ETFs tracking new indexes that focus outside the traditional size and style boxes of yesteryear are becoming the fastest-growing products in the market. With products tracking everything from low-volatility stocks to “high quality,” it’s easy to understand how some advisors might be a bit overwhelmed. We sat down with Brett Hammond, Managing Director and Head of Index Applied Research at MSCI, to get the straight story on this new wave of factor-based indexes.

ETF.com: What’s all the buzz about factor investing? What is it, and why should advisors care?

Brett Hammond: Advisors and institutional investors alike have a long tradition of investing in two different ways: passive investing and active investing. Factor indexes represent a new, third way.

Factors are common characteristics shared by groups of stocks and explain part of their returns. Academic research has shown—and MSCI believes—that historically, six factors have experienced periods of outperformance: value, quality, momentum, low volatility, dividend yield and size. For decades, active investors have been using factors in their attempts to outperform the market.

The MSCI Factor Indexes take the low-cost approach associated with sticking close to an index, but capture some of the extra returns that used to be available only to active investors.

It’s a good combo.

ETF.com: So is factor indexing always better than traditional market-cap-weighted indexing?

Hammond: No. What we firmly believe at MSCI is that this is really just a third way of looking at investing. And remember: Factors are cyclical. There is no free lunch.

Factor indexes should not be viewed as replacements for market-capitalization-weighted indexes. Market-cap indexes remain the reference point for representing the entire opportunity set available to investors.

Traditionally, investors might have started with a large-cap domestic equity portfolio and then bolted on international exposure or maybe some sort of small-cap portfolio. What we finally realized is that, instead of bolting things on and running the risk of having gaps and overlaps in the portfolio, you need to start with the full global market-cap opportunity set. We call it ACWI [All Country World Index]. That’s an extraordinarily good starting point that encompasses all the opportunities that are out there.

What we’re saying is that there are some factors that have been shown over long periods of time to produce returns that are in excess of the benchmark or provide volatility that’s lower than the benchmark. That’s what factor investing taps into.

ETF.com: How do you take one of those factors—let’s say, quality or low volatility—and capture it in an index? What does that actually mean?

Hammond: Methodology matters a lot. Not all factor indexes are born equal. You need to combine sophisticated expertise in both indexing and investment analytics to produce reliable factor indexes.
Let's take the idea of “quality” as the example. Quality has to do with finding companies that have a higher quality than the average company in an index. So to construct a quality index, we’ll first start with a market-cap-weighted index that already exists, like the MSCI World or the MSCI USA.

Then we want to emphasize high-quality stocks. What do we mean by that? Well, stocks with earnings that don’t go up and down rapidly; stocks with low debt-to-equity measures. These are firms most equity analysts would look at and say, “This is a high-quality, well-run company.”

We’ll screen the companies in the parent index on those kinds of measures, so that we have a more concentrated, or tilted, index. We will impose certain constraints to make sure that the factor index retains the characteristics of the parent index and does not introduce unwanted biases. And then we will review that every six months, and rebalance back to the highest-quality portfolio.

Overall, it takes a lot of careful steps, high data quality and high-end investment expertise to produce factor indexes. This is why MSCI is the call of choice of institutional investors. For example, MSCI is the No. 1 index provider for low-volatility ETFs worldwide.

ETF.com: How does the resulting index look compared to a market-cap-weighted index?
Hammond: The quality index—and this is true of some of the others—has been shown to have significantly higher returns over long periods of time compared to the parent index. Quality is actually one of the more outstanding factors, from a risk-return perspective, over the long term.

Those last couple of words are important, though: These strategies aren’t making any guarantee of having better performance or lower risk all of the time. They may over long periods. But there are going to be lots of periods lasting one, two or even three years when they underperform the cap-weighted parent index.

Those two features—the potential for long-term outperformance, but periods of short-term underperformance—are very important for investors to understand.

ETF.com: How should advisors think about using factor indexes given the periods of underperformance?
Hammond: We think it’s very important to understand what these factor indexes do and how they perform over time. But what’s even more important is that there are potential benefits to combining factors. If you look at the six factors we track, the correlations among them are very low. Quality, value and minimum volatility all perform differently at different times, so their periods of underperformance haven’t historically coincided. They are impacted by different market and economic conditions, so their periods of outperformance don’t overlap either.

This is why we have created the MSCI Multi-Factor Indexes.

When you take the MSCI Quality Mix Index, which combines quality, value and minimum-volatility factors, you get a powerful multi-factor index that reduces the periods of underperformance but still has strong periods of outperformance. In fact, some have nicknamed this combination “Buffett’s Beta” after Warren Buffett, because it tracks the shape of his historical returns—and a lot of his stated investment principles—very well.

ETF.com: Is that how institutions are using this? Are they combining different factor strategies?
Hammond: Yes. One of the interesting things, when I’ve talked to RIAs, is they are often interested in knowing what institutional investors are doing. They’re asking, “How can I bring the best of institutional investing to my clients?” And we are indeed seeing institutions combining factor indexes and using them in portfolios.

It’s public knowledge the state of Arizona has done exactly that with a range of factor indexes that, together, lower the chance of underperforming and offer investors a smoother ride along the way.
ETF.com: One challenge investors face is that there are a lot of these factor indexes out there from different index providers. How should an investor evaluate the different products?

Hammond: Three things. Firstly, is it transparent? Can I understand what the index is doing? Secondly, is it investable? And thirdly, does it represent what you’re trying to invest in?

The best place to look for an index that meets these criteria is to start with a solid, cap-weighted parent index. You want one that has been around for a while and has all the latest methodological advances built into it: float-adjustment, buffer zones and so on. A good parent index will come with built-in solutions to the investability and breadth problems. It will already have screened out stocks that you can’t buy or sell. In our case, whether you start with the MSCI ACWI or MSCI World or MSCI USA, you know it accurately represents the market of investable stocks you’re interested in.

Then, when you apply a factor methodology to it like quality, you should understand the factors that are being used so there is no mystery. Do the factors make sense, and do they give you the exposure that you’re looking for?

Our methodologies are absolutely transparent and rules-based. You can see what’s going on, and that’s important.

ETF.com: If I’m an advisor and I’ve grown up in the size- and style-box world, but I’m interested in factors, how do I get started? How does this new world compare to a factor-driven world?

Hammond: Honestly, it’s not that different. Size and style are factors. So from a top-level view, people are already used to the concept. They’ve just been looking at the real world through a two-dimensional prism.

Style boxes typically break the world down into value, blend and growth. The value box represents one-third of the market; the blend box represents one-third of the market; and so on.

In reality, the market won’t be one-third, one-third and one-third. In some cases, we might be in a high-growth period where things that are usually defined as value become growthy. In a typical box system, they have to stay in the value box. But we simply take all the stocks in the index and just tilt towards the ones that are actually expressing that value factor.

ETF.com: There have been some concerns with heavy fund flows into some factor indexes, particularly low volatility. Can trades get crowded? Do observed factors lose their value?

Hammond: We don’t think so, at least not yet. Obviously if every investor in the world invested in a single factor index, it would, by definition, wipe out the effect. But we don’t think we’re there yet. The factor index market has grown tremendously, from $15 billion to $200 billion in the past three years. But the market as a whole is worth tens of trillions of dollars, so we are still talking about a very small part of invested assets.

We did a project last year for the sovereign wealth fund for Norway, which is a huge fund with almost $1 trillion in assets. They were worried that if they started investing in these factor indexes they could crowd the trades. So we asked, “What if you’re investing $100 billion or more in these areas?” What we found was that in many cases, the effects would be almost nondetectable in terms of liquidity, returns and volatility.

We’re a long way from having the trades be crowded.

ETF.com: Let’s take that question on a different angle. A lot of people come to this space and they’re looking at essentially backtested data returns. How should people use historical returns when they’re evaluating factor indexes and how they work in a portfolio?

Hammond: We all know that past returns are no prediction of future results. However, one of the best sources of knowledge about factor index performance is: What did they look like in the past? As we look
at historical returns, we have to ask, “What is the difference between a factor index and a market-cap index in terms of either volatility or returns? And did they move together or separately?” So backtests are an important element to consider, even if they are not the only one. You also want to consider the factor that you’re tapping into. Is this a factor that we think could persist over long periods of time?

Most of these factors have been discovered by academics in the past, and they have grounded these factors in terms of true anomalies that don’t necessarily go away. But you do have to monitor it and be aware of it.

ETF.com: What explains some of these factors? Why should, say, low volatility lead to higher long-term returns?

Hammond: The empirical evidence is that a minimum-volatility index both delivers an expected lower-volatility pattern of returns when compared with a cap-weighted parent index, while also generating returns that are at least on par over the long haul. They’re not going to always outperform market cap, but they’re going to provide similar returns at lower volatility.

Why would that exist? Why wouldn’t the market arbitrage that away? The academic evidence seems to suggest a couple of things. One is that there are some periods of time when there are lower returns, and many investors don’t want to put up with that.

No. 2, there is a belief or view that investors kind of like visible stocks; sexy stocks. And what are sexy stocks? They’re stocks that go up a lot. But they’re also stocks that go down a lot, too. So they tend to be more volatile. Therefore, investors undervalue stocks that are steady, and that’s the minimum-volatility kind of stock. That’s the theory behind it.

ETF.com: Let’s talk about the other factors. How do investors choose between, say, quality and momentum? It seems like everyone would love quality, right?

Hammond: Not necessarily. Remember, the factors are not well correlated.

Momentum is the most unusual case of all six because it shifts so quickly. But momentum in combination with something else might work, or a more dynamic portfolio that tells you when to go in and out of momentum might work.

The other factors are more valid as long-term holdings, but they all have different purposes. Minimum volatility is something that you want to use if you’re trying to control the volatility of your portfolio. Many of the others, like quality and value, will outperform at different points in the economic cycle. But it’s really the combination that is the most valuable. The MSCI Quality Mix Index that I mentioned earlier and that some call the “Buffett’s beta” index is an equal-weighted, regularly rebalanced combination of quality, value and minimum volatility. It just so happens that when we put these together you track Warren Buffett’s returns quite well over a long period of time.

He gets credit for being a value investor, but when you actually look at what kind of companies he buys, they are companies that are a good value, have low price-to-book ratios, steady earnings, and so on. It’s the same things that drive the different factor models. He’s really a quality mix investor.

ETF.com: If the MSCI Quality Mix Index tracks the performance of the best active manager ever, what’s left for active?

Hammond: First, some active managers do market timing with individual stocks. The MSCI Quality Mix Index doesn’t do that.

Second, we don’t lever up, while some active managers lever up something like 1.6x.

In a recent study we did on active investors, we found that, on average, a significant portion of the alpha that they add can be explained by our factor indexes. You can invest in our factor indexes at much lower cost and then get that alpha.

However, there are a set of active managers that are providing alpha on top of what our factor indexes can get. There is still value in active management. You don’t want to buy a closet factor indexer. You want to buy somebody who isn’t being a factor indexer, who’s doing a great job of stock selection or rotation or another approach that’s compatible with the factor investing approach.

Active managers can use MSCI factor indexes to benchmark their own active factor strategies. Further, they can use MSCI multi-factor indexes to implement their own active use in a more effective manner.

ETF.com: So if there’s one point you want investors to take away from this interview about factor investing, what would it be?

Hammond: I think it’s that we’re in the middle of a major evolution. Investors can now get access to returns that used to be only accessible through active management. Today, thanks to the MSCI Factor Indexes and the ETFs tracking them, these returns are available to all investors and their advisors. The first revolution was indexing; now, we are allowing clients to replicate the performance of some active managers, but in a passive way.