Capturing the Growth Factor Premia

Interviewer: Growth investing is one of the most widely practiced investment areas and accessible by advisers through growth ETFs. Mark Carver, Global Head of Equity Factor Products joins me to share systematic approaches to capturing growth factor premia and avoiding unintended exposures. Mark, let's take a step back and discuss how growth has been captured in the marketplace by investors.

Mark Carver: Well, you said it very well in your opening that growth is a well-known, very intuitive investment idea for everyday investors. The idea of investing in securities that are growing, their sales and earnings faster than their peers seems intuitive, seems well known and in fact in financial products the category is nearly two trillion dollars split among index-based investments and actively managed investments. The index side of this is that we've had for a long time now, what we would at MSCI refer to as style indexes. These are sort of first generation factor indexes if you will, where we look at an index universe and you divide it equally between growth and value, and you weight those stocks by their market cap. Now, the use case for those types of indexes has been for universe selection, meaning managers who are pursuing growth, fish from that pond of growth investments in that index. And then on the other side, the people allocating to those managers use that benchmark as a way to evaluate the performance of that manager, whether they're outperforming or underperforming, and this has been well known and well used in the industry for many, many years.

Interviewer: And Mark you're launching the growth target indexes now more than 10 years after you launched your other factor indexes such as value. Why now and what's changed?

Mark Carver: Well, what has changed is that there's much more comfort today with the idea of second generation or next generation factor indexes where we can move from the simple frameworks to more efficient frameworks. So the industry is much more comfortable. But in the spirit of your question, some may look at this and say, "Gee, you know, you're launching a growth target index after a decade where growth stocks like the FANGs have done incredibly well." That's a little bit of a cynical view and in truth, that's not why we're launching this index at all. It's much more because the market is ready for this type of index. And in fact at MSCI, we've had growth as a factor inside of our factor models for many, many decades. Growth is an important factor in explaining risk in the cross section, meaning it's a great factor to do the forecasting. But inside that model, when we look at the pure growth factor, we actually observe a premium, not just for the last 10 years like some people have observed, but in fact even 10 years before that, we've seen the premia of that pure growth relatively consistent with what we've seen in the last 10 years. But the key here is the term I used, pure growth. What this means is its growth that doesn't have unintended exposures. What many of your listeners are more familiar with are ideas where you use an index construction that I might call a 'rank and select'. This is sort of a Fama French approach or the way that academic factors have been built. In a rank and select approach, what you may see is that unintended exposures creep in to your portfolio and that can have a profound impact not only on the risk that you take in that index, but also the return

premia. And so as a result, you may actually see the return get dragged down and that is actually the case in growth. So the difference here is that we're moving away from the simple rank and select to build an index that controls for the unintended exposures to these non-target factors.

Interviewer: Finally Mark, how is the construction of the growth target index different? How does it compare to other factor indexes?

Mark Carver: Well, if we start with, you know, the factor indexes that people are, you know, most familiar with. Let's use value or momentum. The construction of those is similar to the rank and select that I hinted at earlier, where you look at a universe of securities, you rank them for their, you know, their exposure and their strength to the particular factor, value or momentum, and you select the top third and you build your portfolio. With growth, what we're doing is we're using optimization techniques. And the reason is we want to try to extract that premia we see in our risk models, where we can extract it in attractive premia in the pure growth. So what we're doing is using optimization to control non target factor exposures. Things like high valuation, high volatility, low quality or junk needs. The way your listeners might think about this is an idea that's been well known and well-practiced in the investment industry, gap investing, growth at a reasonable price. What this means is you pursue growth without overpaying for stock. Now, if we extend that to say, how do we pursue growth not only at a reasonable price, but at reasonable volatility and reasonable quality? That's really what we're doing in this index. So it's growth, controlling for the things that drag down the performance and the result is we think we have an index that's more reflective of the way actively managed strategies actually pursue growth and therefore it becomes either a better benchmark for those managers or it can become a way for investors who are index based investors to try to extract that growth premia.

Interviewer: Well, Mark, great to have you. Thank you for joining us.

Mark Carver: It's my pleasure. Great to be with you.

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