Russell Investments

Investor

Helping you make informed investment decisions

An introduction to factor investing

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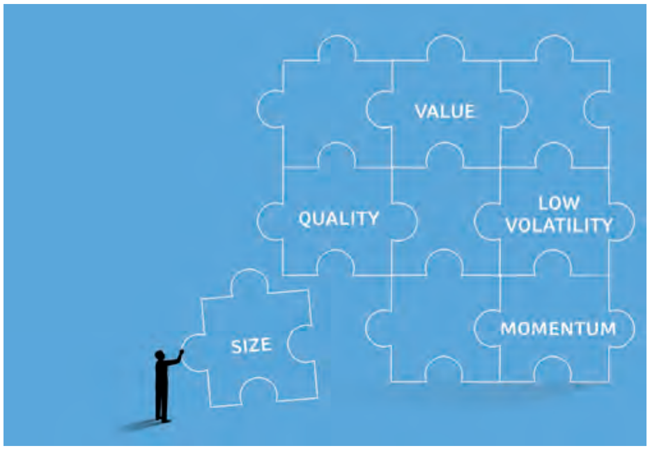
Investing has traditionally focused on selecting among asset classes such as equities, bonds, and real assets. In recent years, many investors have broadened the range of asset classes they hold in an attempt to pursue steadier growth amid market volatility and low returns.

The idea is that by combining assets that have little correlation (that is, they don't usually move in the same direction), returns should be smoother.

Yet as many investors discovered during the 2008 financial crisis, underlying investment "factors" contributed to increased correlations, and nearly all asset classes lost ground. These factors are broad characteristics of individual securities that explain why they may move in sync, regardless of their asset class. Factor investing is designed to identify these characteristics or factors, and then adjust a portfolio's exposure to them in order to better manage risk and return.

The four most common factors used in factor investing are value, momentum, low-volatility and quality. Most of them exist because of investors' behavioral biases. Size is also a frequently used factor.

What factors are missing from your portfolio?



VALUE

Investors tend to focus on the short term.

Value investing focuses on companies whose stock is selling at a market price below the "intrinsic[1]" value. Since most stock prices eventually return to their long-term average, a tendency known as "mean reversion", investors who have the patience or time horizon to identify stocks that are trading below their intrinsic value, and then hold on to them until they revert to their fair price, tend to be rewarded.

MOMENTUM

Investors have a natural bias to move as a "herd".

Momentum investing presumes that if stocks have performed well in the recent past, they probably will continue outperforming the market for a short period in the future. Investors have a natural desire not to miss out on what they see as a good thing, and our tendency to move as a "herd" fuels the momentum. Momentum may also occur because investors can either overreact or underreact to new information.

LOW-VOLATILITY

Investors prefer greater gains than lower losses.

Low-volatility investing identifies stocks that display a lower level of risk than the overall market. Low-volatility equities often lag when the market is rising, but may outperform when the market is falling. Although Low Volatility doesn't generally drive excess returns, it can help smooth out returns.

[1]Intrinsic value is the actual value of a company or asset based on its fundamentals, such as the present value of expected future cash flows, the value of assets held (buildings or stocks for example), or the value that its assets would command if the ongoing operations were to be sold.

QUALITY

Investors have a tendency to be attracted to nice things.

Quality focuses on identifying companies that are believed to have a greater ability to deliver sustainable returns to shareholders. These companies are typically characterized by high profitability, low leverage and low earnings volatility.

As well, high quality companies are more likely to hold their value in a market downturn, meaning they will have less ground to make up when the markets recover.

Investors tend to favour stocks that have greater potential short-term upside, often ignoring the risk that these same high-leverage stocks can have greater potential short-term downside as well.

SIZE

Investors flock to familiar things.

This factor is based on a belief that smaller companies often are more capable of outperforming the market than larger companies, which are more familiar to investors and are therefore more vulnerable to changes in sentiment. Size generally has similar volatility as the broader market, but can carry a higher level of active risk.

HOW DO FACTORS AFFECT OUTCOMES?

- Value, momentum and quality are well-suited to investors who are striving to outperform the market, or who want an offset to a capitalization-weighted benchmark, such as the S&P/TSX Composite Index.
- Although low-volatility strategies can reduce overall portfolio risk, for many investors their performance is often too low to help reach investment goals. Investors may need to take on equity exposure with a higher level of risk.
- Size can be a powerful factor to consider when building a portfolio. Typically, the size factor performs well when investors want to increase their risk appetite.

HOW CAN INVESTORS GAIN ACCESS TO FACTORS?

The growing popularity of factor investing has led to an expanding array of vehicles for investors to gain access to specific factors. Investors can purchase mutual funds that aim to maintain a certain "tilt" to either one stated factor or multiple factors, or through Exchange-Traded Funds that focus on a select factor.

Factors can also be incorporated into a diversified multi-asset portfolio, where the allocation to specific factors will vary depending on market conditions and the portfolio manager's preferred positioning. Factors tend to move into and out of favor over market cycles, which can introduce volatility and underperformance to an investment that focuses on only one factor.

There are potential benefits to directly targeting factors within a portfolio as they:

- Increase the tools a portfolio manager can use in the pursuit of performance.
- Provide increased diversification and efficiency to a portfolio.
- Complement active management in low return environments.
- Are designed to capture risk premia in inefficient markets.

For many investors, a core equity portfolio with a strategic allocation to a combination of these factors provides well-diversified exposure to the desired factors, and may increase the chance of more consistent risk-adjusted returns over time.

Important Information:

Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments. Please read the prospectus before investing. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated.

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