HFG Trust White Paper Series

Is factor investing the right strategy for you?

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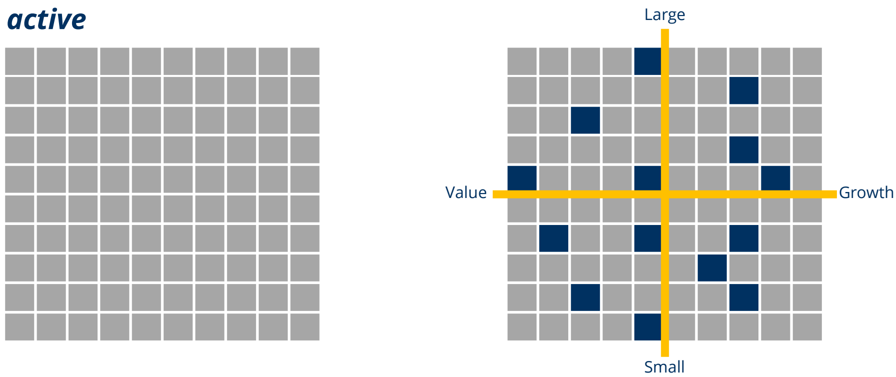
The age-old question, “how do I select a portfolio manager that will add value on a consistent basis?” routinely surfaces when markets experience volatility and uncertainty. Although the short-term behavior of stock returns remain as unpredictable as ever, sparing no manager, academic and evidence based research on the make-up of stock returns has progressed noticeably. The two commonly documented management philosophies include:

Active Management: The use of a human element, such as a single or team of managers relying on analytical research, experience and personal judgement in determining an investment position. A manager will select individual securities to either buy, sell or hold within a portfolio in the hopes of adding return value because they selected the right company. This method of management typically includes above average fees, trading turnover and concentrated positions.

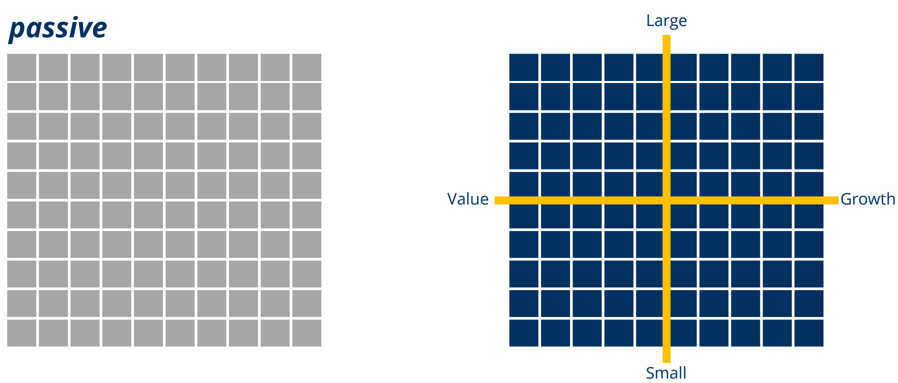
active



Market Portfolio

Passive Management: Also known as the buy and hold strategy, this style has the belief that market prices reflect all available information and individual security selection does not add value. This strategy eliminates the human element and attempts to capture a well-defined passive position over a long period. Characteristics of this philosophy include low management and transaction costs along with a well-diversified position.

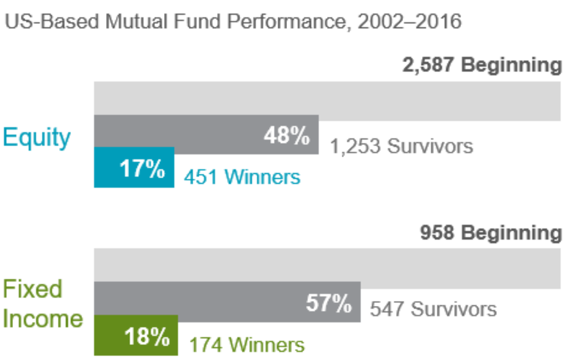
passive



Market Portfolio

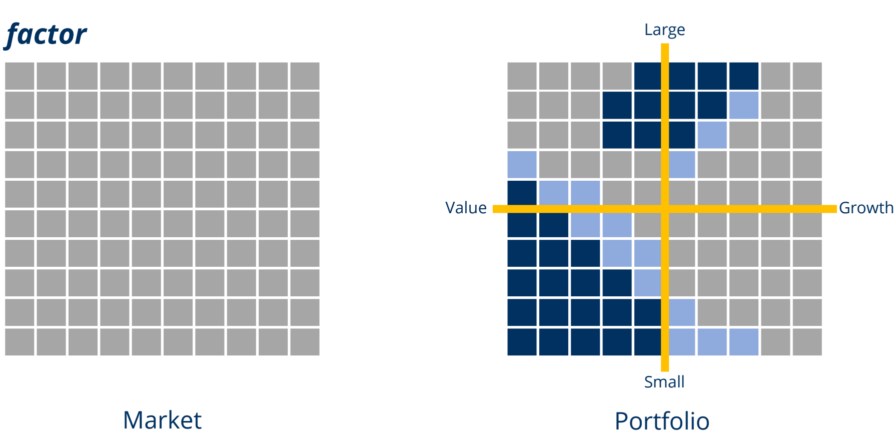
Recent evidence supports that passive investing often outperforms the best active managers decade to decade. This happens because active managers tend to hold very concentrated positions, trade frequently and charge excessive fees to the investor. In fact, [according to the S&P Indices Versus Active (SPIVA) funds scorecard](), over the five-year period ending Dec. 29, 2017, 84% of large-cap funds underperformed relative to the S&P 500. Exhibit A below courtesy of Dimensional Fund Advisors led by the research of Dr. Eugene Fama and Kenneth French illustrates that from January 2002 to January 2016; only 17% of actively managed stock funds outperformed their benchmark. That means less than 1 in 5 managers beat their passive index over a 10-year period with a lower probability of repeating the next decade.

Exhibit A



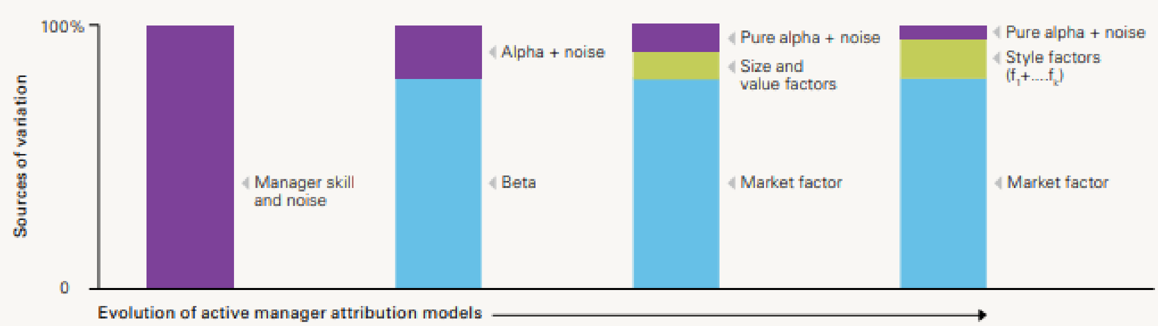
Introducing Factor Based Investing

Factor investing is a little less known to the do-it-yourself investor because it is not easily accessible to the retail public or prevalent in a 401k investment menu. A factor strategy selects securities based on a series of criteria in an attempt to generate greater return than passive management and increased consistency than active management. Instead of hand picking individual stocks or owning the general market, the manager will filter from a passive index and select securities that meet certain attributes. These attributes have proven over time to increase the probability of better results sometimes at the expense of higher volatility. Well-known factors that have been substantiated through academia include Small Factor, Value Factor, Quality Factor, Profitability Factor and Momentum Factor, to name a few.



Factor investing is not just a recent phenomenon. In fact, Graham and Dodd first identified the existence of the Value premium in 1934, encouraging investors to buy stocks that were priced below their intrinsic value, following the Great Crash of 1929. Sanjoy Basu in 1977 formalized Graham and Dodds research by identifying the relationship between Price to Earnings ratio and future stock returns. Factor investing however, only became available to mainstream investors when mutual fund companies began creating product lines that acted on the study.

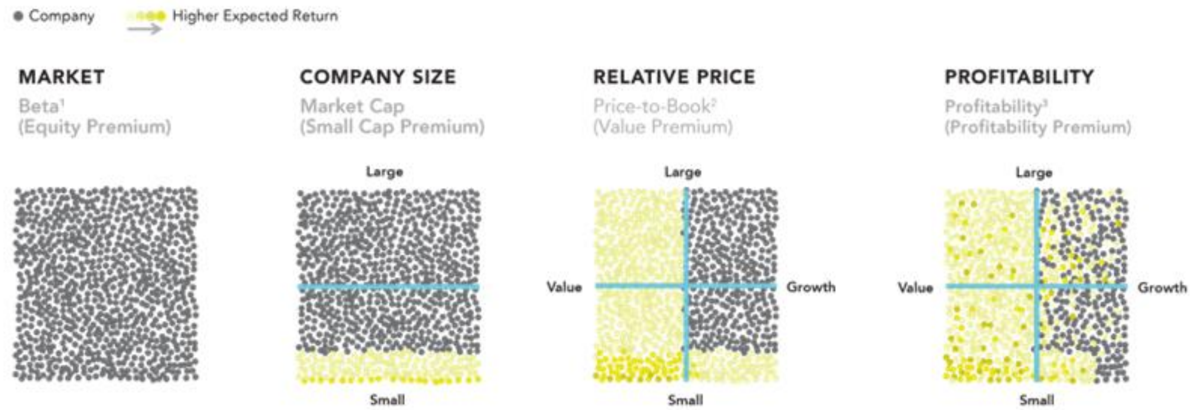
The evolution of portfolio management:



Notes: This is a hypothetical scenario for illustrative purposes only. It does not represent any particular equity investment. "Noise" refers to the fact that through any period, some degree of randomness always affects results versus the broad equity market. The degree of influence varies and can be difficult to statistically distinguish from alpha without extensive data.
Source: Vanguard.

In the beginning, investors attributed all of their stock returns to the skill of the manager. Investors understood very little about why owning a company (i.e. Buying stocks) would produce a premium to lending money (bonds). Over time, research from William Sharpe (1964) identified that managers and stockbrokers were not brilliant; the equity premium or "beta" was the driving force behind better performance. There remained some manager skill, otherwise known as "alpha" but the value add compressed dramatically. In 1992, Eugene Fama and Kenneth French hypothesized that a managers skill can be attributed not only to their exposure to "beta" but also their exposure to Size (small companies outperform large), Value (cheaper companies outperform expensive) and Profitability (higher profitability companies outperform the average) furthering minimizing a manager's value. Since then, three to four additional factors have been published and implemented into strategies by reputable fund families like Vanguard, Ishares and Dimensional Fund Advisors. "Pure alpha" or manager skill has slowly compressed over time, so much so that the retail investor should reconsider their chances of identifying a consistently outperforming manager.

Factor investing is the understanding of the historical breakdown of returns. On the equities side, there are more than six factors identified today. Although the purpose of this blog is not to go into detail regarding each factor, it is helpful for investors to understand how factor investing applies to an investment strategy. Let's use Eugene Fama and Kenneth French's three factor model as implemented by Dimensional Fund Advisors (small, value and profitability) as an example.



General US Market has 3000 companies which makes up the equity premium (stock outperforms bonds)

US Market can be divided into large companies and small companies with small outperforming large (Small Cap Premium)

The Market can then be divided by style. Value represents companies priced below a specific book value while Growth is above. The Value premium exists almost 89% of the time over a 10-year period

The last factor is know as the profitability premium, which states firms with higher profitability outperform those with lower profits 92% of the time over a 10-year period (profitability premium)

What does all this mean? Should an investor sell all of their active funds and buy every factor strategy available? The answer is emphatically no. It is important to understand the predictability of any investment strategy and gauge your expectations. Even the most proven of strategies can disappoint if an investors expectation is too high or unsupported. For example, historically speaking factor investing has proven fruitful for the patient investor, but they do not outperform every year or every decade. They also often vary from the general market, so if you are a religious S&P 500 observer, you may feel you are getting subpar results in that year, when in fact, you just own something very different. All strategies come with a caveat and that is they never work every year or every cycle. The benefit of academic research is that it provides an investor a basis of understanding probability and the ability to make calculated decisions.

“If you want to have a better performance than the crowd, you must do things differently from the crowd” – Sir John Templeton