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TRANSCRIPT

2021 Factor Investing Mid-Year Review Part II: The Value Trade and Implications for Investors

Featuring:

Paul Riccardella, Head of Wealth Advisory Americas, MSCI
Dana D'Auria, Co-Chief Investment Officer, Envestnet
Don Calcagni, CIO, Mercer Advisors
Bryn Talkington, Managing Partner, Requisite Capital Management
Bob Hum, U.S. head of factor ETFs, iShares

Paul Riccardella:

Thank you, Jenna. And thank you too Reyna and Andrew for providing some research detail to help frame today's discussion. With the halfway point in 2021, there'd been a lot of developments and factors and a significant rotation in performance leadership since we last did a panel like this at the end of last year. And I'm excited today to be joined by a group of well-known factor practitioners to help us understand these recent developments and their future implications.

And so let me start by adding a bit more detail on the backgrounds of our panelists. My name is Paul Riccardella, I'll be moderating today's panel. And as the head of MSCI Wealth Advisory Team in the Americas, I oversee a group of people tasked with working with professional investors in index tracking products. Helping these investors understand the construction of MSCI Factor Indexes is a significant part of our responsibility.

Our first panelist is Dana D'Auria, who became the Co-Chief Investment Officer of Envestnet in September of last year. In that capacity she plays a key role in Envesnet's research, overlay, and portfolio management functions. Before Envestnet Dana was with Symmetry Partners for 15 years, where she took on progressively more responsibility and was ultimately president of the Symmetry Panoramic Mutual Funds, which were a multi-factor suite of funds. Dana has published articles on factor investing in the Journal of Financial Planning and The Journal of Index Investing.

Our second panelist, Don Calcagni, is the CIO of Mercer Advisors, in which his role is setting the strategic direction of the firm's investment platform as well as overseeing all investment related communications. Don chairs Mercer Advisors Investment Committee, and he

oversees the manager of research and portfolio construction efforts. As a renowned thought leader and industry commentator, Don is regularly interviewed by the news media and financial press on a variety of economic and market related matters.

Bryn Talkington, our third panelist is a Managing Partner of Requisite Capital Management, which is an RIA firm based in Dallas that she co-founded with her partner, Doug John. Bryn has more than 25 years of experience in financial services, much of which was spent at UBS Asset Management. Her areas of expertise include all facets of asset management with a focus on capital markets, alternatives and investor behavior. Bryn has spent the vast majority of her career working with private clients, foundations and endowments. And if you recognize Bryn, it's most likely because you've seen her on CNBC where she's a regular contributor.

And last but not least, we're thrilled to have Bob Hum from BlackRock with us. Bob has taken on progressively more responsibility in his five years at iShares. He's currently the U.S. head of factor ETFs at iShares where he leads a team of strategists who are subject matter experts on factor investing. Bob's responsibilities include setting the overall product strategy within the U.S. for factor ETFS as well as engaging directly with clients to share BlackRock factor analytics, thought leadership and content. Prior to BlackRock, Bob was with Ladenburg Thalmann where he oversaw ETF due diligence with their global multi-asset portfolios.

Thank you all for joining us and very much look forward to today's discussion. And I'd like to start with the topic that seems to be on everyone's mind these days, and Dana, if it's all right, I'd love to start with you. I know both in your current role and your previous one with Symmetry, you've been a big believer in value investing. And we've seen a pretty dramatic rotation to value, which began last November. This followed a decade plus of incredibly challenging value performance, where some investors had begun to lose faith in the factor. And I'm just wondering, did your confidence in value ever waiver and how are you feeling about value staying power?

Dana D’Auria:

Well, thank you. And thanks for having me on the call today. I will say numb, my belief in value as a factor certainly didn't waiver for several reasons. But I think I will be remiss not to say that we certainly learned a lesson in terms of just how bad the chasm can get between value and growth, and what that means for the retail investor. It's one thing to say that low price will out in the end, right? And I remain a firm believer in that. When you think about value as a style factor, really you're investing in low price, which goes beyond style factor considerations and really two fundamental tenants of it. I think of investment, which is that higher expected return follows from lower price generally speaking.

And so to say that my faith might've wavered in the factor, no, certainly I think and especially too as we saw in much of the case in the last 10 years, it was really multiples getting higher and higher for growth stocks. It didn't fundamentally challenge in a lot of ways the premise behind value. But I think an important takeaway for those of us who were investing money for

retail investors is, how do we balance with other factors to make the experience livable, right? If I have 10 years of under performance of value and I get to a point where it's extremely painful, how much of a value tilt should the retail investor take regardless of whether in the long run we still believe for sure it's going to pay off?

I think there were definitely lessons learned from that period about how well you need to diversify these factors. But belief in the factor itself I think it's cyclical, it's always been cyclical. The last 10 years it was tough, but it didn't fundamentally change the dynamic from my perspective.

Paul Riccardella:

Don, I'd love to get your perspective on that same question. I know that Mercer Advisors is a very significant owner of value assets. And I'm just curious from your vantage point if you feel that reports of values demise prior to this recent resurgence were perhaps a bit premature.

Don Calcagni:

Absolutely Paul. I would argue that value's death has been predicted many, many times throughout the past 78 or 80 years ever since Don Graham wrote about it in their classical book Security Analysis. Our face in the value of premium never wavered. In fact, when you actually look at value of returns over the past 10 years or so, what's actually more interesting is that growth returns relative to value have really been quite anomalous, right? The real question was over the past decade why has growth so significantly outperformed? If we actually look at the returns on value as an asset class, it was very much in line with its longer term returns ever since the 1970s and eighties. There was really nothing unusual about values returns. What was unusual was what was really happening with respect to growth equities over the past decade.

But I do want to echo Dana's point, the real lesson I think for wealth managers is, how do we manage a retail investor expectations? How do we build portfolios that they can understand, that they can get behind, that they can hold on to through thick and thin? Minimizing tracking error and making sure that they genuinely understand as much as we can what exactly they own in their portfolio. Again, our faith in the value of premium never wavered, but it was a challenging time with respect to coaching retail investors through a very difficult period for the value of premium.

Paul Riccardella:

Excellent. Thank you, Don. And so, Bryn, I'd love to go to you next here. If you think about the first half of 2021, there were many different forecasts for the reopening of the U.S. economy and what implications that would have in terms of factor leadership. I'm wondering if you feel it's played out as expected or if there have been a lot of surprises.

Bryn Talkington:

Well, I think looking back the past year and a half, but 2020 specifically, I think everything surprised me as an investor. I always start with being a humble investor and I don't think any of us were going into 2020 with even a remote sense about what was about to be upon us. And so I would say everything was surprising about 2020. But to me when I reflect on it, what's been such a good lesson, and Don hit on it about talking about managing expectations is that we saw a close to a 35% peak-to-trough decline from February to March as we were all coming to the realization of this pandemic yet the S&P ended the year of 18%.

And so to me in terms of a really good note for investors to remind themselves about the importance of staying in the event, even when these massive exogenous events occur, is how quickly the market recovered largely due to the Fed's quick action. I will say it was also to me so fascinating how the S&P was up 18 while you saw growth largely was up around over 30%, and momentum which had a lot of growth inside of it was also up close to 30% while value was up one. And so I think this year is a little bit of mean reversion which is normal in life. But I think when it comes to back to managing expectations, what we try to do is educate our clients about how volatility is delivered, and volatility is evergreen and last year was more extreme.

And I think the factors played out as you would think. Momentum had a lot of the growth of your names, big tech, some of the names like Tesla, and that's where once again, the market wanted to go to and that outperformed, while the, we'll say reopening names, which were more value biased, were left for dead. And that has mean reverted as in November when Pfizer came out with that first drug, everything changed. And so from that perspective, I still think you have that push and pull of everyone's... The market's a little bit manic right now, but I think the factors played out in hindsight as you would have expected them to.

Paul Riccardella:

Excellent. Don, I'm just curious, coming back to you here, what's been the biggest surprise for you in the first half of 2021 forecast versus lived reality?

Don Calcagni:

Paul, you're right in that beginning of November we saw a rotation into value, Paul. I think when all of the new inflation data came out towards the end of April early night, I would have expected value to continue to outperform growth over the past say two months. Whereas in reality we haven't seen that, we've actually seen growth now outperform value really since the beginning of May. I think that's been a big shocker. As well as the decline in the yield on the 10 year treasury, I would not have expected us to go from 174 to around 145 on the 10 year given 5% year over here headline inflation. I would argue those are probably the two biggest takeaways for me. To really echo what Bryn said, is to really bring to the market a very healthy dose of humility when it comes to building client portfolios and always keep your expectations in check.

Paul Riccardella:

Excellent. Thank you, Don. And so, Bob, I think this is probably a great time to bring you into the conversation here. Clearly the pace of reopening has not been the same across the globe. It's been slower outside of the U.S. And I'm just wondering if you can share BlackRock's views on international factors, given this disconnect in vaccination rates and reopenings globally.

Bob Hum:

Yeah. Absolutely, Paul. And so I think when thinking about the value rally that we saw, to bring in Don's point, really after the vaccine news on November 9th, that we would deem Pfizer day, really it has taken hold across the board, right? If you look within the U.S. the value factors outperformed the market by nearly 15%, not surprising, right? If you think about the dynamics of what's inside of value portfolio, you have a lot of airlines, potentially hotels. Those are the types of security that really outpaced given the market was starting to reopen, right? And there was a light at the end of the tunnel. Personally I'm actually about to go on my first vacation in almost a year. It's incredible. And then what hasn't done well are some of the work from home stocks that we saw do so well like last year, right? The Zooms of the world, Netflix that were... Zoom was up over 500% prior to the vaccine news on November 9th.

And so what we've seen in the U.S. hasn't fully been played out within international to your point, right? On the international side you've seen outperformance of the international value by about 9% relative to that 14% for the U.S. And I think it's to exactly what you're saying is that they're a little bit further behind on vaccinations, right? If you look at vaccine rates in the U.S., you're looking at over 50%. But if you look at international, X maybe the UK, there are some numbers that are really staggering.

If you look at Japan about 15% vaccination or one dose for their population of 15%. And so for us, we do think international value is still earlier in that stage, last year was the second worst year in 100 years for value on the international side. So we do think again, a lot of room to run potentially for that international value trade given where they are in their vaccination rates, and then also activity rates, which are looking at about 15 to 20% worse than pre-COVID rates depending on the region.

Paul Riccardella:

Excellent. Thank you, Bob. Bryn, I guess I'd love to hear from you on this, any thoughts you can offer on what you're telling Requisite Capital Management clients on international factor considerations these days?

Bryn Talkington:

Yeah. Well, I have a little bit of a different view involved. We're an asset allocator, we don't have any current direct or explicit international performance right now. And I think it's interesting if you look back just from May 31st, the MSCI USA versus the MSCI EAFE. The MSCI USA has outperformed the MSCI EAFE by 225, outperformed by 225% over the last 13 years. The outperformance has been so large. And I think that you have more structural issues at play, which for our investors to me are really important. And so first of all, if you look

at the makeup of the S&P, and so what I mean by structural differences, currently technology is 26% of the S&P. Which we all know those technology names are made up of the Apple, Facebook, Amazon, Google, et cetera.

Well, in Europe, if you look at the Europe technology, you only have 8% in tech. In Japan you have 13. And then when you actually dive beneath that and say, "Well, what technology do you have?" Well, they have old 1990s tech. They have SAP, they have Ericsson, they have Nokia, they have Fujitsu. And so those are companies that may have cashflow but they haven't done anything innovative in 20 years. And so I think you have the structural disconnect with, we'll say, there's not a Silicon Valley per se, in Europe or Japan that's been able to grow these big now trillion dollar companies.

And then on top of that you have currency. And we really think about our investors are in the U.S. And I would say it's a big factor that is very hard to predict. And if you look at the last time international really outperformed the U.S. it was that 2003, 2006 or 2007 timeframe. And what was the key ingredient why did that happen when you had this massive rally in the Euro? And if you look at 2003 specifically, half of the return came from currency. And so we look to go invest internationally, we think there are some structural headwinds that will continue to cause multiple outings relative to the U.S. to international.

That being said, if we did to Bob's point, which I agree with, if you started to get a structural shift in value that lasts more than seven months, international and currency was, let's say neutral. Internationally absolutely has the ingredients to outperform, especially if big tech takes a back seat to more of the cyclicals and the value. That being said, I think it's been such huge under-performance the last 13 years. To make a big call or a big pivot, I think would be somewhat of a guess to do, to think when is that actually going to change?

Paul Riccardella:

And that's a really interesting point you make about international equities, just being more value centric in general than in the U.S., they're less faggy for lack of a better term and have better characteristics, makes perfect sense to me. And I guess next I wanted to get into implementation. And so for our audience, I'm wondering, starting with Dana, if we can just discuss how much factor tilting your firms do in the portfolio. And if you can explicitly give us a framework about how you think about tactical flexibility in terms of, if you like value right now, how much can you overweight it versus underweight it? Those sorts of things.

Dana D'Auria:

Yeah. Put your answers. I would say high level Envestnet PMC produces asset class portfolios every year. And they actually come out of our quantitative research group and we don't employ tilts towards value or growth in those portfolios. High level starting point is really neutral between value and growth. And that's in spite of the fact that I'm a co-CIO and investment. My co-CIO, Brandon Thomas and I are very much on the same page in terms of belief in style factor investing value in particular. We have quantitative portfolios which are

SMEs that we produce that do employ value tilts. And we certainly have models that look to style or factors, but at a high level in terms of just how we set our asset class portfolio standards, there really is no tilt.

Now, when you talk about tactical movements into value, I think that it's one of those things Paul, where everybody wants it to work. And there's a lot of demand for it because if you look at the research ACO style factors out perform over time, but geez, you've got these long periods and very painful periods where they underperform. Can we bring to bear some of the information that we have in the market? And the problem with that is the evidence around the efficacy of that is pretty poor. And first of all what types of measurements would we bring into to be tactical while we might look at valuations, right? Say, okay, well, how spread is the difference between growth and value from say a price to book perspective.

There's a little bit of evidence that has some value, but of course if you're employing that, you're kind of employing value on value. If you already have a value tilt to begin with, if you're a believer in long-term value investing, then you're just adding to that bet on price to book. Now, if you're not a believer and you're not already tilted, that may be a metric that you would look at. You may say, geez. I don't typically go there, but there is such a wide divergence now in multiples that I think it's time to rotate into value.

The one caution I would give on that of course is, that's where everybody was at the end of 2019, right? If you remember, we were in 90 plus percentiles of the difference between value and growth. And to Bryn's earlier point about the surprise that 2020 brought us, this is markets, this why idiosyncratic risks just swamps the signal in so many of these efforts to time. And you couldn't have had a better example than what happened last year. If you're going to be tactical based on valuations, you absolutely would have rotated into value at the end of 2019 and you would have had quite the comeuppance, right? In terms of your tactical capabilities. With that havior, and unfortunately that's probably the best evidence we have, is that valuation multiples.

Some of the other things people use, where are you in the economic cycle? Certainly on a backward looking basis we can say that value does better in recoveries. And we can say, okay, we're trying to figure out where we are in the cycle. But as we all know, stocks are a leading indicator. Getting in front of that and investing tactically on that is difficult dispersion, momentum of factors or other things that are out there. I would say to you that all of these things have some amount of signal to them, but the noise just swamps the signal. And so we end up in a place where we don't do a lot of tactical maneuvering with these factors. I will say though that it behooves you to watch. And I'll make one plug in terms of if you're running a factor strategy and you're blotching this different matrix, one area where you might want to pay attention is, are you trending away from your desired exposures?

If you have a goal to be exposed to value and exposed to momentum or quality or whatever it is, because of the correlation structure among these factors changes so much in the short-term, you may find that because of the way one factor, another other is trending. You're losing

exposure to some of the other factors because it's trending more negatively on correlation. As an asset allocator, you need to be aware of that.

And if you are seeing multiples moving in a certain direction and you're losing some of your exposure to a factor that's looking increasingly positive, I think you would maybe want to react to that. You maybe want to at least say, just as you would rebalance when you're moving away from your equity to fixed income exposure, you would want to rebalance the factors. It is a little bit like moving the Tychonic because these things, they interact with each other, but you certainly wouldn't want to be in a position where you say, "Hey, we will benefit by low price and find that while you trended away from that in terms of what you're actually implementing.

Paul Riccardella:

Really interesting point on the the short term correlation changes amongst factors. And Don, I guess I'm wondering, do you see it the same way as Dana in terms of the fruitfulness of being highly tactical? And then can you tell us about the structural factor exposures that you have in your portfolios?

Don Calcagni:

Sure Paul, I would agree. I'm largely aligned with where Dana is out on this week. We avoid trying to be very tactical. Many of our clients are taxable investors. And to Dana's point on the time varying nature of factor correlations, I think is a big issue. I think there's a lot of noise in the data. I wish in the worst way that we could time up factors that we could predict when value is going to outperform momentum more or vice versa. But I have not seen any real robust peer reviewed evidence that would lead us to that conclusion. And so when we consider that taxes are persistent or pervasive, and that's a known factor, for that reason we shy away from being really tactical within the factor part of our portfolio. We take a core and satellite approach to implementing our portfolio.

We have a market component and then we have a factor component. We're presently taking equal weights between those. And that's because we have an expected tracking error constraint that we are maximum. I should say that we're looking to adhere to within our portfolios. To Bryn's point, we're not entirely out of non U.S. equities, but we are overweight U.S. equities for many of the reasons I think that she cited. When it comes to the factor part of our portfolio, we take equal weights across value, momentum, and quality. Our investment committee is constantly debating whether or not we should be more tactical.

To Dana's point, in late 2019, we had a very robust discussion about going much, much heavier into value. We ultimately had shied away from that. And thankfully we did. But that's always an ongoing evergreen conversation. I think for factor investors like Mercer Advisors and like many of the folks on the call here, we're always looking for ways to build the time factors. I have not seen the evidence that would lead us to that conclusion.

Paul Riccardella:

Bryn, Bob, I'm just curious, is this a consensus view on the panel or does someone want to take the other side of this?

Bryn Talkington:

I'll start. We're all different firms, right? I don't necessarily think it's non-consensus or consensus, we have full discretion. My partner, Doug and I run a firm and so we have full discretion and aren't looking to stay within a tracking error or non tracking error. We'll have to take a step back and say, what risks do we have in our portfolio? I look at our moderate portfolio, which to give some context would be 87% equities and 13% fixed income. And if I break that down, right now it's 40% margin cap weighted, which I guess technically is a factor, right? It's 40% margin cap weighted. It's 40% factor, whether it's mean vol, momentum, small cap value that's focused on high quality. And then we have 20% active, with active ETFs that are doing what we hired them to do. And really what we focus on...

I think what Don said, we're so similar is, our clients are very sensitive to taxes. And I think what's been great is something like a momentum had... I don't know, I know one at least, maybe two, I just can't remember, in February and March of 2020, those ad hoc rebalances. And then the May and November rebalances, a momentum is doing the heavy lifting for us in terms of rotating. And what's great about that is since... Just to use that as an example because we own it is since 2013, my MTUM hasn't had a capital gain to distribution. It doesn't mean it can't have one. They had huge turnover in May of this year of close to 70%, but our clients are very tax sensitive as all taxable clients are. And I think it's just a really good example of sitting back and sitting still and letting them do their work.

This year a momentum is underperforming pretty much everything. I think just some of it because of the randomness of the May rebalance happened in May. But that will work itself out and it's not a taxable event typically, and historically hasn't been a taxable event versus if we went and said, "We're going to shift momentum down to go somewhere else." I know emphatically that would be a taxable event for our clients. I think these factor strategies inside of an ETF are very clever. And that's why you continue to see a movement out of mutual funds into ETF because the vehicles just so much more efficient.

Bob Hum:

Yeah. And Paul, I'll take not fully the other side, but I do think when looking at our investors, I think there's clearly investors that are being tactical now. When thinking about tactical, I'm not saying that they're trading this on a daily basis or anything like that, but I do think they are looking at trends within the factors and expressing those views, right? Just as an example, this year has been a record year for factory ETFs for value, right? And the flows that we saw in Q1, I think clearly people are trying to play that reopening. And just in for example, VLUE took a nearly $5 billion year to date.

And in other years when things are getting maybe a little bit frothy and markets are a little volatile, we see significant flows into quality or minimum volatility. Most importantly, and for most investors, I think the way that we see people invest is more strategically, right? And so diversifying factors across the board because we know that they are cyclical, and the easiest way to reduce that cyclicality is diversification.

And so thinking about, if you're a value investor, maybe things like quality, momentum, minimum volatility offer that low to negative correlation to value. And it's also been rewarded, so why not diversify? And so I would say we are seeing some people tactically express views within factors, but I think for the most part most of us tend to be more strategic because they know that there is a risk premium here for the factors and wanting to own it and making sure that you don't fall into some of the behavioral biases that are the reasons why these factors persist over the longterm.

Paul Riccardella:

Got it. Bryn brought up a point that I definitely wanted to get into in terms of some current events. Clearly there was a major index rebalance for MSCI indexes at the end of May, and it impacted momentum in a significant way. Turnover was elevated for this particular semi-annual rebalance. It increased its holdings in sectors that have historically considered value sectors. And I'm just wondering, starting with you Bryn, has this change in the profile of the momentum ETF in any way changed how you use it in the portfolio?

Bryn Talkington:

No, I'll just start there. You could just know that because obviously it's focused on six and 12 months price momentum. And so just intuitively even before the rebalance, you knew a lot of tech was going to come out and industrials and financials are going to come in. And so our portfolio actually had been very underweight those sectors. And so as that reflation has occurred, we were excited actually to have more of that exposure because we have been underway that. And once again, we don't on international, which is also value. And so for us, we were ready for it.

And I think that what's so great about it is, in 2019, I think Procter & Gamble was the top holding in MTUM. Last year it was on Apple, Microsoft and Tesla. And then, nursing is more of a Berkshire Hathaway, JP Morgan with a PayPal and a Tesla still stayed in there. We definitely didn't change. We're going to let the process work. And I think that once again, if value continues to have legs more than seven months, momentum will continue to do well. And if it doesn't momentum of those names will come out and you'll read other names. We are big believers in letting that engine do its work and just sitting still.

Paul Riccardella:

Don, how about from your vantage point? Any difference of opinion on the use of momentum given its profile over time or are you in line with Bryn here?

Don Calcagni:

Yeah. We're very much in line with Bryn. In fact, our investment committee just had this debate ad nauseam. And if you really think about it, where we landed was, look, if you're going to somehow unwind what the momentum factor is trying to do for your portfolio, then why you own it in the first place, right? We've had similar discussions around value, right? Value has become relatively more growthy than it has in the past. Well, what are we going to do? Are we going to unwind our value tilts in our portfolio? To do something different, to dial back on MTUM would be really just to unwind the factor tilt that you were offensively seeking to target in the portfolio. Our view is let momentum do what it's designed to do. Like Bryn said a few moments ago, ETFs are very tax efficient vehicles so it makes a ton of sense to let the manager do their job within that ETF vehicle. And try not to try not to overthink it.

Now we do strategically rebalance across the portfolio. When value became overweight relative to the other factor tilts in the portfolio, certainly there's a rebalancing exercise we go through. But over and above that strategic rebalancing exercise, our view is you should not seek to unwind the value tilt or the momentum tilts that you have in the portfolio.

Paul Riccardella:

Perfect. Then the next thing I wanted to get into was referenced by both Dana and Bob earlier in their comments about correlation as well as factor pairing. And I guess starting with you Dana, I was wondering if you can just share your views on which factors are most likely to compliment value in a multi-factor portfolio both in the short term, to your point about the moving of correlations over time, as well as in the long-term strategically?

Dana D'Auria:

I think the answer is pretty much the same for both. Even though the correlation structure definitely moves in the short run you're going to I think when you put, say momentum for example, is the big one that's well known to pair well with value, right? Whether it's short run or long run, it's still probably your best bet. Momentum, I would say quality as well, has some efficacy, has a compliment to value in terms of just offsetting. They do tend to do better at different periods in the cycle, momentum in particular. There's an argument that momentum stocks become value stocks over time, so they offset, right? You have this movement short run return time and then overtime the market kind of corrects and you end up in value territory. So absolutely.

And when we look historically too at returns and periods, worst drawdowns for value periods when growth really outperformed value, oftentimes you do see that momentum can add some balance to the equity part of that portfolio by that addition. Certainly if you're combining and to piggyback on comments on the momentum index that were made just a few minutes ago, there are reversals in momentum. Momentum can be kind of whipsaw and right, because you can have a sudden reversal and really get caught. That's on the other hand, the beauty of having value mixed there with momentum.

I think you're going to probably get a lot of impetus from this group behind having a multifactor stance precisely for these reasons, right? Because you don't want to jump out of momentum when momentum is doing what it's supposed to be doing, right? It's rotating. But at the same time, if you were very concentrated there, that's a volatile ride for the client. Having value and momentum working together in the portfolio has really demonstrated to be a nice pairing. I'd say to a lot of it is... And this gets into your asset allocation technique, but how much exposure are you able to get to these factors at the same time? Right?

When you have two factors that are negatively correlated, you've got some decisions to make around. First of all, what types of stocks? Do I want to measure each stock by it's factor exposure? I'm getting sort of C minus to B plus players for all the factors, or do I want the best value players sitting next to you the best momentum players? How you build out that security selection is going to make a big difference in terms of how you're going to fair by complimenting these factors. In a lot of cases, right? What's driving that value factor return is probably a sector and industry, right? We're seeing energy, financials, industrials. How you build the portfolio of the value stocks that are in that portfolio can make a difference. But certainly momentum, quality as well.

I would say that to a certain extent, there is a place for a minimum variance in this as well. We've seen that you can certainly reduce exposure to your volatility risk, right? We do standard deviation without necessarily a commensurate loss in return there. But one caution I'd offer on that is that it's easy to lower your beta when you do a factor strategy. If you want full beta and you add something like minimum volatility, you may need to think in terms of whether there's a ratchet back up or how you're approaching it if you're saying, I'm getting the exposure via the factors. But certainly those are all complimentary factors I would say to value.

Paul Riccardella:

Thank you. Bob, how about from you, any BlackRock news on how to combine factors?

Bob Hum:

Yeah. I think Dana really hit it on the head. I think the three most diversifying factors to a value portfolio tends to be quality, momentum and there's minimum volatility. I think the one thing that's really interesting though is that oftentimes when we're meeting with factor investors they think or they tend to be paired most with value and small caps or value and small size. And if you look at the research and what we've seen historically, value and size have actually been the most correlated factors historically, about a 0.61 over the last 20 years on an excess return basis. And so oftentimes you may think that you're diversified because you're owning value in small caps, but really they actually tend to perform well at the same times, right? Coming out of recovery or coming into a recovery, kind of like what we've seen since the end of March of last year.

And so just to put some numbers behind it, because I do think again, diversification is king here. If you look at a value in size portfolio over the last 20 years on a rolling three year basis, it's outperformed about 70% of the time. If you look at a five factor portfolio, inkling value, quality, momentum, size, and minimum volatility, you've seen that probability of success increase to over 90%. And so for us, again, if you think all of these factors have been roared over the longterm and they add diversification benefits to each other, we do think it makes sense to implement them in a multi-factor approach.

Paul Riccardella:

Thank you. I wanted to pick up on another thread that Dana alluded to in her comments. And that has to do with how you access the factor in an ETF construct, ultimately how the index is built. And I guess starting with you, Don, I was just wondering if you can explain your firms due diligence products, specific to factor products and selfishly, I just have to ask how much does the index matter in that due diligence process?

Don Calcagni:

Well, it does matter, because at the end of the day we need to be able to measure how well a manager is doing. And when we use indexes at Mercer Advisors, we use multiple indexes depending on what questions we're trying to answer, right? If we're doing a factor regression and we're trying to understand how well a given manager or vehicle has done, for example, harvesting the value premium, really getting under the hood and really trying to understand, well, how does that particular index define value? How do they construct the portfolio? Obviously you could take something that's looking at forward earnings and comparing that to a manager who focuses on price to book, you're going to get some noise in your data.

Really a foundational tenant of our due diligence process is multi-factor regression both over time, but then through time. So we'll do rolling regressions and look at the volatility of the factor exposures over time. We're doing our best to really get under the hood and understand what consistent exposures or is the manager giving us access in the vehicle? And I think at a real high level begins first and foremost, by working with managers who share our investment philosophy. Well, we don't want to have as a manager who accidentally tripped and fell into the factor. We want to work with managers much like BlackRock, that share our approach to factor based investing. That way we know that we're getting factor exposure on purpose and not by accident. I would say regression modeling, factor definition, proper benchmarking, and then of course working with managers who share our particular view of the world with respect to investment philosophy.

Paul Riccardella:

And so Bryn, I guess I'd love to hear from you on this topic, both the due diligence process at Requisite Capital Management and the index mattering. And do you use historic index performance to splice the track records and do a more rigorous analysis?

Bryn Talkington:

Thanks first. It starts and ends for us actually at the index methodology, because we ask ourselves, what are we trying to solve for? Right? And so the methodology is the most important thing because we want to see, is it solving for what we needed to solve for? Then we'll look to say who's the provider? Is it BlackRock? Is it Invesco? Is it Global X? What have you. We started at the foundation of that methodology, then move to the provider. And obviously firms like, especially BlackRock... BlackRock specifically, are just like the 80-pound gorilla, but have a huge think tank where they work together with an MSCI to actually create really interesting portfolios.

And so we want to start find what we're trying to solve for. But where I have a real issue is with some of the, we'll say methodology makers is for example, S&P. Everyone owns the S&P 500. I get it. You need to own it. But it's like, I'm not a big fan of just cutting that in half and saying everything on the left is value and everything on the right is growth. And then if a client asks me, "Well, why did Tesla get put into the S&P 500?" I'm like, "I have no idea." Because they don't tell you. They just put these names randomly in there whether it's political pressure or whether it's because they have cashflow or not cashflow. And so I have a bias really against those types of methodologies where you don't know who's making the decisions, and me as a fiduciary can't understand their methodology. And so we definitely have a bias for the firms that provide that transparency.

And I will say, there's a great quote or a great phrase in investments in the stock market, that money goes where it's been best treated. And I will say MSCI as a company has always been known as an innovator and a think tank is that on a five-year basis, I think the stocks up like 600% on a ten-year basis, close to 1300%. So multiples higher than the S&P. And so I think once again, that money goes where it's been best treated. We are really excited to be working with good index methodology makers that continue to scour to find interesting ideas that we can potentially vet and allocate too.

Paul Riccardella:

Dana, anything from you on this topic. Any ground you feel hasn't been covered yet?

Dana D'Auria:

I think I would agree with pretty much everything that's been said on this. And I guess if I was going to add anything, it would be when you're thinking about what you are trying to achieve with the index that you're picking. And this may lead to I think where we're going with this conversation to a certain extent, but what is the client going to see? And what are they going to understand? You have that choice between for example, great multi-factor strategies where it might be sort of opaque to the client, what exactly is going on in there? It's got value, it's got momentum, it's got quality. But what drove what in terms of the return, it's very hard to tease that out. If the client needs to be able to understand attribution and to be able to say, okay, I understand we're in a value market and I got this valuable thing it's doing well, momentum's maybe not doing as well. But it had its time. It was carrying the portfolio last year.

Being able to have those narratives can actually sometimes drive better client discipline. When you're looking at indexes, I think absolutely you're looking for a robust provider like an MSCI. You're looking for a good methodology. A lot of times you cannot do as great of a job for example, in the factor space, say in international on an output basis, because you've got all these countries mix. It's difficult with regressions and even holding space analysis to really put a finger point on exactly what those exposures are. But if you understand the input methodology, you can get to comfortability complemented by these other, again, regression, et cetera. Certainly working with robust provider with some academic imprimatur behind them is comforting and understanding the transparency. But then also saying where is the client going to be able to sit in? How are they going to be able to stay disciplined in this?

Paul Riccardella:

Dana's comments make a really nice segue where I wanted to go with the final major topic here, and that's client discussions. Clearly, factors can be a complicated topic if you listen to some of the lingo on the panel and the concepts we're discussing. But it doesn't necessarily need to be. And for the average end client, and I guess starting with you, Don, when you were pulled into client situations, I'm just wondering if you can share any wisdom on how you speak the language you use, tips for making it relatable and understandable to the average person.

Don Calcagni:

Absolutely, Paul. And I think the first rule is to avoid the jargon, right? To try to find a way to use language that the client can really understand. I love what Andrew Ang does in his book on Asset Management, he likens factors to nutrients. I've used that particular analogy in the past and I find that clients are quite receptive to it. When I think of value and when I think on momentum, we can draw parallels to everyday experiences that investors have, right? Value is all about saying that price matters, right? Price matters when you're shopping for a home, an automobile or a college for your son or daughter. Trying to find some sort of analogy, some parallel that the client can grab onto, that's really a big help to make it meaningful.

But again, back to the first role, is really avoid the jargon. Try to avoid things like price-to-book and forward earnings. And try to just put it in terms that they can understand. And I say this to our advisors all the time, is to slow down the conversation. If you're speaking too quickly at the end of the day, clients are also going to have a hard time grasping what it is you're saying. Slow it down, use language, use examples that they can understand and avoid the jargon.

Paul Riccardella:

Makes perfect sense. Bryn, any tips from your perspective? I know that you work with end clients quite a lot. Anything to share?

Bryn Talkington:

Yeah. Well, you'll definitely never hear us talking about the Z-score to a client. And so I agree with Don wholeheartedly. We think it's really important first of all is that, we're trying to trade security selection, which has a low probability of success over time for factor selection. And so we think it's incredibly important to provide transparency in portfolio, and to provide context of the content in the portfolios. We write a piece last year, which we update once a year for our clients called Focusing on Factors. And it went through in very plain English what each of the factors do, how they fit together with examples. We write a lot of pieces. It was our most well-received piece because investors are drowning in information and they're starving for knowledge. And to be able to educate investors about some of these factors exposures versus trying to say, there's 300 analysts that all track Apple.

Do you really think any of them have any insight to any of that? Have any idea? No, but there are these factors exposures that will just passionately screen for whether they want to own Apple or not. And so we're wanting to invest in probabilities. And so those factor exposures give our clients a higher probability of success than trying to put together an individual stock portfolio that is all of the data we'll show you has very little consistency or persistency. And so that's why once again, flows continue to go to factor-based and passive strategies and out of individual security active managers, because I just think it's really, really difficult to do. We definitely don't just keep it high level, but we try to just once again, don't use these scores and just educate, write it out and we get great feedback from clients on that.

Paul Riccardella:

Very helpful. And I guess on the concept of writing out. I wanted to close this last main section before going into a little bit of a rapid fire with the same question to Bob and Dana, but a slightly different angle on it. More about, how do you make sure to keep clients invested when a particular factor is underperforming like the value reference for most of last decade that we referenced earlier in the discussion? Any tips there?

Bob Hum:

Yeah. Sure. Paul, when I think about keeping clients invested, that is the number one job I think for a financial advisor and for our industry as a whole, right? Making sure that people just get the equity premium. And so when thinking about how do we keep investors invested in factors when they're underperforming, I really break it down to three things, right? Number one, it's making sure clients understand that factors work overtime, but they don't work all of the time, right? Factors are cyclical. Depending on where we are in the cycle, certain factors should outperform others. When the question is value dead that I've been getting ad nauseam for the last five years?

It's really understanding that's actually cyclical. That's not structural. You would expect value to underperform in an expansion and in a slowdown. And the second thing I think and it was actually discussed on the panel today, it's be humble, right? Understand that you're not always going to get the factor calls, right? Making sure that you have a well-diversified portfolio, I think is critical to actually reduce some of the tracking error, which ends up leading to bad decisions by investors. And so those are really the two things. Again, understand the factors

are cyclical, and second be humble, be diversified, make sure that the tracking doesn't lead to bad behaviors by our clients.

Dana D'Auria:

I think that's great advice. And I would add that from my perspective, you win that battle with clients before the factor is underperforming. It's when you're putting them in the portfolio and you're setting expectations that you're going to set whether or not this is the right portfolio for them. And what I mean is that you really are trying to move them out of an expectation where you will correctly time the market. Because if you decide to go for a factor approach to investing, it's because you recognize that there's not going to be the ability to get in and out of the market or in and out of the right stocks at the right time. Because factors of course are very much as Bob just said, a long run type of proposal. And you're doing it because you've been educated enough to know that what other managers are promising to you, which is in fact picking the right stocks at the right time has not worked.

And so I think it's kind of an interesting place that you have to move because there is a fair amount of upfront education with a factor strategy, because you have to get the client to the point where they recognize that this promise of getting in and out of stocks when is best to do, it's just that it's a false promise. I'm going to get them past that and say, "Okay, well, then what's our best fat, right? How do we be the casino as opposed to playing in the casino?" Well, it's to tilt toward these long run exposures, these anomalies style factors, whatever you want to call them, that academics have determined, have the ability to outperform over time. From my perspective, it really is about setting the stage properly with the client.

Paul Riccardella:

Okay. Well, thank you, Bob. And so let's conclude there. Bob, Bryn, Dana and Don, thank you so much for a very robust discussion on factor investing. I think there were a lot of insights gleaned by our audience. And I can tell you that I thoroughly enjoyed the conversation. Again, really appreciate your time. And and back to you, Jenna.

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