



Equity factor investing: AN EVER-EVOLVING JOURNEY

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Our panel of experts looks at what equity factor investing means for portfolios today, how different factors have performed amid the recent turmoil, and what the future holds for factor-based strategies going forward

Chair:



DANIEL MORRIS
Chief Market Strategist,
BNP Paribas Asset
Management (BNPP AM)
Daniel is chief market

strategist and co-head of the Investment Insights Centre at BNPP AM. His experience encompasses advising clients and providing investment recommendations, as well as offering a strategic perspective to senior management and portfolio managers. Daniel previously held senior roles at TIAA-CREF, J.P. Morgan Asset Management, Lombard Street Research and Bank of America Securities.

Panel:



STEVE ARTINGSTALL
Investment Director,
Alternative Risk Premia,
Railpen

Steve has been with Railpen since 2008 and is currently investment director, alternative risk premia, leading a team of PMs and data analysts that manages £10 billion of global equities. He has been an equity analyst, portfolio manager and fund research analyst/fund-of-funds manager in a career spanning 25 years in investment management. He has a BSc. (Hons) in Human Geography & Economics from Loughborough University and is AII MR.



RAUL LEOTE DE CARVALHO
Deputy Head of the Quant
Research Group, BNPP AM
Raul has 19 years of

experience in the financial industry and has been deputy head of the Quant Research Group at BNPP AM since 2017. This team is present in Paris, Amsterdam, Hong Kong and London and centralises the research and development of quantitative strategies for all investment teams managing equity, fixed income and asset allocation portfolios. Raul has held a number of positions at BNP Paribas, joining the firm in 1999.



**SNÆDÍS ÖGN
FLOSADÓTTIR**

MD, EFIA pension fund

Snædís is the managing director of EFÍA and LSBÍ

pension funds and the operations manager of Lifeyrisauki supplementary pension fund. She has worked in the asset management sector in Iceland for the last 10 years. She is also chair of the education committee of the Icelandic Pension Funds Association. Snædís holds a degree in industrial engineering from the University of Iceland and a brokerage licence from the Ministry of Finance and Economic Affairs in Iceland.



BEN MATTHEWS

Head of Equity Research, Isio

Ben is the head of equity research at Isio. Isio,

formerly KPMG's UK pensions practice, launched in March 2020. His responsibilities include coverage of equity manager research and selection, whilst also dedicating a portion of time to ongoing client management. Prior to working at Isio, Ben worked at Exane BNP Paribas as an equity research analyst in the telecoms sector. He holds an MSc in Finance and Investment, and a BSc in Business Management.



IAN NAGLE

Senior Investment Consultant, Mercer

Ian is the head of wealth consulting for Mercer

Denmark, and has been a senior investment consultant with Mercer for over 10 years. Ian leads Mercer's investment strategy, client value proposition and relationships in Denmark and believes in innovation and co-creation, ensuring that Mercer Denmark continues to grow its investment footprint in the market. Ian holds a Bachelor of Commerce degree from University College Dublin.



ANDREW PEACH

Associate Partner, Aon

Andrew is a client consultant within the Aon investment practice and

also heads up the specialist factor investing team at the firm. Andrew first joined Aon in 2012 as a senior investment consultant, and prior to this was involved in investment consultancy at Bluefin Corporate Consulting. Andrew regularly attends client meetings, industry events and roundtables, and is a regular contributor to the UK and European pensions and investment press.



JAMES PRICE

Senior Investment Consultant, Willis Towers Watson (WTW)

James joined WTW's

manager research team in 2006, researching a wide range of asset managers and investment approaches. James also works with asset owners helping them construct portfolios or designing bespoke strategies. James is also a researcher at the Thinking Ahead Institute – its purpose being the mobilisation of capital for a sustainable future. James graduated from Imperial College London with an MSc in Physics.



RAMON TOL

Fund Manager Equities, Blue Sky Group

Ramon is a senior fund manager (equities) at Blue

Sky Group, which manages the pension assets of KLM. He joined the group in February 2000 as a quantitative analyst in the performance and risk department. Ramon was responsible for setting up and implementing the manager monitoring and selection process at the group. He holds a master's degree in Economics with a specialisation in international financial economics and investment theory.

Chair: What are the panel's experiences of equity factor investing, and the recent appreciation of performance versus expectations?

» **Matthews:** Factor investing is a relatively new phenomenon for our clients. About a year ago, we started to really educate our clients on factor investing as we were getting a lot of questions on the topic. We also spent time trying to understand factor strategies and what they could mean for our client base. To date, and this is mainly due to recent under-performance, we have seen limited appetite for factor-based strategies.

Most of our clients generally have market cap exposure and that would be split between global and emerging markets in some cases. Generally, we've seen the governance budget for asset allocation being allocated elsewhere in the portfolio as opposed to making refinements to their equity portfolio as it stands. With the recent underperformance in value/size, for example, factor investing as a strategy has been a difficult conversation and a hurdle for our clients to overcome, but we've certainly had some interesting discussions along the way.

» **Peach:** We have been having these conversations with clients for several years now and, generally speaking, the appreciation of factors, what the factors mean and the investment rationale behind factor investing has gone down well, especially for those clients that have got market cap. Some investors who have made the switch, however, have been stung in the past 12 to 18 months by factor performance, so we've also done a lot of digging under the bonnet to help clients understand what's been going on.

Thinking about expectations, when you actually look at how the factors themselves have done, some have done better than others, but they have performed how we would have

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expected them to, given the set of circumstances that we had.

If we have that conversation with clients, generally they understand that. So yes, there has been a period of short-term pain, but it has been in line with expectations.

» **Flosadóttir:** It's important to look at the performance of the different factor investing styles, compare them with their relevant benchmarks and how we believe they should have performed given the situation faced in the last year, and the weights applied on different styles within the portfolio. If we look specifically at quality, growth and global value performance in 2020, they were in line with expectations given the economic and market conditions this year. The growth style did quite well, outperformed the benchmark and delivered, all in all, a good result for us. Value, on the other hand, did not do as well, but it is important to look at the broader spectrum here – it underperformed compared to MSCI but, compared to its benchmark, the value index actually outperformed.

When comparing these two styles it's also important to keep in mind that, in the last years, the FAANGs have been leading the growth performance; and the low-interest rate that we have seen in the last year has complemented growth style better than value.

I would add also that, when you are a pension fund and you're investing for the long term, it's important to communicate to both the board and your members that you have to look beyond one-, two- or even three-year performance. And one of the key elements of diversification in the portfolio is that different asset classes do not behave in a synchronised manner, so different results within each year should be expected.

» **Artingstall:** Our experience of

factors goes back at least 10 years. We started with the low volatility (low-vol) factor and then diversified into other factors. Our experience over that period has been positive. That's less obvious when you look at the raw returns. The past 10 years have been a strong period for market cap returns for the index so, low-vol in particular in the last couple of years has struggled to keep up.

But we know that factor strategies generally do better in weak market conditions than strongly in rising market conditions; and that's particularly true for low-vol, but also true, to a degree, for most other factors too. Quality and momentum have done fairly well in recent years. Value has struggled as well as low-vol, so those have been the main drags on factor-based strategies.

We don't have size as a specific factor that we target, but any factor portfolio that you build tends to underweight the mega cap stocks, so we already have a bias to that; and we have been looking at size, or at least the efficacy of factors in the smaller cap universe.

» **Chair:** How did returns compare to your expectations?

» **Artingstall:** Generally, our returns have been in-keeping with our expectations and it's just the last couple of years where it's been particularly difficult due to the strong market environment – bizarre when you consider that we've been through a pandemic, but the markets have been strong.

The value factor has clearly been struggling for many years and there are a lot of potential reasons for that but, on the flip side, growth stocks have been doing very well. Growth isn't necessarily just the inverse of value i.e. expensive stocks. There are other characteristics, which can be identified as specific to growth rather than just valuation, but it is interesting that growth has done so

well considering that, historically, it's not been seen as a factor in the academic sense as one that should be included.

The Fama/French history, for example, hasn't included it and, again, growth is then lumped in with 'expensive'; but in the past few years we've seen these mega businesses, the FAANGs, which are very large and have this sort of scale advantage.

A lot has been written about flywheel economics in Amazon etc and we've seen these big companies evolve and disrupt the corporate ecosystem since they've had this ability to grow on small amounts of capital relative to the amount of profits they seem to be able to generate. It's been a challenge to conventional economics about scale diseconomies and it's also distorted the market environment to a large extent because other companies that maybe don't look that attractive can be bolted on to these bigger businesses and they can make huge returns from them by leveraging their digital platforms.

Performance disparity

» **Chair:** Investment performance of quantitative factor-based strategies has been varied. What do we believe are the reasons for that variation in performance?

» **Leote de Carvalho:** Multi-factor investing is based on a number of bricks which include the value, quality, momentum, low-risk and small cap factor investment styles. Clearly they don't have the same performance and, in 2020 in particular, value and small cap performed poorly. So, if you had more allocation to the small cap and to the value factors, you are likely to have had poorer performances than if you were more exposed to quality and momentum in your factor approaches. That's one of the

reasons that can explain differences in performances for different multi-factor approaches.

A second reason that can also make a difference is the choice of the factors themselves that go in each investment style. Not everyone uses the same factors, for example, for value, some use price to book, others don't. That can make a difference; also, whether you diversify more or less when you construct your individual factor styles matters.

Another reason that can make a difference relates to how you actually construct each investment style once you have selected the factors that go in each of them. In particular, whether you neutralise sectors or not. Some do neutralise sectors, others don't. If you look at value in particular, this can make a huge difference. If you do not neutralise sectors in the value factor, you may be looking at poor performances since 2007. If you neutralise sectors, you probably were quite happy until 2019 and you enjoyed good performance from the value stocks from each sector. So, that can also make a difference.

Finally, those who take more tracking error can get better performances in good times.

» **Chair:** What is the panel's interpretation of what has gone on over the last couple of years?

» **Matthews:** Large cap technology has been the place to be. It has delivered, and that has fed through into client discussions. As well as that, the longer-term thematic plays have been appreciated by the market, more so than traditional value names.

When we consider factors such as value, there are obvious reasons for that underperformance and reasons that can be easily understood.

When considering performance, though, we've got to be mindful that single factors such as value, such

as size, can underperform under specific time horizons and it is important to make clients aware of that. In fact, we prefer to have an allocation that is balanced and to be diversified. But the key point is to not be overexposed to individual single factors.

» **Peach:** We also prefer a balanced

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approach to factor investing. We've done a lot of analysis of performance to help clients understand what's been going on. Yes, the factors matter and the definitions of those factors matter to a degree but, no matter which way we sliced it, what has dominated has been the index construction – the diversification. Not being exposed to the very biggest stocks that were mentioned earlier can make a huge difference.

We provide attribution waterfalls of what's caused the performance in the past 12 to 18 months, and index construction clearly dominates because that is felt across your entire portfolio. If you're running a balanced portfolio, your definition of value, for example, is only one part of that particular piece. Articulating that to clients has been key – helping them to understand that index concentration is a risk that we want to diversify against, and that concentration risk has continued to grow over 2020.

With a blank sheet of paper, would you be investing 15 per cent of a balanced portfolio in five stocks right now? The answer would be no. We didn't think it was the right

answer at 10 per cent. We certainly don't think it's the right answer at 15 per cent. So, yes, definitions of factors can make a difference, but that's dwarfed by the index construction methodology element; and those products that maintain a link to the market cap as their starting point of the index will have done better in the past 12 to 18 months than those versions of multi-factor or factor investing that break that link and go for a more diversified approach.

» **Flosadóttir:** Factor-based investing has its ups and downs and there are periods of time where specific factor premiums such as size and value will experience underperformance relative to their counterparts. Performance of value and small cap has been poor, and the different use of factors and different combinations can have a large impact as well as neutralising sectors.

But, there *should* be a difference in performance based on styles. That's why we choose them; and why we emphasise the importance of a diversified portfolio, not only when it comes to bonds and equities, but even more importantly when it comes to investment styles, factors, sectors etc. The cyclical nature of factor-based investing is also an important note to keep in mind.

Value

» **Chair:** There has been much debate about the value factor, its performance versus growth, and its relevance as a factor – what are the panel's views?

» **Price:** Value has certainly been a huge topic of discussion: is value going to work? Why might it not be working? It's almost acted as a case study as to how a lot of the things we have talked about today have come together. Depending on an asset owner's portfolio, for example,

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they may have exposure to only value, in which case, the poor performance of value will have been a real issue for them. Alternatively, they may have value plus exposure to other things and, hopefully, a number of the other things have done well in that same time period. In that case the discussion is around the challenges of being diversified across lots of things – i.e. that you're portfolio is never the best, but hopefully it's never the worst.

The key point is that we need to ensure asset owners are thinking about their portfolios in the round.

With value in particular, while it hasn't worked and performance has been poor, in our view none of the explanations that have been put forward as to why it's done badly are particularly strong. In that sense, it's not obvious that there's something to fix; and that suggests that we need to hold on.

Our perspective on that thought is partly informed by a lot of the academic work that we see which focuses on book value. A lot of the other value metrics have done pretty poorly too, so we can poke holes in book value for not including intangible assets and things like that, but why has price to sales also done poorly as well? Or, why has price to cash flow done poorly? It's certainly a tricky one, and broader than any particular metric being a poor measure of asset value. That said, it's also not obvious to us that value is more attractive now than it was before, just because it's cheaper.

There are lots of good reasons why some of these companies that have become more expensive arguably should be priced at a premium; and therefore, should we assume that all valuations are going to return to where they were before? It would be nice, if you are a value investor, but it's not obviously the case that it will happen, or that it

should happen.

So while value has done poorly, we should be careful about assuming that, because it's done poorly, it's either going to do really well in the future or that it's going to keep doing poorly.

» **Tol:** Value hasn't been working for quite a long time, and that raised some issues internally and even some clients have asked about it. To give you an example, in our global small cap portfolio, we have a deep value manager. Last year, they underperformed the core index by 1,200 basis points (bps), so that raised a lot of questions internally.

"The key point is that we need to ensure asset owners are thinking about their portfolios in the round"

We had a growth manager sitting alongside that, and they outperformed 1,600 bps. I made clear that the two managers operate "in tandem". In case we were to consider terminating the value manager, we should consider terminating the growth manager as well, because otherwise our manager mix would no longer be style neutral (which we strive for).

I am quite interested in exploring the question of whether or not value can be improved by including intangibles. Some people say you can only slightly improve your risk/return relationship by doing so, others argue that adding intangibles improves the value factor significantly. We are fortunate that the value manager we have in place does include intangibles, and they believe it did add to performance.

But it has been extremely difficult because value has been underperforming not for five years,

but for a much longer period of time. YTD 2021, the performance of the aforementioned managers is the opposite of what it was last year. Again, you need to look at the manager combination.

Eventually, it all comes down to communication – properly communicating both internally and externally and stressing that we are in it for the long run. Also, a balanced, style diversified approach is crucial to a successful active manager portfolio.

» **Leote de Carvalho:** The actual impact of intangibles can be difficult to estimate and, from sector to sector, can have quite different impacts. Therefore, what we tend to do, is to control for sectors – and we try to compare companies that are more easily comparable with each other. Intangibles can be important in the tech sector but if you compare tech to tech, they all have intangibles and then the question becomes less important.

Our experience with sector neutral value investing has been quite positive. We saw very good performance from our sector neutral value style from 2000 until mid-2018, with just a blip in 2009. The reason for this good performance is that we control for sectors. However, despite the fact that we control for sectors, value stocks performed poorly in 2019/20, and indeed, irrespective of whether we use price to book as a value factor or not, all value factors performed poorly since 2019. But we found exactly the same in the tech bubble in 2000.

What we have also found is that the period that tends to be favourable for value investing is a period where the dispersion of value metrics remains relatively constant or actually compresses. Value is about investing in cheap stocks and you expect the price to converge to fundamentals; and you move away from expensive stocks because,

there, the stock has to perform poorly for the valuations to converge with those of cheaper stocks. However, there were periods in time when value spreads expanded. The tech bubble is an example and 2019/20 offers another example.

In fact, value spreads today are at the same level as at the peak of the tech bubble. So, we believe now that we have ahead of us quite a favourable period for value stocks because it's much more likely we will see a value spread compression than a value spread expansion as it happened immediately after the tech bubble.

» **Tol:** Can we talk about growth? A number of years ago, MSCI revived its growth factor index claiming there was sufficient evidence for growth to outperform in the long run. I am sceptical, but growth has performed well over the past couple of years and I've seen some quant managers looking into the growth space to add it as an additional long-term factor.

» **Artingstall:** Growth has been dismissed possibly because it came with too much baggage. Growth stocks have historically been associated as being the opposite of value. i.e. if it's expensive, it's a growth stock and that's a bad thing because it's going to disappoint. They also tend to be volatile, so maybe there's too much positive sentiment about them at the moment. Everyone's jumping on the bandwagon – although that could be momentum which is potentially a good thing, but not if it's too much.

The work I saw by MSCI essentially had tried to strip away some of these other factor exposures and look at the residual growth factor and they were highlighting that it was a positive factor when you excluded all these other negative contributors to a growth factor portfolio.

It makes sense – if you can access portfolio companies that have

illustrated the ability to grow faster than their peers and they're not expensive, and you can avoid overpaying for them, then that seems to be a positive attribute. Why would you want the opposite? Why would you want a portfolio with terrible growth? Maybe you'd buy them if they were dirt cheap, that's the value idea, but then you have this headwind that they're cheap, but they're not growing at all. They're growing very slowly, so maybe they're priced correctly anyway. They are cheap for a reason.

There's always this interaction between factors and it's very dangerous to take a narrow view on something with a monovision and ignore other effects that also have an impact on the return situation.

Growth is also linked to the quality factor. Companies with high returns on capital should grow faster and arguably it's also linked to the idea that if you've got a high return on capital, you should be investing more than your depreciation rate. You should be over investing in the business to grow faster to benefit from the high returns on marginal new capital.

» **Leote de Carvalho:** To pick up on that, we don't have growth explicitly – we have quality. Quality did extremely well. Quality was really the counter lever of value in our approach. We saw an absolutely fabulous performance of the quality factor last year.

» **Flosadóttir:** One point that hasn't been raised concerning the growth factor is interest rates. The low interest rates that we have seen in recent years tend to complement growth style better than, for example, value. We saw this recently. If you look at just the past three months, when interest rates turned up a little, we saw an immediate effect – value went up and growth went down a little.

However, when you think ahead, how optimistic can we be that interest rates will go up more than just for the short term? Given the increase in savings and the change in demographics, in the long run, when it comes to money and savings, it will be a matter of supply and demand. This is eventually likely to keep interest rates rather low, which will fuel the growth sector even further or at least make room for its continuum.

» **Matthews:** The point around including growth as a potential factor is interesting and we'd be supportive of seeing developments in that field, mindful obviously that the overall portfolio should be tilted towards the factors that are going to add value as opposed to having something which looks a bit more like the broader markets.

Regarding the interest rate discussion, it will be interesting to see how the market evolves over the next year; what the reopening trade means for the broader market and what it does to rates as we see businesses recover in beaten up sectors.

» **Peach:** It has been tough for value and that has highlighted why we need a balanced exposure to factors.

Value investing is characterised by long fallow periods and potentially short periods where investors can 'fill their boots'; that means it requires discipline and therefore value is often the factor that gets a hard time. As soon as factors/multi-factors aren't doing well for whatever reason, value gets the blame without possibly understanding the nature of what it means to be a value investor for the long-term.

We've noted the value spread is at historic highs, but from that we should not assume that it's going to be a 'fill your boots' period for value. As has been mentioned, the trajectory of interest rates is not clear.

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But we also need to consider what's driving the wideness of the value spread. Back in 1999/2000, a lot of stocks were very expensive and possibly without merit, and value snapped back. That's not really the case this time. It's more on the cheap side. It's that cheap stocks are depressed rather than lots of stuff being overvalued. So, we don't think there will be a snapback, but we do see the conditions for value to do quite well.

On the point about lack of valuation support, that comes down to how you frame your value, in terms of how you use the value score to allocate to value. If you use your value score to allocate to the factor, you will end up with the very cheapest stocks and you run the greatest risk of allocating to companies that are actually cheap for a reason. So, even within factor exposures, diversification is key.

» **Nagle:** One other point to mention is that, as we transition to lower carbon investments, it's going to present some structural challenges for value investing. Traditionally, those types of companies are more carbon intensive than the stocks we've talked about under growth.

At Mercer, when we're looking to build our active equity portfolios, we believe it's important to include a range of risk and return drivers and style is one of the lenses we use to ensure that we are blending complementary managers together within our multi-manager funds. So when we think about style, we would consider our exposure to value but as part of a diversified portfolio taking into account quality, momentum, size and low-vol too. Value shouldn't dominate the portfolio but neither should any other factor and, looking ahead, we believe that value can provide some element of diversification to the styles that we discussed that have

done well over the last decade. We certainly still feel value has a role to play but the backward-looking systematic strategies, particularly in index form, may face the most challenges in the years ahead.

The low volatility factor

» **Chair:** The low volatility factor performed really well during previous crises, but not as much in 2020. What are your views?

» **Nagle:** For the reasons I just mentioned, we believe in allocating to a range of factors as part of a well-balanced, diversified portfolio and low volatility should form part of that. When you look back over the last decade, low-vol has done well. It's delivered the objective of lowering absolute volatility but also producing long-term outperformance versus a broader market. At the beginning of 2020, some level of protection was provided versus equities overall but not to the same extent as in previous crises.

A large part of that was due to the nature of the shock to the markets as a result of the pandemic and the fact that the impact on the global economy was so unprecedented – stocks in some traditionally more defensive industries sold off quite heavily.

In terms of low volatility as a factor, it's an important part of a diversified portfolio. Actively managed low volatility strategies would be our preferred approach versus a passive index-based approach because of the risks that are inherent in low volatility equity, particularly around interest rate sensitivity and valuation. We think that active managers are better placed to mitigate those risks going forward as well as incorporate ESG risks into their investment process.

» **Leote de Carvalho:** BNPP AM research has shown that low-vol stocks continue to have higher sharpe ratios than higher volatility

stocks, at least until last year. 2020 was a year when the premium was not there. It's not the first time, but it was unfortunate because there was a short period of very strong market underperformance and it would have been good to have that low volatility anomalous premium.

The period I reference however was extremely short because actually, 2020, for most of the year, if you remove the five/six weeks starting in mid-February, was a very positive year; there was just a big drawdown in late February and March. For low volatility stocks, even if they have higher Sharpe ratios, when markets have very positive performance, the fact that you have low beta makes it difficult.

2020 was a combination of the fact that the alpha was not there; the fact that, if you remove those five/six weeks of very negative performance in late February and March, the markets actually had very positive returns; and finally, the fact that the very mega caps significantly outperformed. If you really invest only in low volatility stocks, most likely you had a large underweight on those very large cap stocks and that also didn't help. So, low volatility strategies really had a difficult 2020 for those reasons.

» **Peach:** The global financial crisis (GFC) was triggered by a very specific set of circumstances that were not remotely the same as what we experienced last year. During the financial crisis, liquidity dried up, there was very clear shock to the equity market and, to a degree, a flight to quality; so government bonds did well and bond proxies, essentially low-vol stocks, did well during that period.

The sell-off last year was pretty indiscriminate. Following that, we saw a very strong market afterwards; but that was driven by a very narrow set of very large growth stocks. If

you put those things together, it's not that surprising that low-vol hasn't done very well in 2020. For the sharpe ratio reasons that have been mentioned, we also still think it warrants a place in the multi-factor portfolio and we are certainly supportive of it going forward.

» **Artingstall:** I agree that the market sold off in aggregate heavily in 2020, but I wouldn't say it was indiscriminate. I'd actually say it was extremely discriminate in that certain stocks and sectors got hammered. Anything in the leisure and hospitality sectors, anything to do with retail, such as shopping centres, got hammered. We all know the sort of stocks that have suffered immensely.

Equally, the market was highly discriminating in bidding up the beneficiaries of the Covid-19 pandemic. For example, all the tech companies that allowed us to do video calls and so on. So, in that respect, there were some extreme polarities in what was going on in the market. Low-vol didn't benefit from that – it was probably a net sufferer from those effects.

Low-vol tends to prefer the quieter backwaters of the stock market and those quieter backwaters are normally a good place to be in a crisis, but in a crisis like a pandemic, it didn't work out that way. It was different and there were clear reasons why low-vol didn't work so well.

The real question for low-vol is whether or not you leverage it up or leverage adjust, which obviously people tend not to do given it's a bit difficult to do that for pension funds.

» **Matthews:** We have mentioned 2020 and, in a sell-off, it can almost be hard to stomach when you employ a value and low-vol strategy or you have a tilt to those particular factors, and you end up doing quite poorly and you see clients where they've got growth exposure doing a

lot better. We had a lot of interesting discussions around that and it's understandable how it's hard to stomach, but the key point here is that, given it was a pandemic, it was a different situation to consider for clients; and the point around growth having better upside capture but also seemingly better downside capture as of late was more of an education piece. We still believe that the academic findings of the low-vol factor are undeniable and, over the long-term, we believe that the return premium is still there and it still remains, as part of a balanced

effectiveness of the factor could have broken down. The only short term concern I have here is the interest rate sensitivity of low-vol.

» **Price:** We consider every low-volatility strategy to be active, whether it's via an index or not. We see that as important because it gets to the question of the design of a quant manager's low-volatility strategy or the design of the low-volatility index that is being tracked. It's important to understand what's going on inside the strategy.

There's a big difference between a portfolio that's maybe optimised to

“Low-vol tends to prefer the quieter backwaters of the stock market, and those backwaters are normally a good place to be in a crisis”

strategy, a key aspect of what clients should be considering.

» **Tol:** Our clients have been investing in low-vol since April 2010. Last year, it was hard when clients found out that their low-vol portfolios didn't help them. But there were very strong polarities in the markets. The typical low-vol stocks – energy, materials and so on – were hammered. That's what happened in March. But then, when the stock market rallied, rather than these stocks rallying the most, which was expected, the IT stocks in fact rallied even more than the typical low-vol stocks; so it was almost a double-edged sword for low-vol because the stocks went down the most during the huge market correction and lagged in the upturn.

In the long run, we still believe in this factor. It does exactly what we expect it to do – market similar returns, but with lower volatilities. One disappointing year for low-vol does not mean it has stopped working and there are no fundamental reasons why the

be low-volatility and has 200 stocks in it versus one that's tilting towards low-volatility stocks and has 1,500 holdings. If markets rebound with only a few stocks rebounding a lot, then the optimised strategy might own them, but it might not. You're then really into the specifics of the strategy and who designed it and what it is designed to do. It's important to review all these things, just as it is when investing in a value strategy, or any strategy.

Linked to that, we don't usually recommend clients use standalone low-volatility allocations within their equity portfolios, primarily because while it's an excellent approach if you're looking to reduce your equity risk in an equity portfolio, most of our clients are multi-asset investors and so the real question is not, 'do you want to have an equity portfolio with a beta of 0.7?'; it's, 'do you want to sell 30 per cent of your equities and what might you reinvest that into?' You could move assets into the corporate credit space or different parts of the

Roundtable

credit asset class – some areas like alternative credit have very different profiles, albeit for some of those strategies last year's performance was not so good. Or you could invest in hedge funds and think about discretionary macro, CTAs and other strategies that, when equity or bond markets sell off, it's not a question of selling off less, it's possibly a question of making money for the overall portfolio.

Finally, when it comes to reviewing how various strategies have performed through 2020, it's interesting to consider whether or not we've actually seen the regime shift that we all think we've seen last year. Typically, when we think of a regime shift in markets, we think of large drawdowns like the dotcom bubble, or the GFC. These are often accompanied by sector rotations and that's where we see leadership change in factors and styles as well.

However, in 2020, while there was a sudden drawdown, we didn't really see that rotation in market leadership. We saw the sectors that had been performing very well in the time running up to it perform well during it and have performed well since.

In this market setting, yes we've seen a level of markets move up and down a lot, but actually we haven't seen that rotation. So maybe our expectation that strategies that worked before shouldn't have worked afterwards is a little bit off in this case. I think this rapid change in market level, and the repricing of assets positively or negatively affected by events, relates to the previous point about the market being quite discriminating and adapting quickly. 2020 wasn't like other crises. It wasn't a slow realisation with different parts of the market realising there were issues. It was quite abrupt.

ESG

» **Chair:** A big topic across all asset classes is ESG and how it is addressed within a balanced portfolio. As managers, BNPP AM is fully embedding this into its processes. How much consideration do you give this in your decision-making when choosing a manager? Could it become a stand-alone factor?

» **Flosadóttir:** Our pension funds all have ESG policies which we

“One disappointing year for low-vol does not mean it has stopped working - the only short term concern is the interest rate sensitivity of low-vol”

apply through the entire investment process where we put special emphasis on certain areas. A significant part of that process is evaluating the ESG policies applied by the fund managers during our due diligence process and follow-up from there. In recent years it's rarely something that we need to start the conversation about as it has become an industry standard and therefore usually one of things that the funds that we are meeting with introduce and talk about first.

Looking ahead, ESG scores and ESG will become more significant as a factor, but not necessarily as a standalone factor. I believe it would serve better being compiled with other factors as well. It is also important that investors understand how ESG investing can potentially lead to unintended factor tilts.

If we're going for ESG as a standalone factor, perhaps we could look at some impact funds that are strictly focusing on making an impact through ESG metrics. But in

other equity funds, I think it will always be coupled with some other factors as well.

Applying ESG metrics throughout the investment process will gain momentum in the coming years and be of even more significance to investors, pension funds in particular. So, the evolution of ESG as a factor or coupled with other factors will be an interesting progression to watch,

» **Nagle:** At Mercer, we believe that a sustainable investment approach is more likely to create and preserve long-term investment capital and that ESG factors can have a material impact on the long-term risk and return outcomes. For these reasons, it is fully integrated into our investment process.

In terms of ESG ratings, we maintain ESG ratings for over 5,500 strategies and we've incorporated ESG ratings into our research process since 2008.

To answer your question, if we are looking at managers for inclusion in a portfolio, we will always take the ESG rating into account and, if you had two strategies with the same prospect for performance, we would have a preference for the strategy with the higher ESG rating.

On the point of ESG as a standalone factor, historically, ESG indices have provided better risk adjusted return. However, standalone implies that it's looked at almost in isolation or separately and our approach is very much that it's at the core of our investment process, so it informs the investment decisions as a whole as opposed to being looked at on a standalone basis.

» **Peach:** We have ESG ratings for all of our funds generally and that ranges from recognising that it's either not taken into consideration, it's incorporated in the financial decision making or it's a bit further in the direction of impact investing.

When it comes to factors and multi-factors indices, it's trickier because it's systematic so you're relying on robust data, something that you can create a rule about. So it's not without its problems, but that's one of the reasons we favour focusing on where the data is more consensual, like with carbon emissions. When you go further into ESG, that's where it's more problematic because it's such a broad church and the ESG agencies themselves differ. There's not a huge amount of correlation between them so data there is a problem.

We employ ESG and climate considerations in tandem with our factor methodology, but the data is going to have to improve for this to become considered a standalone factor.

» **Matthews:** We incorporate ESG into our investment process. It's a key factor now. Any decision we make or any thesis that we have is underpinned by strong ESG ratings. Picking up on the point around the data providers, there would need to be a greater level of consistency between them to allow some more shared thinking on the underlying stocks. ESG is considered as a method of good stewardship so typically companies that are strong in the sense of ESG ratings tend to be quite strong companies from an underlying fundamental basis as well, so that can feed into the wider factor piece.

» **Price:** We expect investment decisions to be made using all relevant and available information. Whether that is data in the report and accounts or ESG data or something an analyst has read in a trade journal - all that information should be incorporated to make the best investment decisions possible. To that extent, ESG data, data vendors and so forth are a great source of additional information

that's becoming widely available to financial markets and we would expect that to be priced in to markets over time. Therefore, it's important investors take it into account when making decisions.

I would argue that the disagreement, in terms of ESG scores and metrics, amongst the data vendors is a positive. If you're a skilled investor, you should be able to distinguish between the good and the bad, or the data points that are relevant and not so relevant, and that should help you generate stronger performance than your peers. From an active investor standpoint, having disagreement in a wide range of information is positive versus a situation where everybody agrees that company A has a good ESG score, and company B does not.

In that case the ESG information about companies A and B is probably reflected in the price already and therefore offers no competitive advantage. For asset managers, both stock pickers and quants, we think this is potentially a pretty rich area for them to demonstrate their abilities and gain a competitive edge.

» **Artingstall:** At the moment we are applying some exclusions for specific companies that are related to thermal coal and tar sands – the 'dirty' carbon intensity areas which seem to be sunset industries. It's hard to see them as being attractive as long-term investments and they are unattractive from an environmental perspective. It's difficult to apply a heavy screen since that could screen out a lot of companies and it also depends on whether you do it absolutely or relatively. If it's absolute, then you're significantly reducing your exposure to utilities, energy and materials as those are the three sectors that account for about 80- 90 per cent of carbon exposure. Then you have level one/

two/three emissions which further complicate matters.

Lastly, what if you are looking at a company that is bad at the moment but has a great plan to evolve into a far less carbon intensive business model going forward? Rather than avoid these companies, should you not be engaging with them, because you may well benefit in the future from owning such companies which are evolving in a positive way.

» **Leote de Carvalho:** We have a company-wide ESG scoring system which is sector specific, and which is inspired by the Sustainability Accounting Standards Board (SASB) framework. That scoring system is what we use in our quant approaches and we found that our ESG scores are actually exposed to quality and low-risk factors. We find that natural and we are quite comfortable with that finding – it is backed by academic research and it is also helpful for our quantitative equity approaches because we tend to be exposed to quality and low-risk anyway.

So we chose to use an integrated approach and we use portfolio optimisation to control for the ESG factor exposures. That's also because our products meet certain criteria from ESG industry labels, and we find that using optimisers to make sure that we always meet those standards is the easiest. We're quite comfortable because ESG is aligned with the type of factor exposures we have in our quant equity multi-factor approaches so it works.

» **Morris:** To conclude, there are certainly a number of key takeaways from today's discussion – diversification remains essential in European pension portfolios, and the multi-faceted nature of equity factor investing means it continues to play a dynamic and highly useful role in pension portfolios today. ■