For professional clients only. Capital at risk.

Factor strategies Q&A

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Is factor investing still a valid style of investing?

Yes. Factor investing remains a valid investment approach consisting of researched-backed strategies that aim to systematically capture persistent sources of returns over the long run.

These return premia – such as Value, Momentum, Quality, Low Volatility and Size – offer diversification[1] and transparency around the return drivers of a given strategy.

Although factors have historically temporarily underperformed over certain periods, there is evidence from both academic research and real-world performance to show that factors have historically captured systematic risks for which investors are compensated in the long run.

What is the outlook for factor investing?

We expect factor return premia to persist over the long term. Factors such as Value, Quality, Momentum and Low Volatility have historically outperformed the broader market over the long term, providing potential for higher returns and better diversification.

Over shorter periods, it's important to note that factor strategies have displayed different risk and return characteristics in different economic and market environments. Factors are also cyclical — their performance tends to vary in different economic and market regimes.

Single-factor portfolios can sometimes underperform, so a mix of factors can help reduce risk.

Key Risks

The value of an investment and any income taken from it is not guaranteed and can go down as well as up, and the investor may get back less than the original amount invested. It should be noted that diversification is no guarantee against a loss in a declining market. Assumptions, opinions, and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.

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What sets our factors apart?

Our factor strategies take a modern approach built on fine-tuned definitions that reflect the modern realities of today's market economy. While our style factor definitions are fully aligned with academic literature, we have also integrated additional features that reflect our investment thinking. We highlight some of these additional features below:

Innovation capital and the Value factor

The Value premium arises from the observed outperformance of undervalued securities relative to overvalued securities over the long term. Fama and French (1992) identified this premium using the book-to-market ratio as a valuation measure. However, in the modern economy, businesses have undergone a gradual structural shift from capital-intensive models to asset-light, service-platform models. This has altered the structure of a company's assets, with a growing focus on unrecorded intangible investments, particularly in research. Collectively, this is known as 'innovation capital'. Therefore, we enhance the definition of Value by incorporating this innovation capital into the book value and earnings measurement. Read more about our approach to Value on our blog.

Investor risk perception and the Low Volatility factor

When using plain volatility, one considers both negative and positive deviations from mean returns equally. A rational investor, however, wouldn't ordinarily consider deviations to the upside as risk, but instead as potential. It has been widely recognised that losses 'hurt' a lot more than the 'joy' provided by equivalent gains. Thus, we believe downside volatility aligns more closely to an investor's perception of risk. Read more about our approach to Value on our blog.

Momentum: the trend is your friend, until it isn't

Our Momentum factor incorporates a risk-aware feature that is designed to reduce the severity of drawdowns typically exhibited by standard Momentum strategies. Read more about our approach to Momentum on our blog.

The illustration below shows our factor enhancements in more detail.

Value	Low volatility	Quality	Momentum	Size
We make adjustment made to reflect future embedded value based on historic R&D investment	We focus on the downside volatility associated with each company	Beyond the generic income & profitability metrics to focus on the how these metrics are met and the sustainability of them over time	Traditional momentum factors focus solely on the historic returns in isolation to identify trending stocks and tends to favour S/M cap companies	Integration via universe selection and features in portfolio construction and diversification
Metric & Financial Statement	Metric & Rationale	Metric & Rationale	Metric & Rationale	Metric
Earnings Yield - adjusted Income Statement **Book to Price - adjusted** Balance Sheet **Free Cash Flow Yield** Cash Flow Statement	**Downside Volatility** Capture stocks with downside risk to protect investor capital from significant drawdowns overtime	**Aim for return on capital. Net Profit Margin.** Key metrics to review the income & profitability of a company **Leverage. Earning Variability. Accruals.** Identify the quality & repeatability of the income & profitability	**Risk-managed price momentum** A risk adjusted signal enhances the momentum factor & better reflects how active investors manage assets	**Indirectly targeted via universe selection and portfolio construction**

How should investors use factors?

Factors offer investors the tools to construct long-term equity portfolios, which could help them meet their investment needs or objectives.

We believe allocating to equity factors can enhance portfolios by targeting specific drivers of return, such as Value, Quality, Momentum and Low Volatility.

The iSTOXX L&G Global Multi-Factor ESG index is a cost-effective solution that provides multi-factor exposure, while incorporating real-world investment practices (see What do you mean by links to investor practices? point below for more information), enhancing transparency and integrating ESG/climate features. Because this strategy is market-cap aware and tracking error-controlled, it can potentially be used as a replacement for a global market cap equity index strategy.

In addition, the bespoke and modular nature of our approach provides the ability to make further changes and amendments to best reflect our clients' objectives and preferences.

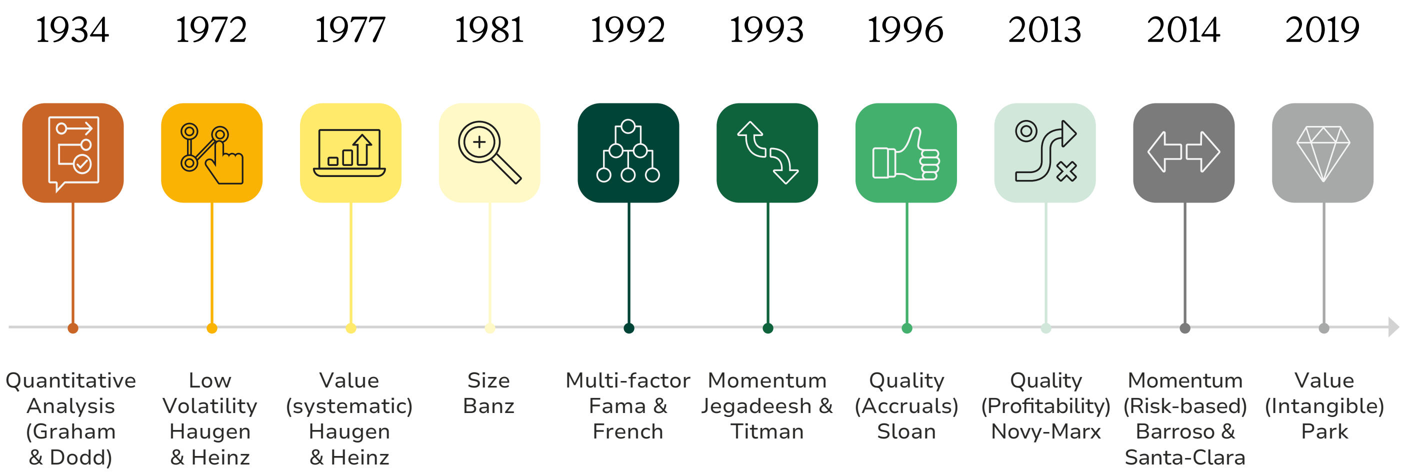
How have factors evolved over time?

Over time, factors have evolved from a narrow focus on market beta and basic metrics within Value and Size in the classical Fama-French Three-Factor Model to a broader set that includes Momentum, Quality and Low Volatility.

The illustration below shows the timeline of how factors have evolved over time.

Advances in research have refined definitions to adapt to the modern economy and market conditions. For example, as detailed above, our Value factor incorporates an element of 'innovation capital' that has been designed to reflect the realities of today's market environment. In this example, research and development adds value through new products being created and productivity gains, but this is not recorded on the balance sheet.

This evolution reflects a deeper understanding of market dynamics, enabling more dynamic and adaptive ways to better capture persistent risk premia.



Source: Zaher (2019), Index Fund Management: A Practical Guide to Smart Beta, Factor Investing and Risk Premia.

Our process for identifying financial factors is built on rigorous research and analysis.

What is needed for a factor to become established?

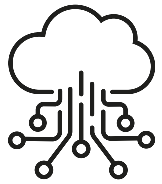
Our process for identifying financial factors is built on rigorous research and analysis. We blend investment-led thinking with the latest academic insights, validating our ideas through data-driven experiments and historical testing.

Below are the three key questions we consider when deciding whether or not to include a factor in our investment strategies:

1. Is there a long history of reliable data?
2. Is there a body of academic research supporting the existence of a positive return premium in the factor?
3. Is there an economic reason, a behavioural trait or a structural anomaly that explains why the factor should be rewarded?

Only if the answer to all three questions is 'yes' will the factor become a candidate for inclusion into our factor strategies.

Ingredients for factor qualification

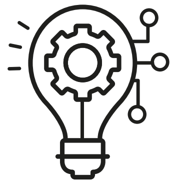


Data

Long history of reliable data

Academic Consensus

People have reviewed, tested and agree the data is saying something



Logic

There needs to be some reason for this 'thing' to exist (e.g. behavioural, structural)

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What is L&G's process to create a factor strategy?

The illustration below outlines the investment process in five different steps.

First, the process considers investment goals (step 1) in terms of factor and ESG exposure and investment outcomes, corroborated with ongoing research and analytics (step 2).

Portfolio construction and index implementation (step 3) are designed with a rule-based, systematic approach, and regularly validated during ongoing rebalances (step 4).

The strategy is subject to ongoing monitoring and review to ensure it is fit for purpose and in line with expected objectives and risk profile (step 5).

At the heart of the investment process, we believe risk management must be reflected in the underlying policies and governance, the evolution of the strategy and fund management insights.

What do you mean by links to investor practices?

Our factor strategies have been constructed to maintain the link between factor scores and capital allocation in a transparent manner.

In addition, practical elements of portfolio construction such as the consideration of transaction costs and turnover are incorporated into the index construction process. We expect this to enable the index to be replicated more closely in a live trading environment.

Is it possible to target ESG objectives within factor strategies?

We believe so. Factor strategies can be combined with ESG objectives, from broad ESG integration to more targeted objectives such as decarbonisation. For example, our flagship multifactor ESG strategies target an ESG portfolio score enhancement of 5% while retaining factor exposures.

Furthermore, in a recent blog and forthcoming paper we observe that highly diversified global style and factor portfolios can preserve factor characteristics and risk/return profiles after reducing carbon intensity.

Therefore, investors can achieve alignment with their net-zero or carbon intensity reduction commitments without necessarily compromising their return objectives.

Risk Management   Strategy Evolution   Fund Management

1. Investment goals

Establishing Factor Exposure, ESG Exposure, Minimum Exclusions and Other Investment Parameter

2. Research, Analytics & Data

Dedicated Factor & ESG Research Teams, Score Creations and Evolution, Custom Exclusions, Climate Impact Pledge, Market Research

3. Portfolio/ Index Construction

- Rules-based Index Calculated by Stoxx-ISS.
- The approach involves exclusions.
- Tilt
- Optimisation, setting Investment parameters and Capital Allocaton

4. Validation

Dedicated Factor & ESG Research Teams, Score Creations and Evolution, Custom Exclusions, Climate Impact Pledge, Market Research

5. Monitoring & Review

Independent Review of the Index/portfolio and Allocations

Rebalancing
Reflect the index changes in the fund

Whilst L&G has integrated Environmental, Social, and Governance (ESG) considerations into its investment decision -making and stewardship practices, this does not guarantee the achievement of responsible investing goals within funds that do not include specific ESG goals within their objectives.

Our factor strategies have been constructed to maintain the link between factor scores and capital allocation in a transparent manner.

Contact us:

For further information about the L&G Asset Management business, please visit am.landg.com or contact your usual L&G representative.

L&G Talks Asset Management

L&G Blogs Asset Management

Key Risks

The value of an investment and any income taken from it is not guaranteed and can go down as well as up, and the investor may get back less than the original amount invested. Past performance is not a guide to future performance.

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