**Vial:** We don't see ESG as a factor. First of all, we have a statistical definition of factors so we need to have a lot of data and do regressions to see whether it's present in the past. So, number one, there's not an awful lot of data. Number two, governance is pretty much like quality – a good quality factor would encapsulate governance. Interestingly enough, it perhaps brings new data and new ways to look at quality, which is good. We published an academic paper that states that G as governance, part of quality, would be a factor in the sense that there's a little bit of data, and it has a positive outcome in terms of performance. But with the E and the S, it's very unclear as to whether there's any money to be made, at least when looking historically.

So, because we're very conservative, and because our definition of factors is persistence, but over decades, we're a little bit sceptical about calling it a factor as it is, and we think it probably is already within the existing factors.

**White:** Factor investing's broad by definition – it's typically a large number of securities. It's not a concentrated...
approach. It’s a diverse approach. You need to spread your bets. You want to reduce stock-specific risk. You want to access factors. So, with respect to, say, carbon for example, one can form a view, and we have formed a view, that it’s the right thing to do to reduce exposure to carbon. We think that would be a long-term benefit to investors as the planet moves on a transition to low carbon and away from high carbon-intensive industries. That is a forward-looking statement, and I think as an asset manager one should make those types of statements.

But at the same time we could also, because of the diverse nature of factors, look at our capacity to build a factor-based portfolio with and without these high-carbon companies, and actually it doesn’t really impact it. You can still build a really good factor portfolio and not invest in the most high-carbon utilities out there.

Say you’ve got two utility companies, A and B. They’ve both got the same factor footprint which at face value is attractive. However, company A is a high-carbon, coal-intense company, and the other one, company B, has a low-carbon footprint and is expanding its use of renewables. We would not invest in company A but we would increase our allocation to company B. Overall the portfolio gets the same factor exposure, and we also get to embed our long-term view that lowering carbon intensity makes sense.

**Concluding thoughts**

**Chair:** Following today’s discussion, what key message would you like to make about factor investing?

**Cole:** I think factor investing is a great idea and there’s clear value in it, but the most important thing is for the advisory side and for the fund managers to continue to educate trustees, because I believe people will buy into it. There’s merit in factor investing, but the knowledge base is relatively limited.

Some trustees are aware of it, some are investing in it, but the industry needs to help trustees along the journey.

In response to the suggestion that we analyse portfolios to understand the factors that we’re already invested in, that absolutely needs to happen. But it’s the education that is key. It’s making sure that the journey is as easy as possible. Trustees are going through a change in the way that we have to look at the assets under management and what we’re trying to achieve out of those assets, so we need to make sure their journey plan is clearer and more obvious, especially as many schemes are beginning to de-risk, and changing the journey that they’re on. So, education is fundamentally important.

**Baird:** It is important also that we’re not trying to be too clever with these factors and trying to time them. One thing we would suggest is, when you allocate into this space you want to have a diversified, blended approach to these. It’s very difficult to accurately tilt towards value or momentum or whatever’s going to work over the next five to 10 years. So, the key thing is, if you believe in these things, and you believe they work, a diversified approach is the most sensible way of implementing.

**Mills:** I agree that there’s value in these factors and that diversification is key. There are lots of different ways to access them, but the key point is that there are sound reasons why they should work, but they won’t all work all the time. So building a diversified approach is key.

**White:** With factor-based investing, we should always be conscious that we can learn from the past, but we’ve got to treat investing with great humility and recognise any sort of future volatility is not going to be an exact replication of the past. We should therefore be humble about how we invest. We also need to innovate, and continue to think about how we can build the best possible ideas that are going to be robust into the future. That means thinking about new data like ESG, thinking about analytical techniques like machine learning, how we can build that into these ideas to embrace change and to embrace innovation, because we can’t rely on exactly what we’ve done in the past.

**Van Boven:** I agree. Where we see an interest is to go beyond equities and to look at multi-asset factor investing. There’s quite a bit of demand to expand beyond equities.

**Vial:** Yes – these concepts are moving towards fixed income, FX, and so on. It’s only an investment framework, and I also agree with the knowledge gap that needs to be filled between investors and managers. It’s a long road, but we’ll get there.