

# Growing Your Factor-Investing Toolbox

**Adam Bass** ([00:03](#)):

This is MSCI perspectives, your source for weekly research insights as investors respond to the COVID-19 pandemic. I'm your host Adam Bass and today is September 17th, 2020. This week, the idea of a growth factor premium isn't new, but it has been difficult to capture in its purest form. What does it take to build a growth factor portfolio and put it to work in today's markets? To find out, we spoke with Medhi Alighanbari, Executive Director on MSCI's Core Equity Research team. Medhi, thanks for being here.

**Medhi Alighanbari** ([00:43](#)):

Thanks for having me, Adam.

**Adam Bass** ([00:44](#)):

Obviously, no one is happy about the situation we find ourselves in today, but one great thing about being human is our ability to adapt. So what about you, Medhi? What's getting you and your family through?

**Medhi Alighanbari** ([01:01](#)):

It's been difficult, but I was actually thinking about this the other day and there has been some silver lining. I think one that I probably share with a lot of working parents with small children is that for the past six months, I got to spend quality time with my daughters and see them growing real time, which has been great. I also started playing tennis again, something that I've been thinking about for quite some time now, but my schedule didn't allow it.

**Adam Bass** ([01:31](#)):

Well, that's fantastic. Hopefully when all of this behind us, maybe we can have a match.

**Medhi Alighanbari** ([01:38](#)):

[inaudible 00:01:37].

**Adam Bass** ([01:39](#)):

So today we're talking factors, growth factors specifically. Let's go all the way back to the beginning, back to the basics. What is the growth factor and why are we talking about it today?

**Medhi Alighanbari** ([01:52](#)):

Sure. So growth is a style factor, like value, momentum, the science. As you know, if factor is a characteristic of a group of securities that can explain their risk return behavior of those group of securities. For example, smaller stocks behave differently than a larger stocks, so if you look at the risk return of stock, you can associate some of it to its size. Now in growth, we characterize the stocks based on some growth metrics, such as sales growth or earning growth and the idea is that some of the risk return characteristic of stock is explained by the growth score of that stock. Now, why you and I are talking about this today? I guess it's

because we finally launched an index to capture the growth factor premium. We had index on all other premium factors, the non-premium factors, but not on growth.

**Adam Bass** ([02:55](#)):

Okay. That's fair enough, Medhi, but why are growth factor index now?

**Medhi Alighanbari** ([03:02](#)):

Sure. So one thing that I should have start with is that growth factor premium has always been there. It's not like it just appeared over the past 5 or 10 years because of the good performance of a few cross technology companies. So it's been there for a while, and if you look at the performance of the growth factor in a factor model, you can see that the performance has been consistent and persistent over the past 20+ years and that is the growth premium that we are talking about. Now, for reasons that we can get into, if you want, growth factor premium is a slightly more difficult to capture when compared to all other factors, such as value and momentum, and it requires a more sophisticated methodology to capture it. Investors have become more comfortable with the idea of factor investing and also factor indexes and also using more sophisticated approaches to capture the factors. We feel that in this challenging market environment, investors need a complete toolbox to navigate the market and we're hoping that these growth target factor indices is another complementary tool in their toolbox.

**Adam Bass** ([04:17](#)):

When you talk growth, the classic split is growth versus value, right? Is that what we're talking about here? Is it the same idea?

**Medhi Alighanbari** ([04:27](#)):

It's actually quite different and growth is sometimes defined as the opposite of value and the traditional value growth in nexus divide the university into growth, versus value of stocks. But when you look at it in practice, growth investing is far from anti-value investing. Growth investors always have an eye on the valuation of the stocks and value investors also look at the growth of stocks. When we talk about growth premium, and what we're trying to capture in our growth factor indices is also very different from an anti-value definition of the growth.

**Adam Bass** ([05:05](#)):

Thank you for clearing that up. Now, moving on to the construction, we spoke with your colleague Abhishek Gupta a few weeks ago about building single factor portfolios generally, some best practices there. How does that work overlap with what we're talking about?

**Medhi Alighanbari** ([05:24](#)):

It's very related actually, Abhishek's recent research is answering a few very important question in the single factor index construction. And one of the questions that he's trying to answer is whether we should use the exact same methodology for all the different factors and the answer is a clear no. For example, for value is common practice and very sensible thing to do is to look at value within the sector and even create the sector, neutralize the factor index but if you do that for momentum, you weaken the factor quite significantly. So one size doesn't fit all. Now in growth because of the characteristic of the factor, we need even more sophisticated approach to capture its premium. And the rather simple approaches that we use for all these other factors fail to capture the growth premium in an efficient way.

**Adam Bass** ([06:25](#)):

What is it that makes growth so different?

**Medhi Alighanbari** ([06:28](#)):

Well, it's all about unintended exposures. Now when you create a factor index, the idea is to have the highest exposure as high as you can to the factor that you're targeting and have low exposure to all other procedural factors. Now for most factors, value, quality size momentum. When you use a simple rank and select approach, a simple heuristic approach, you end up with the index that does that. So you, so you end up with high exposure to the factor that you're targeting and low exposure, relatively low exposure, that is not damaging to your performance, to all these other factors. If you do the same thing for a growth, you indeed end up with high exposure to your target factor growth and if you look at the performance of such an index, you can see that growth factor is positively contributing to the returns. But you also end up with very consistent and quite significant exposure to a few other factors, such as value, quality, and volatility, and the performance of these factors and your high exposure will create a drag on the performance of the factor index.

**Adam Bass** ([07:51](#)):

So that's very clear what the problem is. What do you do about it? How did you go about capturing the growth factor premium?

**Medhi Alighanbari** ([07:59](#)):

We need to use optimization and also factor models to directly and explicitly control for these unintended factor exposures. Need the optimization or the optimizer in conjunction with the factor model allows us to directly and very explicitly maximize exposure to growth factor, but at the same time constraints to make sure that we don't end up with an index that is high in valuation, expensive, low quality or high volatility. It's a bit more sophisticated approach and more complex, but it's not something, a new approach. So this is the tools that we're using in a growth target factor analysis are the same as we use in our minimum volatility indexes, and some of our multifactor indexes.

**Adam Bass** ([08:55](#)):

Sounds a little bit like what we've talked about for years, growth at a reasonable price or GARP strategy.

**Medhi Alighanbari** ([09:05](#)):

Exactly. Exactly. You can think of it as an extension of GARP.

**Adam Bass** ([09:09](#)):

And when you look back at the performance of this index that you constructed in back tests, were you indeed able to strip out these other factors and focus it on growth?

**Medhi Alighanbari** ([09:21](#)):

Yeah, so exactly. So when you look at the historical performance of this growth index, you can see that you end up with an index that has high positive and significant exposure to the growth factor and that has provided positively to the return of the index. But the index is not expensive. Insultive devaluation is not very high and

the value is not a drag on the performance anymore. The same goes for quality and volatilities. It's the reasonable quality and the quality is no longer a drag and volatility is no longer a drag.

**Adam Bass (10:00):**

Well, thank you very much, Medhi. I appreciate your taking the time to come on and walk us through not only the importance of capturing the growth factor premium, but also the difficulties and how you went about capturing it. Thank you again for joining us.

**Medhi Alighanbari (10:18):**

My pleasure.

**Adam Bass (10:21):**

That's all for this week. Our thanks to Medhi, and to all of you for joining us. Be sure to tune in next time. It's climate week in New York, we'll be speaking about the intersection of climate change and investing across private assets, including real estate. Remember it takes just a moment to subscribe to the podcast, leave a comment or share with a friend. Until next week, I'm your host Adam Bass, and this is MSEI perspectives. Stay safe, everyone.

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