

INSIGHTS FROM CFA SOCIETY SINGAPORE

How factor strategies can help enhance portfolio returns and risk control



JOSEPH SIMONIAN

THE benefits of factor investing as stand-alone strategies are well documented. Less well known is the positive impact factor strategies can have when they are added to institutional investors' completion portfolios.

A completion portfolio is a strategic programme designed to complement existing holdings and fill in any gaps or inefficiencies within an asset owner's overall portfolio.

By employing factor strategies at the plan level, asset owners can fine-tune their allocations to suit their specific objectives in an efficient and cost-effective manner. I will discuss how factor strategies can be effectively utilised within completion portfolios to enhance plan performance and risk control.

The symbiotic nature of these two commonly pursued goals in institutional portfolios begs the question: Why wouldn't you include factor strategies in the completion portfolio toolkit?

Factor strategies and completion portfolios

Factor strategies target specific investment attributes such as value, size, momentum, low volatility, low investment and high profitability. These attributes are the pri-

mary drivers of asset returns, and have historically demonstrated a persistent risk premium.

An integral part of modern portfolio management, factor strategies offer investors a systematic approach to capturing specific risk premiums and enhancing portfolio diversification.

Now let's look at a completion portfolio. Such portfolios make supplementary allocations aimed at achieving specific objectives – such as enhancing diversification, managing risk or capturing additional sources of return.

The concept of completion portfolios stems from the recognition that traditional asset allocations may not fully capture all available investment opportunities or adequately address specific investment goals.

Completion portfolios are tailored to address these shortcomings by incorporating assets or strategies that can provide complementary benefits to existing portfolio holdings.

Completion portfolios can take various forms, depending on asset owners' objectives and risk tolerance.

They may include different asset classes and strategies that offer unique risk-return profiles and low correlations to traditional stocks and bonds.

One common application of completion portfolios within the context of institutional asset management is where investors seek to optimise portfolio efficiency and achieve specific performance benchmarks. In this way, completion portfolios may be employed to

fine-tune asset allocations, adjust risk exposures or exploit market inefficiencies – thereby enhancing overall portfolio performance and risk-adjusted returns.

Clearly, completion portfolios play an important role for asset owners by providing them with a flexible and dynamic framework to address evolving investment objectives and market conditions. Whether used to enhance diversification, manage risk or capture additional sources of return, completion portfolios offer a strategic tool for asset owners seeking to optimise their overall investment portfolios and achieve their long-term investment goals.

Benefits of adding factor strategies

There are several ways in which factor strategies can help enhance the building of completion portfolios.

The first is diversification enhancement. Factor strategies offer an opportunity to diversify a completion portfolio beyond traditional sector and geographic approaches to investing. By allocating to factors with low correlation to existing holdings, asset owners can

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Factor strategies, including value and growth, can help asset owners fine tune their allocations in an efficient and cost-effective manner. PHOTO: PIXABAY

potentially reduce overall portfolio risk and enhance risk-adjusted returns.

The second benefit of utilising factor strategies in completion portfolios is risk management. Certain factors, such as low volatility, have defensive characteristics that can help mitigate downside risk during market downturns.

Incorporating these factors in a completion portfolio can provide additional portfolio stability dur-

ing periods of heightened market volatility.

Performance enhancement is another potential benefit. Factor strategies can generate excess returns over broad market indices over the long term.

By tilting towards factors that have historically delivered superior risk-adjusted returns, completion portfolios can capture these additional sources of return and potentially outperform the overall market.

A major role of factor strategies in completion portfolios is that they can provide a systematic framework to achieve targeted exposures, such as capitalising on value or stock momentum opportunities.

Completion portfolios can be customised to target specific factors based on asset owners' objectives and risk tolerances.

Factor strategies can also imbue completion portfolios with enhanced adaptability. Asset owners can target factor exposures dynamically based on changing market conditions, economic outlook or investment goals. This adaptability is particularly valuable where the goal is to calibrate allocations to optimise risk-return characteristics.

Factor investing is one of the pillars of modern investing.

The benefits of standalone factor strategies are well known, and there is a growing recognition of their value in completion portfolios. The benefits include diversification enhancement, risk management, performance enhancement, targeted exposure and adaptability.

The writer is senior investment strategist, Scientific Beta