POWER POINT

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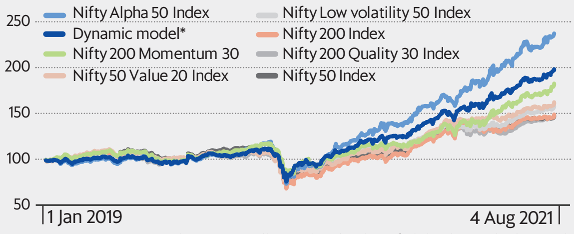
FACTOR INVESTING GAINING CURRENCY, SHOW TRENDS

Beating risks

The dynamic model generated the second highest returns. It had lower volatility, thereby generating a higher adjusted return.



*1 January 2019 to 31 March 2020 equally weighted index of alpha, low volatility, and quality; from 1 April 2020 to 30 September 2020, equally weighted index of low volatility, alpha, and momentum; from 1 October 2020 to 4 August 2021 equally weighted index of value, alpha, and momentum.

Base value taken as 100

Source: Nifty Indices

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In the second half of the 20th century, "information arbitrage" ruled the roost. By looking at a fundamental framework, active investors, including Warren Buffett and Peter Lynch, made their mark. However, as the financialization of savings theme picked up with US investors in 1990 and 2000s, equity markets exploded with large allocations, relying solely on fundamental traits that shrank the alpha (as the information asymmetry vanished with the advent of technology and internet). Hence, passive/index gained currency and was popularized by John C. Bogle (Vanguard). In the last decade, especially since 2008, factor investing has gained popularity as it marries active and passive investing, thereby becoming the third pillar of investing. A similar trend is seen across developed markets and is now making inroads into major emerging markets.

Commonly referred to as smart beta, factor investing has already made its market. Current global assets under management has already surpassed $1.2 trillion (as of July) and this rapid rise is unrelenting as active managers fail to beat benchmark and market capitalization-based passive products have achieved a skewed and clone construct.

Green shoots in place for India: In India's case, the financialization of savings trend picked up only after demonetization (in 2016). Since then, there has been a flurry of investments in financial assets, especially equities, with most deployment only based on fundamentals, resulting in cloning of portfolios and shrinking the alpha in NSE 200 (85% of market capitalization). This has led to the advent of passive investing, which is predominantly led by EPFO and CPSE mandates. However, with online platforms offering investment products, passive investing is proliferating faster. The appeal for factor-based investing is never more pertinent than what we are seeing currently where the stock markets are way more exuberant than the revival in the economic activity. Factor investing focuses on macro and micro fundamentals (quality, value, size factors) on one hand, with passive variables (momentum, standard deviation, alpha factors) on the other. This hybrid model ensures a higher risk adjusted return over a complete market cycle and hence worthy of core portfolio allocation.

Current global AUM for factor investing has already surpassed $1.2 trillion

Factor investing 101: While there are over 300 factors, which the global analyst fraternity is looking into, Indian investors are just looking at a handful of key factors to create a benchmark beating portfolio: Alpha (selecting stocks based on high Jensen's alpha over a specified period); quality (selecting stocks with high RoE, positive delta in PAT and low debt/equity ratio), value (selecting stocks with high RoCE, low P/B, Low P/E and high dividend yield); low volatility (selecting stocks based on low standard deviation over a specified period); momentum (selecting stocks based on strong price momentum over a specified period).

These factors, individually or combined thereof, have delivered benchmark beating returns. Importantly, they can help investors to weather market volatility much more effectively.

In bull phase alpha, momentum and value perform the best. In recovery phase alpha, low volatility and momentum perform the best. And in the bear phase low volatility, alpha and quality help to arrest declines. If one can dynamically allocate to these factors along with changes in business and market cycles, then they can generate alpha over benchmark, more importantly a better Sharpe ratio. The dynamic model generated second highest returns (generating alpha of over 0.33). By adopting factor-based approach, retail/HNI investors could aspire to achieve the elusive alpha and higher risk adjusted returns in a very scientific and cost-effective manner. Hence, it's time to embrace this change towards adopting factor-based investing for your core portfolio.

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