

# Factor-based investing

Targeting enhanced portfolio outcomes



# Welcome

Factor-based investing, sometimes known as smart beta, is here to stay. Whether it's aligning factor-based strategies with investment goals, or diversifying a portfolio, more investors than ever are using factor-based investment solutions.

At LGIM, we work to support pension schemes and ensure that they have all the tools available to meet their investment objectives.

We manage a range of factor-based strategies and have the in-house capabilities to partner with investors and build bespoke solutions.

We now have £40 billion\* invested in factor-based strategies. In an environment where costs are increasingly in focus, factor-based investing offers a cost-effective way to meet your investment needs.

Factor-based investing can help pension schemes implement an active viewpoint, while maintaining many of the advantages of an index fund approach such as lower costs, lower governance burden and greater transparency.

## **Adam Willis**

Head of Index and Multi-Asset Distribution



\*Source: IPE2017

# A smart way to build your portfolio

## TRIED AND TESTED

Factor-based investing is an alternative way to access mainstream investment styles. It can be accessed through transparent, liquid and cost-effective indices that can be implemented by LGIM's team of highly-experienced portfolio managers.

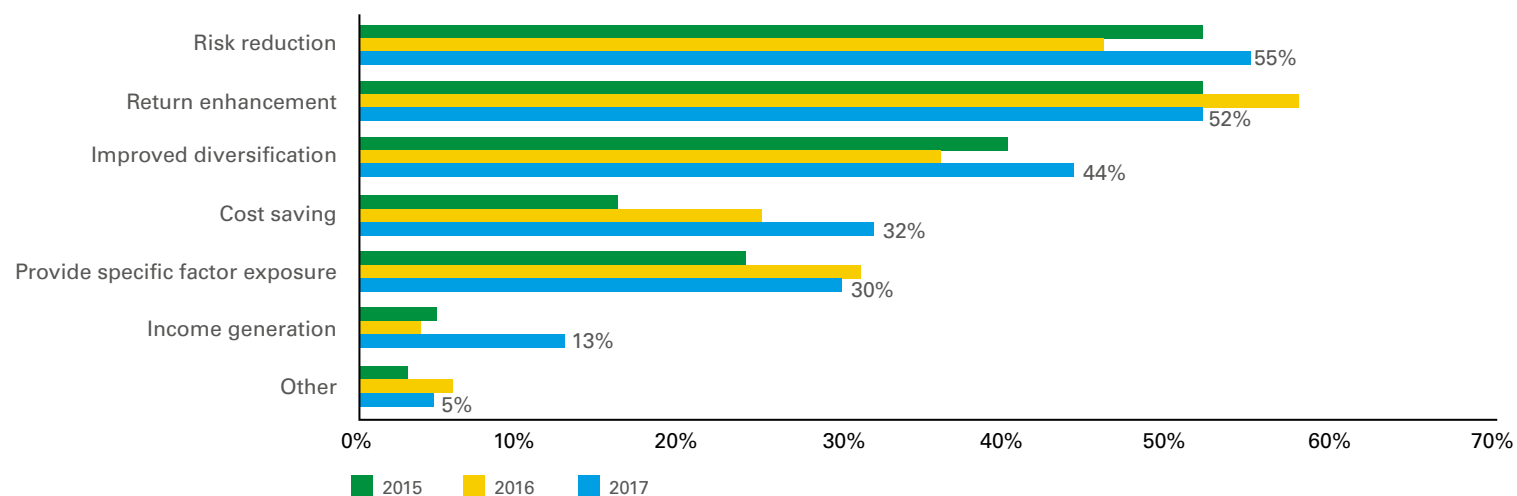
## TAILORED EXPOSURE

Factor-based investing can help investors build bespoke investment strategies meeting specific outcomes related to return enhancement, risk reduction, diversification or income, in a cost-efficient manner.

## TRUE EXPERTISE

Over 25 investment professionals and a twelve-year track record means that LGIM is best-placed to deliver the wide range of factor-based strategies available.

### The many reasons investors are looking to factor-based investing



Source: FTSE Russell



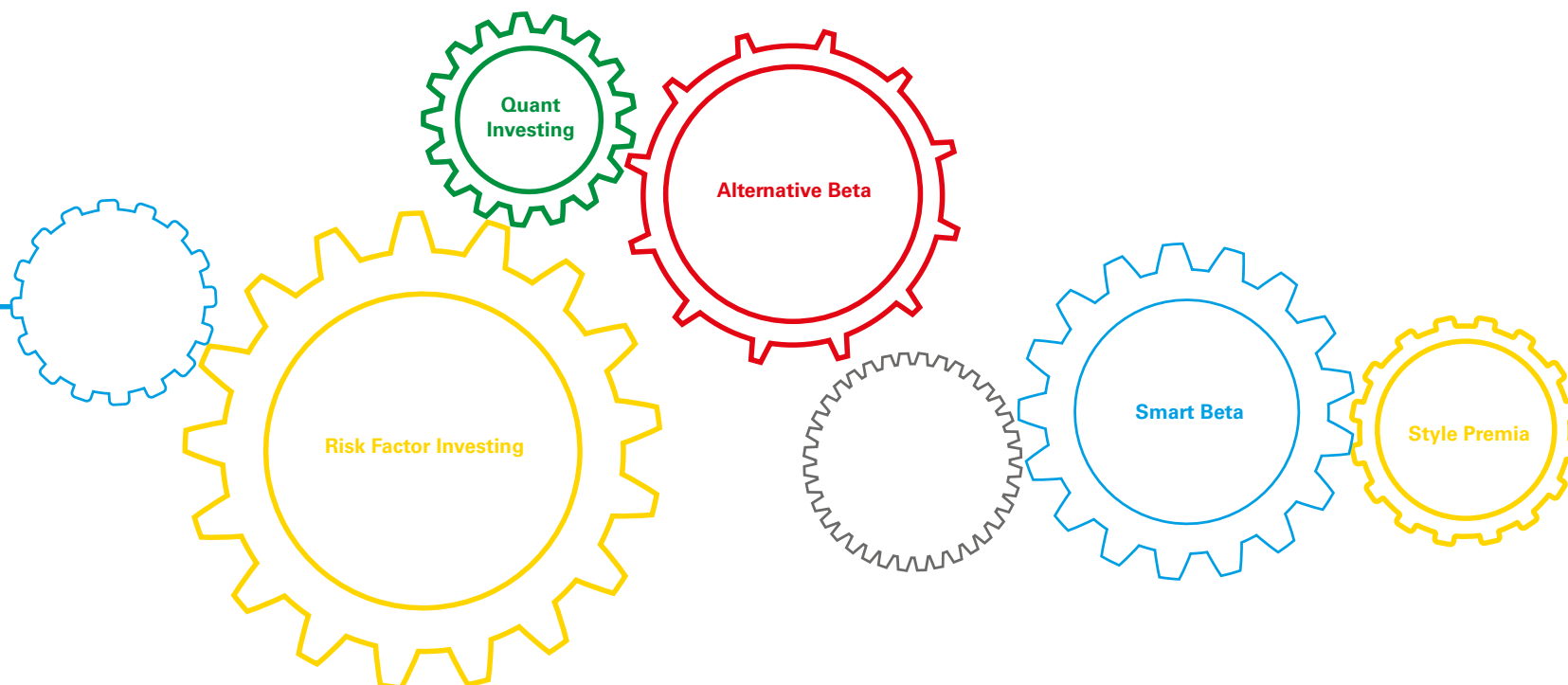
# The many names of factor-based investing

Factor-based investing refers to allocating to various investment styles (factors), within and across asset classes, which an investor believes will be rewarded over time.

Strategies based on this premise are often known by multiple names across the industry including 'smart beta' or 'alternative risk premia'.

However, we prefer to continue using 'factor-based investing' when referring to our innovative approach to investing using factor-based indices.

Many names, same underlying premise...



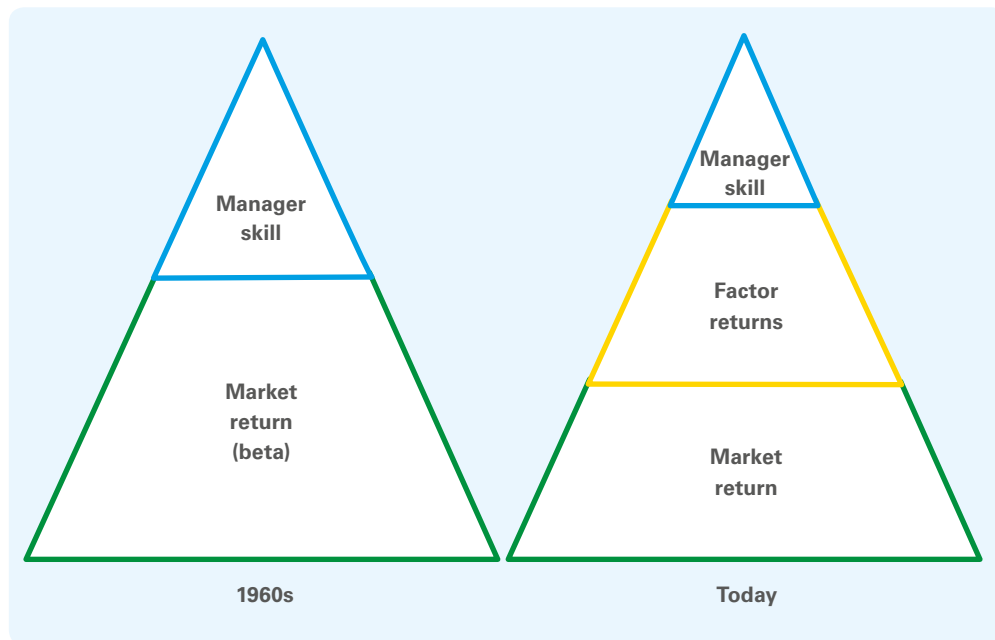
# What is a factor?

A factor is any characteristic inherent in a security which drives its risk or its performance.

## HELPING UNDERSTAND THE SOURCE OF RETURNS

In the 1960s, investors would attribute returns to manager skill, or 'alpha', and market returns (beta). Decades of academic research have shown that a number of common security characteristics or 'factors' have historically delivered improved returns relative to market-cap weighted indices over the long term.

Today, we can understand that part of these returns are actually the result of factor performance.



## MANY FACTORS ARE NOT NEW

Some of the factors, such as 'value' or 'quality', will probably be familiar to investors as popular investment styles in equity investing.

The most common equity factors we find investors focusing on include:



Value



Low volatility



Quality



Momentum



Size

# The factor-based index innovation

Previously, investors who wanted to access specific factor returns had to do so through active managers or expensive, bespoke arrangements.

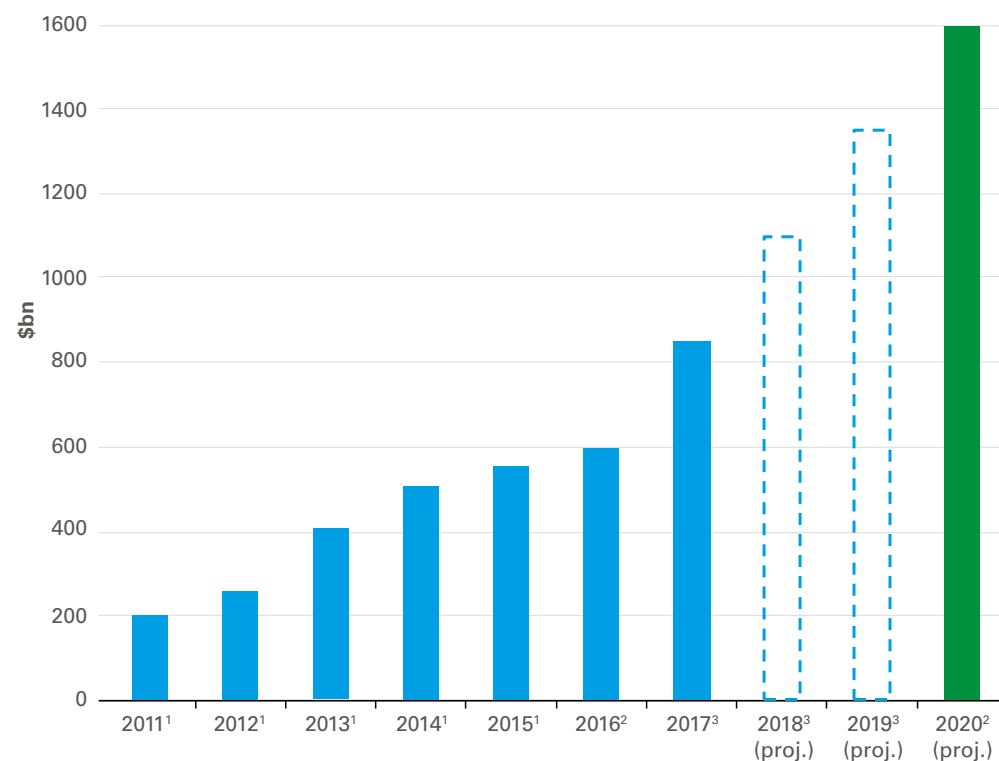
Now, investors can use index funds which are specifically designed to track individual factors or a multi-factor blend.

## A LOW-COST SOLUTION

The rising popularity of index-based investment strategies has been a clear feature of the institutional investment landscape in recent years. Comparatively low transaction costs, ongoing charges and governance costs are often cited by investors as advantages of using index funds.

Factor-based investing has grown quickly since the financial crisis

## Assets invested in factor-based strategies (global)



Source: Morningstar, Citi, LGIM.

1. Morningstar

2. Citi projections

3. LGIM projections – filling in linearly for 2017,2018,2019 (based on Citi projections for 2016 and 2020)





# What is an index investment strategy?

Index strategies offer a cost-effective, typically diversified way of investing in a collection of securities.

## TRADITIONAL MARKET CAP INDEX STRATEGIES

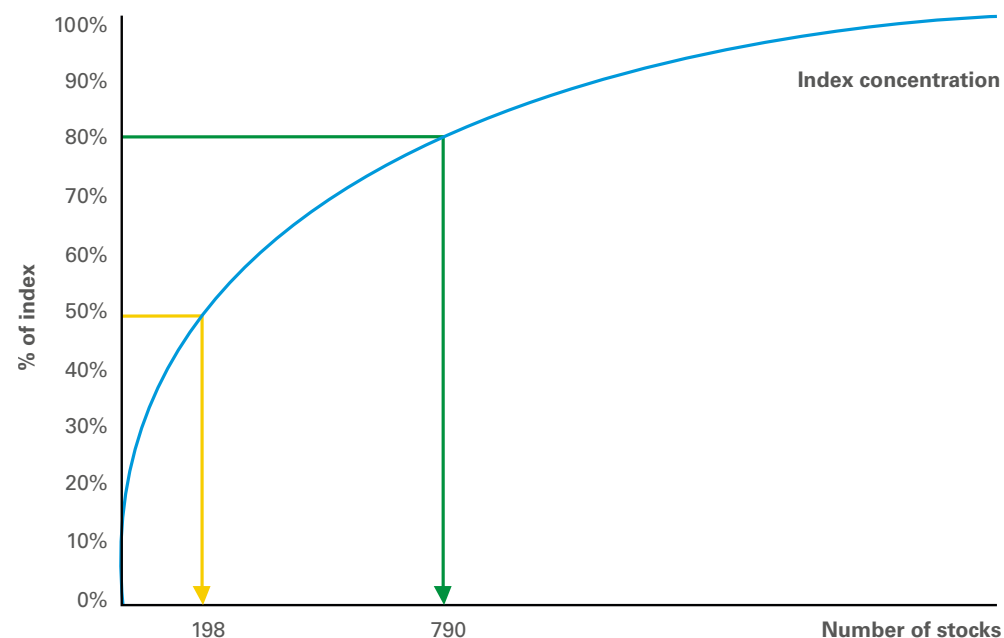
A market cap-weighted index, where each stock in the index is weighted according to its size, means that larger companies carry a proportionally larger weighting than smaller ones, as illustrated opposite. The market cap-weighted portfolio remains a common starting point for long-only investments since it is well-understood and widely quoted.

However, that is not to say that market cap indices are perfect. Market cap indices may be prone to asset price bubbles, biased to past success and risk excessive concentration. As more weight is apportioned to larger, potentially overvalued securities, investors could face significant concentration risk in certain stocks and sectors.

## A FACTOR-BASED ALTERNATIVE

Factor-based indices represent an alternative method of constructing an index. As with any index, factor-based indices use a set of rules to identify a group of securities. However, rather than constructing the index purely based on the basis of company size (as with market cap indices), the rules aim to identify groups of companies with shared characteristics that align with a targeted factor such as low volatility or value.

Market cap-weight index: FTSE All World

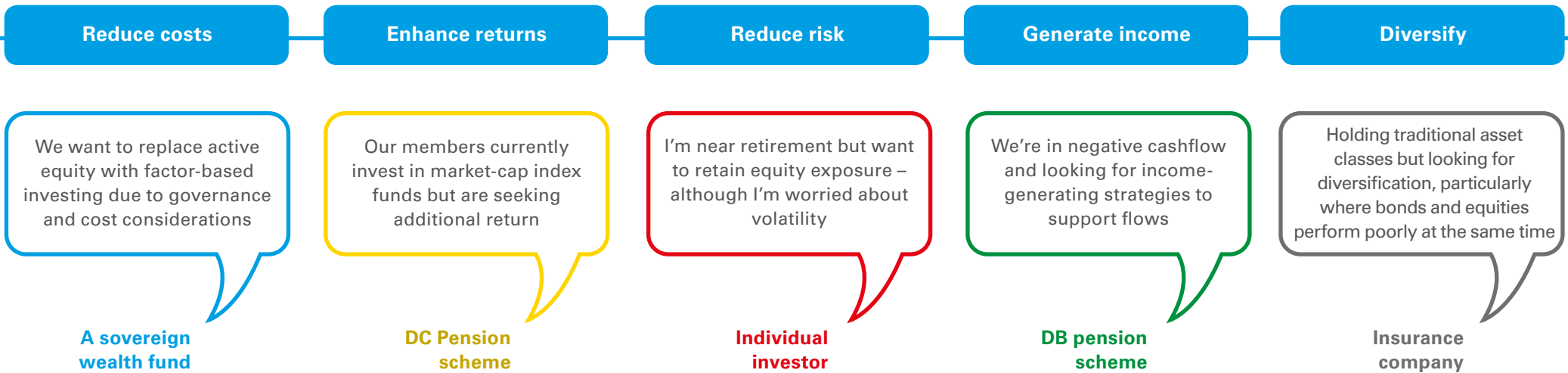


Source: FTSE, for illustrative purposes.

# How can factor-based indices help you?

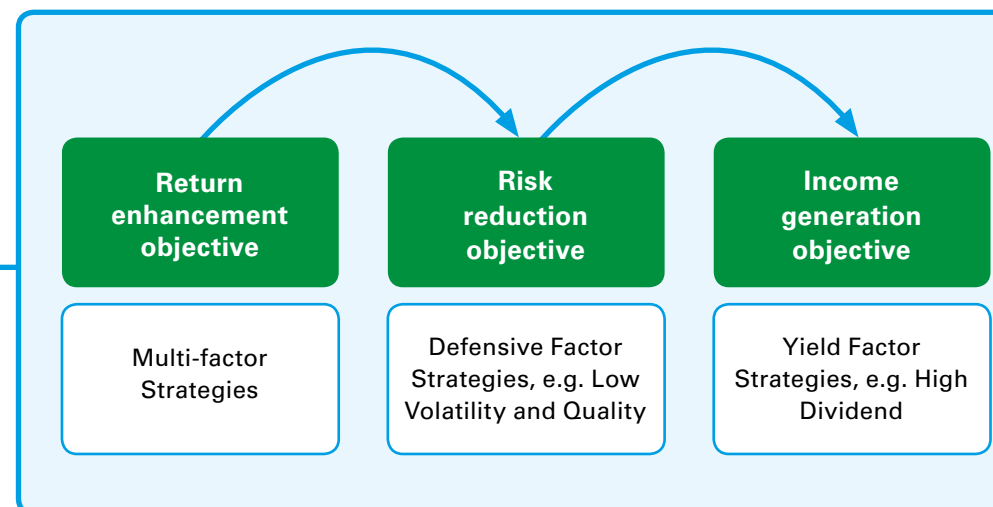
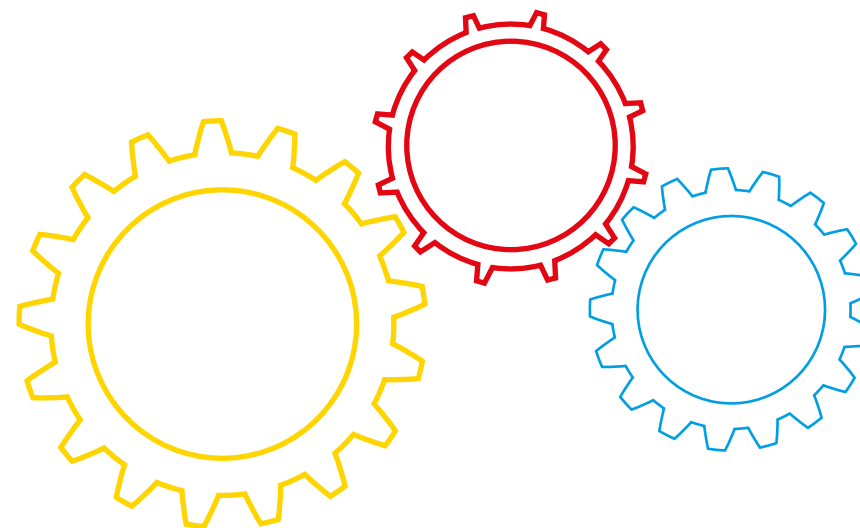
Factor-based indices can help investors achieve a wide range of outcomes.

OUR CLIENTS TELL US THAT THEY WANT TO...



**Defined Benefit** schemes that are looking for a higher return than market-cap equities, with less downside risk to smooth the deficit reduction journey; well-funded schemes might consider low volatility strategies while those in cash outflow mode may look at yield factor strategies.

**Defined Contribution** schemes that are looking for higher return for members during the growth phase, while limiting the risk of poor investment outcomes. The factor exposures could potentially change throughout the lifecycle as shown in the chart below (e.g. pre-retirement where risk reduction is the primary objective and post-retirement when it's income generation).



# Invest with LGIM's expertise

Our range of “off-the-shelf” factor-based strategies and expertise in building tailored solutions means that whatever the requirements of the client, LGIM has the credentials to deliver. We offer three types of service in the factor-based area:

## INDEX IMPLEMENTATION

We can help put your investment beliefs into practice with flagship factor-based offerings from leading index providers as well as indices customised by LGIM.

## DISCRETIONARY FUNDS

Our Asset Allocation team have used factor-based indices for a number of years and offer a range of discretionary funds.

In July 2017, LGIM launched the **Diversified Multi-Factor Equity Fund**. Designed as a long-term core equity holding for DC and DB schemes, the fund diversifies across regions, factors, stocks and currencies in order to deliver better investor outcomes.

## BESPOKE SOLUTIONS

As a trusted partner of UK pension schemes, LGIM has the knowledge and experience to work with clients to develop factor-based solutions that meet specific objectives while respecting beliefs and constraints.

For instance, the **L&G Future World Equity Factors Index Fund** was created for those clients who want to use factors to deliver returns but also incorporate the risks of climate change. While achieving balanced multi-factor exposure, the fund gives greater exposure to companies that are likely to benefit from the transition to a low-carbon economy.

# An award-winning investment manager

We are thrilled to see our work recognised by peers and clients.





# LGIM at a glance

We're a major global investor, leading the market in UK defined benefit pensions.

**£985bn<sup>A</sup>**

Assets under management

**1836**

Legal & General Group founded

**350+**

Investment professionals

**#1<sup>D</sup>**

Smart beta manager, European institutional clients

**275**

Client servicing support staff

**2.6%<sup>B</sup>**

Ownership of the FTSE All-Share Index

**3000<sup>C</sup>**

Clients across the globe

**12+**

Year track record in managing factor-based strategies

A. Source: LGIM internal data as at 30 June 2018. These figures include assets managed by LGIMA, an SEC Registered Investment Advisor. Data includes derivative positions.


B. Source: LGIM internal data and Bloomberg LP, as at 31 December 2017

C. Institutional approximate clients. Source: LGIM internal data 31 December 2017

D. Source: IPE, Top 400 Asset Managers Survey 2017

## CONTACT US

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