Factor Investing: Can it replace fund managers?

Traditionally, one is accustomed to look at equity markets through the lens of sectors. This approach is helpful when comparing companies in a specific sector. However, an alternative approach is to identify common drivers or "factors" that drive stock performance across the cross-section of market. This is the genesis behind the phenomenon of "factor investing"

In simple terms, when a fund manager evaluates stocks, he/she may apply a few filters. For e.g. a fund manager who follows a value-based investment style may identify stocks based on low price-to-earnings multiples. Factor investing takes this approach as a base and creates systematic rules. This can help create an investment approach, without any human bias and based purely on rules that work on certain "factors" – in this specific case, the example being "value" as a factor

According to Blackrock (world's largest asset manager), the AUM for the factor industry is estimated to be $3.4 trillion globally by the end of 2022, up from $1.9 trillion in 2018.

Factor based investing has seen its popularity increase over the last few years. This is because investors seek the following objectives, which may be met my one or more factors

- Seek outperformance to benchmark indices
- Seek reduced volatility
- Seek diversification of portfolios in various market cycles.

The calendar year returns for various factors in India since 2010 are:

	Quality	Low Vol	Momentum	Size	Value	High Beta	Nifty
2010	24.8%	25.5%	19.8%	19.3%	30.9%	-4.2%	19.2%
2011	-14.3%	-12.0%	-16.1%	-32.4%	-37.7%	-53.3%	-23.8%
2012	26.9%	32.1%	38.8%	44.6%	32.1%	44.5%	29.4%
2013	21.8%	6.6%	12.9%	-2.9%	-14.0%	-20.3%	8.1%
2014	32.7%	36.8%	49.6%	65.5%	78.9%	39.8%	32.9%
2015	3.5%	9.8%	10.8%	10.3%	-7.2%	-17.8%	-3.0%
2016	2.2%	3.1%	9.6%	4.8%	25.1%	-2.7%	4.4%
2017	23.5%	30.3%	57.5%	56.6%	47.0%	59.5%	30.3%
2018	5.0%	7.4%	-1.7%	-17.3%	-26.2%	-28.4%	4.6%
2019	5.7%	5.2%	10.6%	-2.0%	-13.7%	-18.5%	13.5%
2020	22.6%	24.3%	20.0%	25.9%	8.5%	9.1%	16.1%
2021	22.2%	24.2%	53.8%	52.6%	56.4%	35.5%	25.6%
CYTD22	-1.5%	-0.9%	-13.3%	-4.9%	4.7%	-4.5%	-0.2%

As one can observe, every factor may not perform in every market condition.

For e.g. In an upward trending market, momentum based strategies tend to outperform the market indices. In a falling market, low volatility strategies help protect the downside of the portfolio.

Hence being able to identify the correct factor or combination of factors that are suited for a market condition, becomes key.

While academicians and practitioners have identified hundreds of such factors, some of the more popular ones are:

- **Value**- Measures excess returns to stocks that are priced lower than their intrinsic value

- **Low size**- Measures excess returns of small caps as opposed to large caps
- **Momentum**- Measures excess returns to stocks that are in strong up phase
- **Low Volatility**- Measure excess returns of stocks with lower volatility
- **Dividend Yield**-Measures excess returns to stocks that give out higher dividends than peers
- **Quality**- Measures excess returns of stocks that are characterized as stable
- **Growth**- Measures the prospect of firms using past performance
- **Liquidity**- Measures variations in stocks with respect to their trading volumes

There are a number of funds in India which focus on factors. Also a few products follow a “multi-factor” approach.

While this field is still in a nascent stage, investors have started to look at it as a possible alternate to large cap space.

As large-cap mutual funds have been finding it increasingly difficult to consistently generate alpha, investors and advisors have started to look at factor-based funds that work with a large cap universe. A rules-based factor fund may likely have a lower expense than an actively managed mutual fund, and may have the potential to generate an outperformance versus the benchmark.