Systematic Equities: A Closer Look

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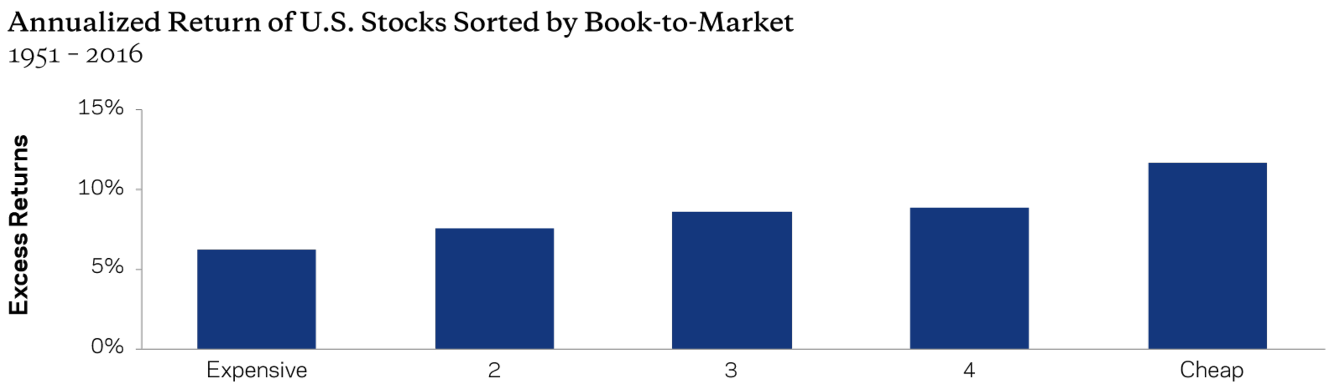
Factor Investing

Factors are one of the building blocks of a systematic approach. They define the characteristics of attractive and unattractive stocks and provide a consistent, rules-based implementation of an investment philosophy. How does it work? In a long-only portfolio, a systematic factor strategy will overweight stocks that rank highly on a certain factor and underweight stocks that rank poorly on that factor. Using factors allows us to explain exactly why the portfolio is positioned the way it is and what the drivers of return are—every time.

Value

Value investing is one of the best-known and most-studied approaches to outperforming the broader market over the long term. Equity valuations can be quantified by the ratio of a fundamental anchor—like book value, earnings or cash flows—over price. There are many ways to measure the valuation of a stock—we find that using a combination of measures yields the most robust results.

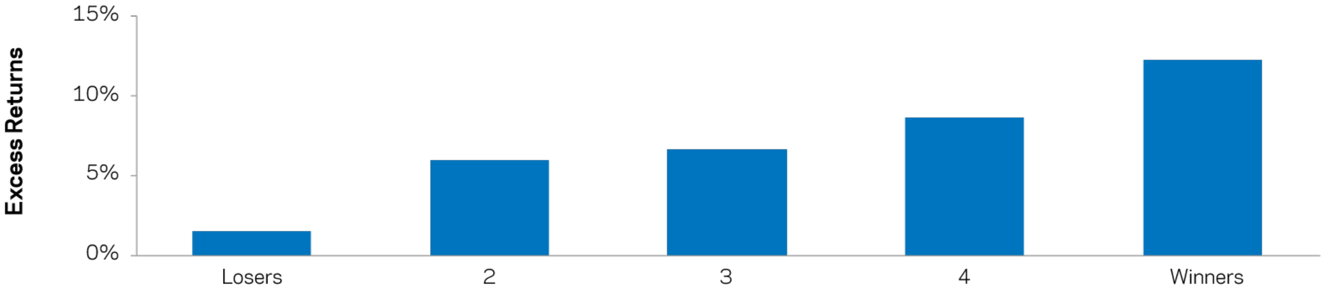


Sources: AQR and Kenneth R. French Data Library. Portfolios from Kenneth R. French Data Library formed based on book-to-market; quintiles are equal-weighted; returns are excess of cash. Returns sourced from “Portfolios Formed on Book-to-Market.” See Kenneth R. French Data Library for further details. These are not the returns of an actual portfolio AQR manages and are for illustrative purposes only. Past performance is not a guarantee of future performance.

Momentum

Simply put, momentum is the idea that assets that have recently outperformed will tend to do better than assets that have recently underperformed. This tendency has been documented in at least as many asset classes as value and over even longer histories. A simple yet common measure of momentum is the last 12-months price return of an asset. Importantly, the returns of the momentum premium have tended to be negatively correlated to those of the value premium—which means they may offer investors great diversification benefits.

Annualized Return of U.S. Stocks Sorted by Price Momentum
1951 - 2016

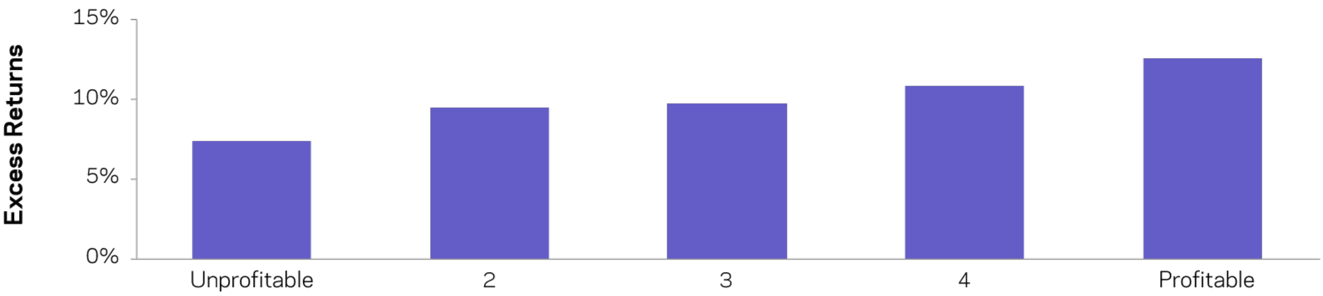


Source: AQR and Kenneth R. French Data Library. Portfolios from Kenneth R. French Data Library formed based on 12-month momentum, skipping most recent month; quintiles are equal-weighted; returns are excess of cash. Returns sourced from "10 Portfolios Formed on Momentum." See Kenneth R. French Data Library for further details. These are not the returns of an actual portfolio AQR manages and are for illustrative purposes only. Past performance is not a guarantee of future performance.

Defensive

Defensive stocks tend to be low-risk, stable or safe. As with most factors, there is more than one way to characterize a defensive company—from purely fundamental measures such as profitability and general quality to statistical measures such as low beta and low volatility. We find that both may help identify attractive stocks. For example, a defensive portfolio is likely to go long or overweight stocks that rank high on earnings quality and profitability and rank low on beta and volatility.

Annualized Return of U.S. Stocks Sorted by Gross Profits-to-Assets
1951 - 2016



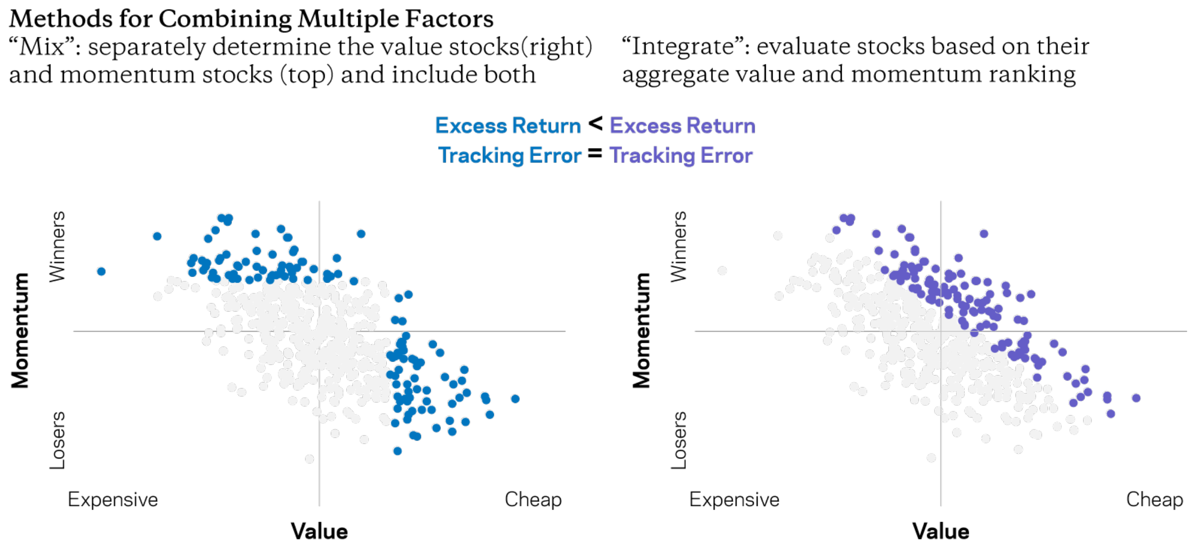
Source: AQR and CRSP/Compustat data. Portfolios formed based on gross profits-to-assets using all stocks in the CRSP universe; quintiles are equal-weighted; returns are excess of cash. These are not the returns of an actual portfolio AQR manages and are for illustrative purposes only. Past performance is not a guarantee of future performance.

Combining Factors into a Multi-Factor Portfolio

The combination of multiple factors has been shown to be more effective than any one individually. But how you combine them matters.

For example, how would you build a portfolio that seeks to capture both value and momentum premia? The easiest approach would be to separately buy the stocks that look most attractive from a value perspective and also buy the stocks that look most attractive from a momentum perspective. This is essentially constructing an aggregate portfolio by mixing stand-alone-style portfolios.

We believe there's a better way. Theoretically and empirically, we find that buying stocks that look attractive from both value and momentum perspectives is more effective than considering each factor separately. In other words, applying investment themes in an integrated manner may be better than mixing individual styles in an "a la carte" manner.



Source: AQR

Factor Diversification Versus Timing

Factors may offer long-term sources of returns, but that doesn’t mean they make money at the time. Can investors do better—can factors be successfully timed?

Factors (like many other sources of return) can become cheap or expensive compared to their histories. It might seem intuitive to test the efficacy of factor timing by overweighting a factor when it’s cheap and underweighting when it’s expensive.

Theoretically and empirically, we find it’s not so easy. Factor timing, especially contrarian factor timing, is far from an efficient way to make returns. Why? First, there is only a weak predictive relationship between how cheap a factor might seem and its future returns. Second, we find the returns from contrarian factor timing are meaningfully correlated to the returns from the value factor itself. What that means for factor investors is there’s only limited benefit (if any at all) for portfolios that already have a value tilt or an allocation to the value factor.

Instead, we find that strategically diversifying across multiple factors to be more effective, not just in U.S. stocks, but in other geographies and asset classes too. Diversification across multiple factors doesn’t rule out timing entirely, but it raises the bar more than most investors might realize.

“ Factor timing is likely even harder than market timing.”

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