The Economist Intelligence Unit

A report from The Economist Intelligence Unit

Factors: Finding a place in institutional investors' arsenal

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Introduction

Institutional investors are always looking for better ways to increase returns, reduce risk and achieve specific investment goals. Particularly in the wake of the financial crisis, investors have been seeking more robust ways to diversify and reduce risk. One approach that has gained prominence in recent years is factor-based investing. At its core, factor-based investing focuses on the idea that traditional ways of seeking portfolio diversification, typically by asset class, are less precise than models that seek to understand factors underlying potential investment risks and returns, including economic growth, inflation, volatility and company size. Today, some firms are using factors broadly, some are quite sceptical and many are finding selected uses for factors.

A recent global survey conducted by the Economist Intelligence Unit and sponsored by BlackRock sought to understand whether and how institutional investment firms are using factors, whether factor use is meeting firms' expectations, what reservations some firms still hold and what tools and tactics have helped firms increase their use of factors.

The results show that a majority of institutional investors surveyed have adopted factors for a variety of uses, that nearly two-thirds have increased factor use over the past three years and that 60% expect to increase use over the next three years. In addition, large majorities of those who have put factors to use report that their expectations have been met so far.

About the survey

The survey was conducted in January and February, 2016, and garnered responses from 200 institutional investment professionals from around the world. Twenty-one percent of respondents were CIOs, with a further 21.5% heads of investment or equivalent; 7.5 % were deputy or assistant CIOs; 20% were senior vice presidents, vice presidents or directors; and 30% were heads of various investment groups. Respondents represented a range of types of firms, including foundations, endowment funds, insurance companies, sovereign wealth funds and public, private and professional association pension funds. By assets under management, 17% of respondents came from firms with $1bn-4.9bn; 17% from firms with $5bn-9.9bn; 33% from firms with $10bn-24.9bn; 25.5% from firms with $25bn-74.9bn; and 7.5% from firms with $75bn or more. Forty-five percent of respondents were from the Americas; 35% from EMEA; and 20% from APAC. To qualify for the survey, respondents had to be somewhat, very or extremely familiar with factor-based investing.

Widely used and widely liked

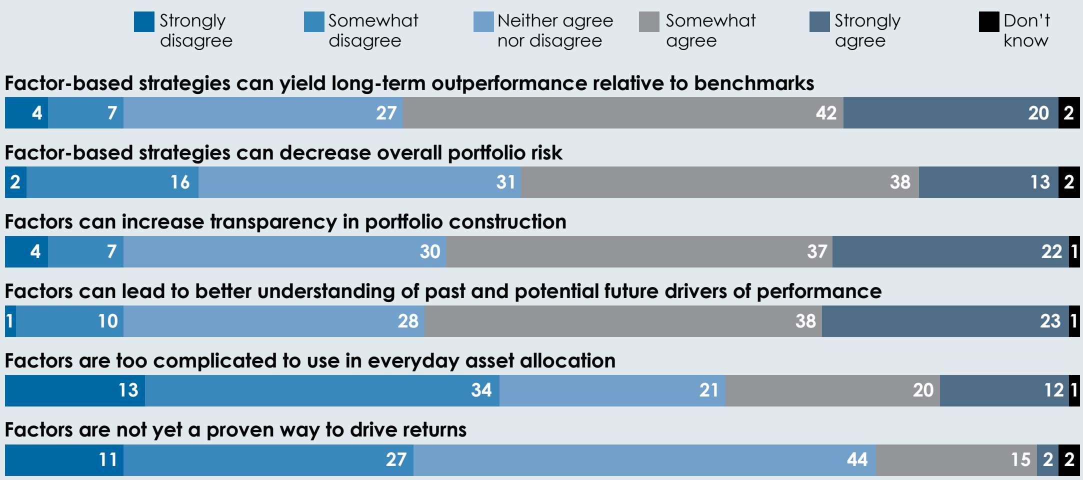
Most institutional investment professionals around the world are using factors somewhere in their investment process, the survey shows, and typically for more than one purpose. Two-thirds of investment professionals are using factors to help understand portfolio risk and return; just over half said they are using them to help shape or optimise overall asset allocation or that they use strategies that target one or more factors. Only 13% of survey respondents said that their firms were not using factors.

In addition, 62% of all respondents said they have increased factor usage over the past three years (compared with only 3% who said they had decreased use). Across types of firms, insurance companies have the highest share of increased use, with 76% saying so; by firm size, those with more than $25bn under management, also most often said they'd increased use, with 68% saying so.

This general increase in factor usage aligns with respondents' overall favourable view of the role factors can play in investment strategies. Indeed, 62% of respondents said factors can achieve long-term outperformance relative to benchmarks, 61% said they can lead to better understanding of past and potential future drivers of performance and only 17% said that factors are an unproven way to drive returns. Some investors do raise concerns: 32% of respondents said factors are too complicated to use in everyday asset allocation; in addition, 44% weren't sure if they were a proven way to drive returns.

A regional look suggests that firms in the Americas may have started using factors earlier than those in EMEA: 42% of investment professionals in the Americas said their use of factors had remained the same over the past three years, 53% said there had been an increase—while 70% of investment professionals in EMEA said they had increased factor use in the same time period.

Opinions about factors
Please indicate your firm's level of agreement with each of the following statements.
(% respondents)



Totals may not add to 100% because of rounding.
Source: Economist Intelligence Unit survey, 2016

Why factors

One important use of factors is for capital allocation: 40% of respondents said they include a qualitative review of factors when they allocate capital across asset classes; 25% include a quantitative review of factors; and 8.5% allocate capital to factors first and asset classes second. Respondents at firms in APAC are widely divided on the use of factors in capital allocation. APAC respondents had the highest share of respondents, 35%, saying they don't use factors in their capital allocation process. Yet respondents from there also had the highest proportion, 10%, saying they allocate to factors first and asset classes second.

Companies' main motivations for beginning to use factors all relate to risk management in one way or another: 76% of investment professionals using factors said they did so to better understand sources of risk and return; 68% said their motivation was a desire for greater diversification; and 64% indicated a desire to decrease their risk profile. Respondents at endowments and public pension funds most often chose a desire to decrease their risk profile with 77% and 66%, respectively, saying so.

Among companies that increased factor use over the past three years, the reason executives most often cited for doing so was to decrease risk or to increase diversification within a specific asset class, which 29% chose; 23% said they had increased factor use to heighten transparency in portfolio construction and asset allocation.

How factors are used

The 53% of respondents who are using factors for asset allocation rely on a range of macroeconomic factors: 75% consider inflation, 73% economic growth, 72% real rates and 67% credit and credit spreads. The two-thirds of firms seeking to understand portfolio risk and return with factors manage their exposure with an equally broad range of approaches: 49% said they manage exposure with quantitative tools and the same share do so qualitatively or informally; 46% said they actively shift asset allocation or explicitly hedge risks as macro views change.

Among the 53% of firms using strategies that target one or more factors, 68% are using single or multi-factor equity strategies; 57% are using long/short multi-asset factor strategies; and 56% are using single- or multi-factor fixed income strategies. These firms most often use factors within the active exposure category of the strategy's respective asset class—37% of respondents in this group said their firms do this. Eighteen percent use factors within a stand-alone allocation. Such allocations are often used to create greater clarity in monitoring, managing and ownership and thus are often a means for firms to introduce a new way of investing and to be able to fully understand its effects.

Expectations are being met

Motivations for organisations to incorporate factors or factor-based strategies and benefits realised.
(% respondents with each motivation whose organisation realised those benefits)

Only selected response choices shown in each question.

Source: Economist Intelligence Unit survey, 2016

Meeting expectations

On the whole, the survey shows that factor usage is meeting investment professionals' expectations. Eighty-five percent of those seeking to better understand sources of risk and return, for example, said they achieved that goal. The goal that was least often met was decreasing risk profile—even then, investors said factors met their expectations 71% of the time.

Pockets of reservations

For all the widespread use of factors, it's notable that 13% of survey respondents said their firms are not using factors, a figure that rises to 23% among respondents at foundations.

There's a tie for the most often given reason for not using factors. Sixty-two percent of those investment professionals cited a lack of empirical evidence that factors can add value over time and the same share cited a lack of benchmarks. This is consistent with one reason—lack of consensus among peers about their use—often given by the few respondents whose companies have decreased or plan to decrease their use of factors.

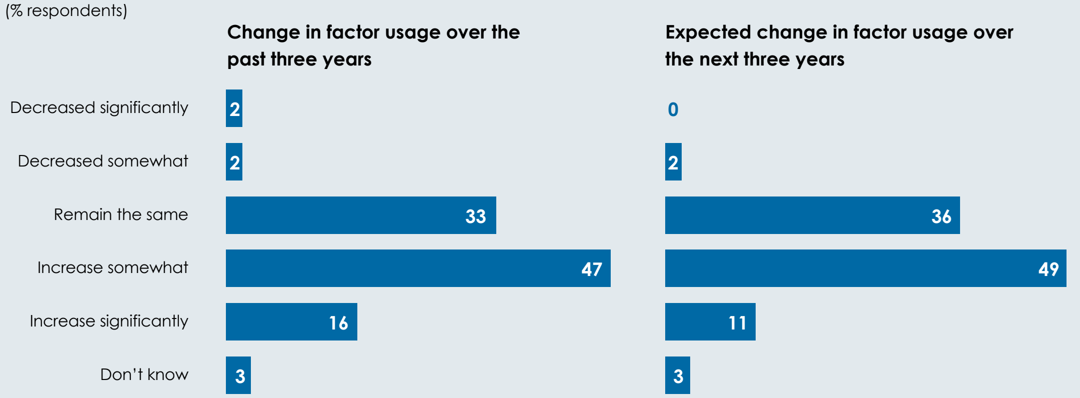
When respondents who indicated that they planned to decrease factor use or keep it the same over the next three years were asked what might encourage them to increase use, they also cited similar ideas. The most often given reasons that would encourage greater use were: more hard evidence that the approach works over the long term, chosen by 27% of this group, and additional tools to aid in the measurement and analysis of factor exposures, chosen by 25%.

Increased usage ahead

Looking ahead over the next three years, 60% of respondents expect to increase their use of factors, only 2% expect to lessen such use. The most often cited reason among those expecting to increase use is decreasing risk or increasing diversification within a specific asset class, chosen by 28% of respondents—consistent with the reasons executives cited for increasing use over the past three years.

Respondents at firms that have increased their use of factors over the past three years or plan to do so over the next three mentioned several steps that their organisations have taken or will take to increase factor use. In both groups, by far the step most often cited was ensuring that the firm had appropriate risk-management systems (73% had done so in the past and 68% expect to do so). Other tactics that were frequently cited: providing information to internal stakeholders and seeking advice from asset managers. All of these align with many companies' motivations for using factors; they may also suggest that many companies are seeking to educate colleagues about a complex set of tools that some still view with scepticism.

Increasing factor use
(% respondents)



Totals may not add to 100% because of rounding.

Source: Economist Intelligence Unit survey, 2016

Conclusion

Despite lingering concerns about their overall efficacy and the lack of benchmarks or tools to measure exposure to factors within portfolios, factors are clearly gaining widespread acceptance among institutional investment professionals worldwide and in all types of institutional investment firms.

Furthermore, 60% of firms plan to increase factor use over the next three years, supporting the effort with risk-management systems, and seeking to allay colleagues' scepticism with additional information and asset managers' advice.

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