

# FACTOR INVESTING

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An Interview with Joseph Smith, CFA,  
Senior Market Strategist at CLS Investments





## GET THE SCOOP ON FACTOR INVESTING

**FACTOR INVESTING** is a hot topic in the investment world. A strategy previously reserved for institutional investors, factor investing is now available to all investors through smart beta ETFs, offering them the essence of active management at a fraction of the cost. In this interview, Joseph Smith, CFA, Senior Market Strategist, discusses the benefits of factor investing and outlines seven of the most widely studied and time-tested factors to watch.

*As a portfolio manager, what draws you to factor investing?*

Factor investing provides another lens to cut through the markets. Traditionally, most investors have looked at and analyzed their portfolios through the traditional style boxes (i.e., large-versus small-caps, or value versus growth) or asset class considerations (i.e., U.S. equities, international developed equities, emerging market equities, bonds, commodities, and alternatives). Factors allow investors to use a lens that effectively cuts across all of those existing segments with a clearer, more definitive focus on risk.

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PROVIDES ANOTHER LENS  
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### **FACTOR 1: VALUE**

*Value really gets at the heart of what every investor’s trying to accomplish, which is, ‘How do I go about identifying securities or companies that can be a great benefit to my portfolio in the long term?’ Even for today’s modern investing environment, value is very applicable and very necessary to achieving investment success.*

### **FACTOR 2: SIZE**

*Size is a very high-risk, high-reward consideration. In smaller companies, there are stages associated with growth cycles – whether it’s the early stage, starting out in a garage and doing grassroots promotions, or later when the product has legs to stand on and growing the business requires rapid expansion. So over a normal full market cycle, as the economy’s improving and people are chasing their dreams, those companies tend to become more*

## *Does factor investing hold the same value for individual and institutional investors?*

The value of factor investing is universal. We are currently experiencing the catch-up period for individual investors. Factor investing has long existed in the institutional world, going back to the 1970s when a lot of institutional investors were big proponents of it. ETFs have effectively allowed for some of the knowledge and insight gained from the institutional space to be repackaged and made available to a broader audience.

**“THE VALUE OF FACTOR INVESTING IS UNIVERSAL.”**

## *You are a big proponent of accessibility in investing; have factors helped that cause?*

If you'd have asked 10 or 15 years ago, the conversation among institutional investors and asset managers was much more closed door. But with some of the ETF industry's recent efforts, such as launching single- and multi-factor ETFs, as well as what's happening in academia (there's more research being published on this topic), the conversation has really opened up.

Some of the trickle-down effect has been that advisors are now having more of those conversations openly with their clients about what factor investing is, what it means in terms of their investment decision-making, and how it can provide solutions they may be looking for.

### **FACTOR 3: MOMENTUM**

*I refer to momentum as buying what works. Momentum captures a relationship that tends to exist over a given period of time, and represents the likelihood that something that worked yesterday will continue to work tomorrow. When evaluating companies based on momentum, investors who may not have as much in-depth knowledge of one company over another may just look at which company has done best over the last six to 12 months.*

### **FACTOR 4: MINIMUM VOLATILITY**

*Minimum volatility flies in the face of a good portion of what we know as Modern Portfolio Theory.*

*As a rational investor, I would expect to be compensated at a higher rate of return for deploying additional cash and taking on a greater amount of risk. But a lot of us can't borrow additional capital to make our investment decisions. So investors go after even riskier securities to counterbalance what they need in terms of expected real returns. As a result, lower-risk, minimum volatility securities don't get priced where they should be.*

### **FACTOR 5: QUALITY**

*People like buying safety when it comes to their investing. Think about what quality represents: it's honing in on which companies are well-run, have very efficient operations, produce clean balance sheets, and are prudent with the amount of debt they're taking on and the cash they may reward shareholders and other market participants with.*

*With quality, you're basically getting access to companies that have a consistent record, whether it's higher profitability or higher levels of overall cash flow. So the benefit for many investors is to help avoid low-quality companies that will more than likely cut their dividends or create distress.*

## FACTOR 6: DURATION

*Duration is a measure of interest rate sensitivity. The longer the duration, the more sensitive bond prices are to changes in interest rates. Bonds that tend to have longer maturities associated with them will respond with greater sensitivity to movements in interest rates as the value of future cash flows are re-assessed in today's dollars. This effect is also less pronounced for bonds that have shorter maturities since the value of upcoming cash flows in the near term are easier to assess in today's dollars.*

## FACTOR 7: CREDIT

*Credit risk relates to the assurance that investors will be made whole by the issuing entity of a bond such as a company, municipality, or government when they buy their bonds. Entities who are at a higher risk of making good on their debts tend to compensate investors with a higher yield on the bonds being issued. Entities with more solid balance sheets will issue bonds that on trade at lower yields since it is assumed they have to financial strength to pay back their debts.*

## Is factor investing a fad, or is it here to stay?

I actually think it's more of a long-term trend. The beauty of factor investing today is that it's probably one of the oldest secrets within the investment community that's now being made publicly available. It's something that's continuing to encourage the dialogue around effective risk management and how investors think about risk in the context of a portfolio. I believe that over time, more of the tools – including measuring factors and the ability to augment or adjust a portfolio based on factors – that have largely been held within the institutional community will become increasingly available to regular investors and advisors.

So is it a fad? I'd probably say no. It's just building off 30-40 years of institutional-quality research on something that's obviously very important for every investor.

**“FACTOR INVESTING IS PROBABLY ONE OF THE OLDEST SECRETS WITHIN THE INVESTMENT COMMUNITY THAT’S NOW BEING MADE PUBLICLY AVAILABLE.”**

Joseph Smith, CFA, is a Senior Market Strategist at CLS Investments and an expert in factor investing.



Prior to joining CLS in 2015, Mr. Smith worked at Russell Investments, where he served as an analyst responsible for asset allocation research, portfolio construction, optimization design, and risk management research. He later joined Russell ETFs as Manager of ETF Product Development and Research, a role in which he developed quantitative indexing strategies implemented as ETFs.

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