Looking for that WOW *factor*

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Factor-based investment strategies** ARE A GLOBAL TREND* that's finally catching on at some of Australia's largest superannuation funds. Especially as asset owners become ***disenchanted with the shortfalls of more traditional active or passive philosophies, and face intense pressure to *MEET RETURN TARGETS IN CHALLENGING MARKETS.*

By Sally Rose

AS SUPERANNUATION AND pension funds grapple with having to lower return targets and adjust investment strategies in response to the difficult market outlook, more and more are coming to the conclusion that now is the right time to implement factor-based strategies.

Recent research sponsored by Northern Trust found 70 per cent of global asset owners surveyed said they expected to have to lower return targets in the year ahead. This sentiment was reflected locally in the results of *Investment Magazine*'s annual CIO Survey, with 70 per cent of Australian asset owners admitting they were not confident of meeting their return targets in 2017.

"All around the world at the moment, investment chiefs are concerned that the outlook for equity markets is lacklustre and returns from the bond markets will probably be terrible, so they have to look for new ways to improve net returns," Northern Trust Asset Management senior vice-president and director of quantitative research, Michael Hunstad, says.

Hunstad leads Northern Trust's factor-based research and product development across active and passive equity, fixed income, real estate, and commodity markets. The firm, which has more than $US900 billion ($1.2 trillion) in assets under management, has roughly $US60 billion invested in factor strategies globally.

Factor-based investment strategies, sometimes referred to more generally as alternative-beta strategies, aim to achieve much of the cost savings associated with passive investing, while capturing some of the higher returns promised by active management. The idea is to screen and modify an index to target specific factors the asset owner cares about.

The six main factors these strategies target are: value, size, low volatility, quality, dividend yield and price momentum.

"Since the global financial crisis in 2008, there has been a growing realisation across the industry that fundamental active management tends to underperform, especially once you consider the fees," Hunstad says. "On the other hand, asset owners want more juice than passive cap-weighted index strategies can deliver."

THREE STAGES FOR SUCCESS

He says the key to success with factor strategies lies in three critical stages: picking the most appropriate mix of factors to target, getting the portfolio construction right, and monitoring performance.

Colonial First State, the Commonwealth Bank of Australia's $203 billion superannuation and wealth-management arm, is one local asset owner embracing factor-based investing. These strategies have been a part of Colonial First State's MySuper option, FirstChoice Lifestage, since the product was launched in May 2013.

To date, Colonial First State has implemented factor-based approaches in both value investing and volatility strategies across various segments of the equities portfolio. These mandates are handled by a combination of CBA-owned and other managers.

The value factor strategy plays a greater role for younger member cohorts, while the volatility factor strategy is more important for older ones.

"Our aim is to match the characteristics of factors to the objectives we set for each of our member cohorts," Colonial First State head of investments Scott Tully says. "FirstChoice Lifestage is designed to automatically adjust the risk profiles of members' investment portfolios as they age, which is particularly valuable for default members, who tend to be less engaged with decisions about their super."

Tully revealed Colonial First State is doing research to determine whether factor-based strategies can be included within the fixed-income portfolio.

Cbus Super is another major Australian asset owner looking to allocate more capital via factor-based strategies. The $35 billion industry super fund for workers in the construction sector began using factor-based strategies within its global equities portfolio a little over two years ago. Specifically, Cbus uses a factor approach for a low-volatility strategy and a fundamental indexation strategy. These mandates are handled by external managers working closely with members of Cbus's internal team.

"Alternative beta strategies allow us to access preferred factors in a low-cost and transparent manner," Cbus investment manager, public markets, Brett Chatfield says. "It is relatively early days and we would want to look at three to five years' worth of data before drawing strong conclusions... but we have been comfortable that the strategies have delivered consistent with our expectations of their risk-return profiles and fit within the total portfolio."

In 2016, the alternative beta sub-sector within global equities outperformed the index by about 1.1 per cent, net of fees. Cbus is now considering how it might use similar strategies within its Australian small-caps, emerging markets, and global fixed-interest portfolios, Chatfield says.

WIDESPREAD IN THE US AND EUROPE

More Australian superannuation managers, like Colonial First State and Cbus are turning to factor-based strategies but the trend is yet to take-off across the local market to anywhere near the extent it has among large pension funds in the United States and Europe.

Tully suspects the main reason Australian asset owners are yet to go factor-based with the same gusto is that the style is more difficult to implement in our relatively small local market. An incumbency barrier is another challenge, as many super funds find their legacy investment approaches are difficult to unwind.

Chatfield agrees the work required to identify, implement and measure factors effectively might make the decision to begin adopting a factor-based approach a daunting one, especially for smaller funds.

"It takes meaningful resources internally, both in terms of research and systems, to thoroughly research such strategies and to determine the optimal way to incorporate them into overall portfolios," he says.

Cbus has one of the largest internal investment teams in the local super fund industry and is on a hiring spree as it works towards a five-year goal of managing 20 per cent of total assets in-house.

For smaller funds, selecting a manager who is prepared to work closely with them to create a customised approach can help. Northern Trust is trying to carve a niche for itself in the local market by helping their clients fill that information vacuum.

"With so many thousands of factor products out there in the market, I can understand why it's tempting to buy an off-the-shelf solution, but for a large, sophisticated investment fund, that is almost never the right answer," Hunstad says. "We find one of the ways we can add a lot of value for our clients is by helping them identify what factors are already dominant in their legacy portfolios, and exactly what they should be targeting to achieve their investment goals."

That might mean targeting a certain rate of return, or de-risking the portfolio. Increasingly, it is a complex mix of multiple factors. Performance monitoring and attribution, so it is clear what factors were most important in driving returns, is also critical, Hunstad says.

At this point, he argues, the big question for asset owners with regard to factor strategies should have moved on from 'Should we implement this?' to 'How do we best implement this?'

"How a factor-based portfolio is constructed and implemented will almost entirely determine whether it fails or succeeds, much more so than what manager wins the mandate," he says.

Hunstad argues factor-based strategies will work best for those asset owners able to take a long-term approach, but can also be a helpful risk-management tool for those funds under pressure to meet performance benchmarks over yearly horizons. ✖

VALUE
SIZE
LOW VOLATILITY
QUALITY
DIVIDEND YIELD
PRICE MOMENTUM