In my many conversations with investors and industry peers about factor investing, one topic seems to always come up: factor investing timing. I've had recent discussions on this topic with a central bank whose managers need to think about preserving capital and with a more nimble RIA team which explicitly wants to use timing to pursue incremental returns.

Factors, which are broad, historically persistent drivers of return, are inherently cyclical: Because each factor is driven by different phenomena, they tend to outperform at different times. How can investors aim to take advantage of this cyclicality of factor premiums in funds?

Our view: Market timing is difficult to accomplish, and with factors, it is no different. Rushing in and out of a factor strategy can cause harm to long-term returns and erode a portfolio’s diversification. That said, factors do demonstrate some cyclicality, which offers opportunity to improve the prospects of a diversified factor portfolio.

We believe there is a better way. When using factors in your investing strategy, rather than going in and out of factors, consider starting with a portfolio that is well diversified across key factors. Most investors can rebalance to those strategic factor weights.

Some investors might want to go further, and implement modest tilts around that strategic factor allocation. Factor tilting, rather than short-term in-and-out timing, can balance opportunities to seek improved returns while maintaining the potential long-term benefits of a well-diversified factor portfolio.

What signals might an investor use to tilt toward or away from factors over time?

How we tilt factor investments

Our research indicates that it’s possible to tilt to various factors to add incremental return to a multifactor portfolio by over- and underweighting select factors relative to others, while maintaining long-term exposure to all factors.
Here’s how. Let’s consider five equity style factors: value, size, momentum, quality and minimum volatility. For each factor, we consider four indicators to determine whether to tilt towards or away from the factor.

We start by assessing macroeconomic conditions to determine if the factor could be helped or hindered by the current environment. For example, during the expansion phase of the business cycle, when growth is accelerating, the momentum factor has tended to perform well.

Next, we review valuation to see whether the factor is expensive or cheap relative to its own history.

Relative strength measures whether the factor has had strong recent performance.

Another signal, dispersion measures how much opportunity a factor has to outperform in the current environment—or how similarly or dissimilarly the universe of stocks demonstrates factor characteristics. More dispersion creates more opportunities.

Each of the four indicators is valuable on its own, but we think it is even more effective to combine these four insights into a composite indicator. This tells us whether to under-, over- or neutral-weight the factor relative to the other factors, while still maintaining diversified exposure to all the factors over time—i.e. tilting, not timing.

How much does tilting add?

We’ve written extensively about the potential return benefits of a well-diversified multifactor portfolio relative to a benchmark index. A multifactor portfolio could maintain equal-weighted exposure to all style factors and add modest tilts to potentially increase relative returns. The degree of the tilt for each of the five style factors should vary depending on the strength of the over- or underweight indicator and the investor’s risk tolerance.

Factor tilting may also add diversification benefits for investors already holding multifactor portfolios. When comparing the addition of a factor-tilting portfolio or a traditional, actively managed mutual fund, returns from the tilting portfolio may have lower correlation with the multifactor portfolio than returns of active mutual funds.

Our current factor tilts

Our tilts as of March 31, 2017, included an overweight to momentum and an underweight to quality. Momentum stocks typically benefit when economies expand and are attractively valued. Quality had poor relative strength and narrow dispersion.

Ways to implement factor tilts

Investors may choose to incorporate tilting views in several ways: by explicitly allocating to a factor-rotation strategy within the equity allocation, by layering tilting insights over existing investments or by
letting tilting views influence manager selection and rebalancing. The availability of a wide range of factor ETFs makes implementation straightforward and transparent.

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There can be no assurance that performance will be enhanced or risk will be reduced for funds that seek to provide exposure to certain quantitative investment characteristics (“factors”). Exposure to such investment factors may detract from performance in some market environments, perhaps for extended periods. In such circumstances, a fund may seek to maintain exposure to the targeted investment factors and not adjust to target different factors, which could result in losses.

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