Factor rotation ahead?

- Momentum has been the best performing factor
- Can factors get crowded, but can they be timed?
- Will we see a persistent rotation to value?

A Factor-based approach to investing

Factor-based investing means choosing securities for an inclusion in an index based on what characteristics or factors drive their risk-return behaviour, rather than a particular geography or sector.

Just like food can be categorised simply by ingredients, it can also be analysed more scientifically by nutrients. Factors are like the nutrients in an investment portfolio.

What are the main factors?

There is a realm of academic and empirical study behind the key investment factors, but they can be summarised as follows
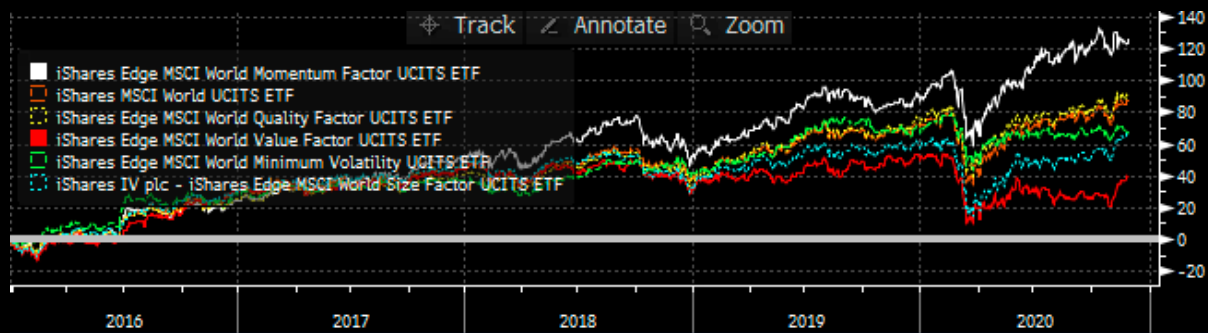
The different factors can be summarised as follows:

- **Size**: smaller capitalisation companies
- **Momentum**: companies with upward price trend
- **Quality**: companies with strong and stable earnings
- **Value**: companies that are undervalued relative to their fundamentals
- **Min Volatility:** companies with lower volatility performance characteristics

Which has been the strongest performing factor?

Momentum has been the best performing factor over the last 5 years. Value has been the worst performing factor.

Fig.1. World equity factor performance

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- ☐ iShares Edge MSCI World Momentum Factor UCITS ETF
- ☐ iShares MSCI World UCITS ETF
- ☐ iShares Edge MSCI World Quality Factor UCITS ETF
- ☐ iShares Edge MSCI World Value Factor UCITS ETF
- ☐ iShares Edge MSCI World Minimum Volatility UCITS ETF
- ☐ iShares IV plc – iShares Edge MSCI World Size Factor UCITS ETF

Source: Elston research, Bloomberg data

A crowded trade?

Data points to Momentum being a "crowded trade", because of the number of people oerweighting stocks with momentum characteristics. This level of crowdedness can be an indicator of potential drawdowns to come.

Fig.2. Momentum Factor is looking increasingly crowded
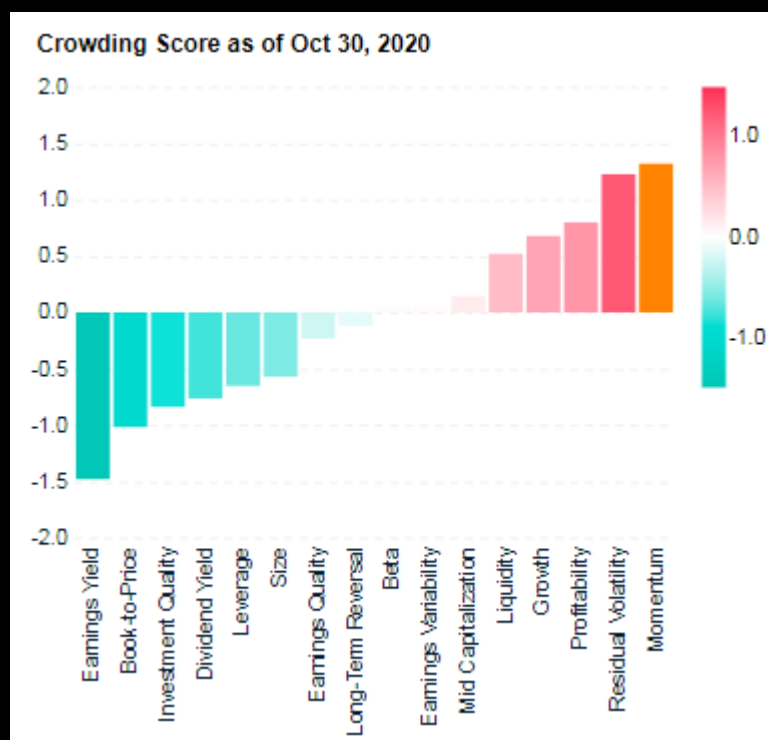
Source: MSCI Factor Crowding Model

The best time to buy into a Momentum strategy has been when it is uncrowded – like in 2001 and 2009, which is also true of markets more generally. MSCI's research suggests that with crowding scores greater than 1 were historically more likely to experience significant drawdowns in performance over subsequent months than factors with lower crowding scores.

Fig.3. Factors with higher crowding score can be an indicator of greater potential drawdowns, relative to less crowded factors
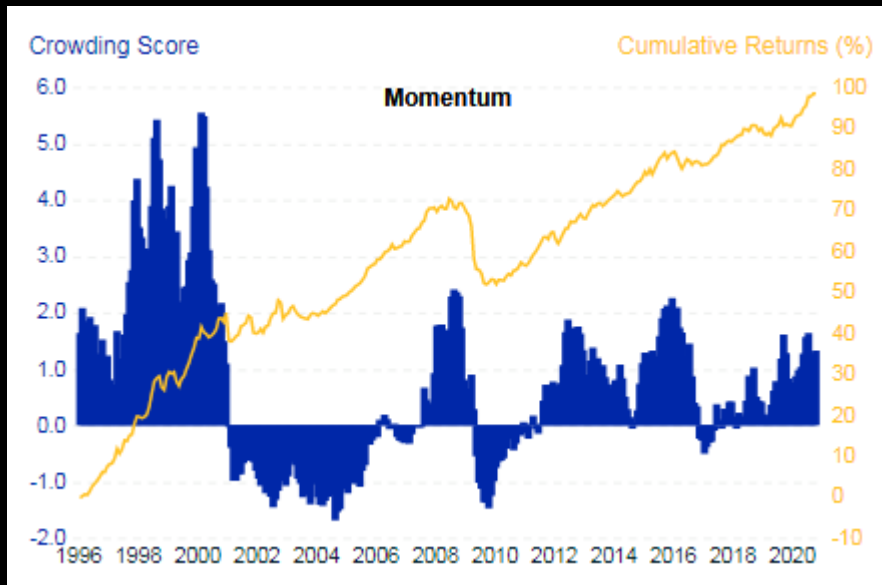
Source: MSCI Factor Crowding Model

Rotation to Value

The value-based approach to investing has delivered lack lustre performance in recent times, hence strategists' calls that there may be a potential "rotation" into Value-oriented strategies in coming months as the post-COVID world normalises.

But can factors be timed?

Marketing timing, factor timing?

Market timing is notoriously difficult. Factor timing is no different. To get round this, a lot of fund providers have offered multi-factor strategies, which allocate to factors either statically or dynamically. Whilst convenient as a catch-all solution, unless factor exposures are dynamically and actively managed, the exposure to all factors in aggregate will be similar to overall market exposure. This has led to a loss of confidence and conviction in statically weighted multi-factor funds.

Summary

Factors help break down and isolate the core drivers of risk and return.

- Factor investing looks at the "nutrients" of investment
- Static "catch-all" approach to multi-factor investing has clear constraints, so a more dynamic approach makes sense
- Factors can get crowded, but factor allocation is hard to time

For more on Factor investing, see

https://www.elstonsolutions.co.uk/insights/category/factor-investing

Find out more

For more insights and information on research, portfolios and indices, visit:

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