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Multi-factor investing and ESG

Clarity is key to minimizing unintended exposures

Factor investing falls under the umbrella of smart beta investing and has become increasingly popular in recent years, with many providers now offering broad suite of strategies. Pension funds have taken to factor investing as it allows them to have more selective exposure on well-established risk premia factors: value, size, momentum, low risk and quality.

Long-term institutional investors are also seeking to incorporate environmental, social and governance (ESG) approaches into their investment strategies by becoming more vocal on ESG- based issues such as climate change, human rights and corporate ethics. Some US$21 trillion of global investments now take ESG into account, compared with almost nothing a decade ago, and we believe this will only rise further.

Clarity is key

We take a two-pronged approach to focusing on clarity. First, we seek to maximize the exposure to the factor or factors that our client has selected.

Second, we minimize the noise from other factors by ensuring they do not work against the objectives of the primary factor or factors. At first glance, this may seem straightforward, but in fact, achieving the client's targeted result requires a disciplined, well-researched approach.

HSBC Asset Management has been managing equity factor strategies for clients since early 2004 and is committed to designing and scaling proprietary smart beta solutions for clients.

Our belief in clarity, backed by a rigorous, investment process, proprietary research and well-resourced research and portfolio management team, is central to the way we construct our portfolios.

When considering an allocation via factor investing, investors need to recognize that while a stock may easily be defined as a single country or sector, the same cannot be said for a factor. Multiply this concept across a larger number of stocks, and a strategy purporting to be "value," for example, can in fact have significant exposure at times to momentum, quality, low beta and other risks.

These unintended factor exposures have become a concern for investors. For example, when done correctly, shifting allocation to equity via equity factors has been a good solution to minimize unintended exposure.

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Over the years, our proprietary research has led us to concentrate our efforts on five factors: size, value, momentum, quality and low risk. Our aim is to manage pure factor strategies that exhibit high exposure to each selected factor.

Active factor exposure

It's important to note that when two factors are highly correlated, it becomes difficult to disentangle the two competing effects. To address this issue, we combine our factors in ways that complement each other and capture independent sources of factor premia. We use mathematical models to test each factor to ensure that they each contribute to the overall multi factor score while ensuring that each factor is independent of other factors.

Incorporating ESG within the factor investing framework

Adding an ESG requirement increases complexity and the potential to introduce unintended exposures. But these unintended exposures can be accounted for if we think of ESG within our factor investing framework. To do this, companies are assigned numerical ESG scores, which can be used to rate them. Viewing ESG within this framework allows it to be evaluated and weighted along with traditional factors like value and quality; subsequently views around correlations between ESG and various factors can then be expressed.

Already, around 40% of the world's major companies report significant ESG metrics. Importantly, investments in companies with improving ESG scores are outperforming those with lagging ones. At HSBC, we are ideally placed to respond to this trend. We already have an award-winning Climate Change Centre of Excellence, and over the last year we have built on that with our social and corporate governance team of researchers. Our ESG approach is based on a combination of robust fundamental analysis that is backed up by our proprietary databases, as well as interaction with policy-makers, industry players and independent market sources. We also recognize that the most important ESG drivers vary from sector to sector and asset class to asset class. We are developing a bottom-up database of around 65 indicators that take ESG into account so that all our analysts can build their own relevant toolkits on a sector-by-sector basis.

Factor investing, ESG and your portfolio management needs

Equity factor strategies and ESG requirements can be selected individually or combined depending on your portfolio needs. Our experience has shown that many pension providers are now customizing specific factors around an existing portfolio.

Plan providers are also considering an allocation to factors where their portfolio is currently underweight. This allows them to balance the overall portfolio allocation, while at the same time looking to benefit from all available sources of potential returns. Finally, clients can also consider simple combinations of factors that can be designed to add very specific portfolio enhancements such as reducing volatility, maximizing returns or reducing a portfolio's carbon footprint.

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