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July 2018

The merits of multi-factor investing

UBS ETF On Track Research

- Factor investing has become a mainstream investment approach, with assets in factor ETFs exceeding USD 650bn globally.
- Indexed multi-factor portfolios have successfully delivered excess returns vis-à-vis market-cap-weighted portfolios over the long term (historical back-tests), as well as the more recent livetrack period.
- Multi-factor exposures tend to deliver return enhancement, whilst limiting the drawdowns and inherent cyclicality associated with single factors.
- Investors are increasingly adopting multi-factor ETFs as part of their core equities allocation. For this purpose, it is advisable to choose a multi-factor exposure that is well diversified and whose active share is not excessive.

Multi-factor investing

Multi-factor solutions provide investors with exposure to well-known equity factors such as Value, Size, Momentum, Quality etc. and therefore have the potential to outperform market-cap-weighted portfolios. They are ideal for investors who want to harvest factor premia in a simple solution, with lower active risk compared to individual factors. Multi-factor solutions also have considerably lower drawdowns and cyclicality compared to single factors and hence they are more suitable as a replacement of core equity allocations. As a result, demand for multi-factor ETFs continues to grow rapidly. In Q1 2018, they attracted USD 6.5bn globally, nearly 40% of all inflows into factor ETFs.

Our preferred multi-factor solution is based on the MSCI Select Factor Mix Index. It makes equal-weight allocations to six of the most established equity factors: Value, Size, Momentum, Quality, Yield, and Low Volatility (Figure 1). The index is rebalanced quarterly, which strikes a solid balance between turnover and maintaining factor parity, i.e. equal exposure to all six factors. The index follows a top-down allocation to individual factors, often called the "Lego" approach. It combines six individual portfolios,