

Markets Insight

Investors need to rethink the ‘factor’ approach

Portfolio management should be based more on themes such as innovation

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One topic that has struck me for the better part of my career is the fact that shelves of equity products and asset allocation frameworks are to this day based on a decades-old model.

This model has followed me in my career in different shapes and forms. Initially my financial economics classes required study of the Arbitrage Pricing Theory model proposed by Professor Stephen Ross of the Massachusetts Institute of Technology in 1976. This introduced the idea that a stock's return is driven by multiple systematic risk factors.

Eugene Fama and Kenneth French expanded on this model in 1992 by showing that three factors – market risk, size (small cap versus large cap) and style (growth versus value) – are related to stock returns. These models resurfaced in my work as a quantitative investor in pursuit of new factors that could be systematically harvested. Later, as an investor more focused on “fundamental” influences on valuation such as cash flow forecasts, I used the models to monitor and neutralise unwanted factor risk.

The impact of these models to the asset management industry has been profound. Many data vendors have institutionalised this framework by selling stocks' factor exposures. Morningstar introduced an influential 3x3 box guide in the 1990s to classify equity mutual funds for factors by size (small, mid, large) and style (value, blend, growth). This grid still defines most asset management product shelves: US large cap, European value, and Asia tech funds are common examples. This in turn has shaped the structure of invest-

ment firms which tend to be organised by asset class, country, sector, and styles.

Yet, over the past 20 years, these categories together explain less than half of the share price performance of companies in the MSCI All Country World index. Our research at UBS has shown that style factors such as value and growth account for only 3 per cent of stock performance. Country and industry play a larger role, together making up 21 per cent of stock returns.

The majority of returns, 52 per cent, are not explained by systematic factors. This does not mean that they do not play a role, but that there is room for a new and complementary investment lens. This, in my view, is focusing more on innovation that can transform the economy at scale, such as the internet.

Even style factors such as value or growth fall short of capturing such an impact. Growth style investing – which targets faster expanding companies – might appear to capture innovation, but it is often anchored to historical performance rather than forward potential. For example, the MSCI Growth Index relies on historical growth metrics among its criteria for stock selection.

Yet, a value investing strategy – which seeks stocks with relatively low valuations – hinges on future cash flows and if the future diverges sharply from today, those projections change. We have seen once strongly growing businesses fail when innovation rendered their products obsolete: for example, Kodak, when digital photography replaced film. This does not mean we should ignore valuations.

Quite the opposite: valuations must anchor every investment decision. The key question is whether stocks are under or overvalued based on future rather than past cash flows. That entails an understanding of structural shifts.

The bottom line is that the returns from transformational innovation do not necessarily align with the familiar categories of the factor model paradigm of the 1970s. The investment industry needs to adapt and rethink capital allocation and investment frameworks.

There will be different ideas in different firms on how to do this. At UBS Global Wealth Management, we now have global cross-sector teams focused on a few areas that we think will have lasting impact – AI, electrification and longevity. Many asset management firms have thematic teams that cover multiple themes at any point in time, and they often shift. Sometimes this approach can lean more toward capturing narrative-driven momentum.

We think it is better to look at where returns are really coming from and focus on two to three structural shifts presenting a decade-plus investment opportunity set. One only needs to look at how the development of AI is rapidly unfolding to see the potential impact on investment portfolios.

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