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Special Section Editor's Introduction for 2022 Special Issue on Factor Investing

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INTRODUCTION

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Welcome to the first special issue dedicated to factor investing. It is a testament to the subject's maturity that the articles avoid simply contributing to the growth of the already crowded "factor zoo." Indeed, the sheer number of existing factors, developed from the same essential dataset, means that skeptical eyes should greet any newly proposed factors.

The articles in this issue therefore focus on three groups of applications: first, how to navigate the factor zoo to determine which belong in a portfolio; next, factors in a portfolio context; and last, a reconsideration of value and growth.

The first topic bookends our edition. We start with "Factor Investing: From Theory to Practice," which argues for economic intuition along with testing across markets and asset classes as an alternative to raising the significance threshold for p-values in order to accept factors as valid. We end with "When Smart Beta Meets Machine Learning and Portfolio Optimization," which pursues a similar goal but with a completely different method. The article considers 87 factors and finds diversification superior to concentration. Furthermore, it shows that using machine learning methods to select among factors yields even more attractive results historically.

The second group of articles explores novel ways of using factors and developing key metrics to prudently implement factors in a portfolio. One article, "Measuring Sector Cyclicality: A Factor-Based Approach," offers an intriguing twist on a classic concept—how to define cyclicality. The authors compare static views of sector cyclicality to a more dynamic one informed by factor and find substantially better results from the former.

In a similar manner, "ESG Equity Index Investing: Don't Forget about Factor Exposures," uses factors as a means to better understand the returns associated with common environmental, social, and governance (ESG) indices in multiple markets. The research reveals that returns can largely be explained by common factors such as size and profitability; evidence of a meaningful, independent ESG factor is limited.

As practitioners consider how to incorporate factors into their portfolios, the question of portfolio construction naturally arises. This, of course, requires a solid process for estimating risk. In "Forecasting Long-Horizon Factor Volatility," the authors evaluate a variety of techniques and observe that the most sophisticated do well in-sample but struggle out-of-sample, while more-straightforward techniques largely possess the opposite characteristics.

The final set of articles seeks to deepen our understanding of two classic factors, value and growth. “Value’s Lost Decade: Learning from Value Strategies’ Behavior over Two Contrasting Decades,” investigates the causes of the factor’s extended underperformance through 2020. The authors note that enhancements to the value factor, such as capitalizing R&D, would have helped results, as would have considering time-series valuation alongside cross-sectional valuation (the two have a low correlation). Removing nonfactor exposures through the portfolio construction process would also have proven useful.

Continuing the value theme, “Long-Only Value Investing: Does Size Matter?” acknowledges that in long–short portfolios, smaller stocks have historically provided more significant returns than larger ones. However, on a long-only basis, the two size categories deliver similar returns even before accounting for the higher liquidity of large-cap stocks.

Growth investors often bridle at the notion that growth is frequently defined as anti-value. They will therefore find some comfort in “Redefining Growth: Using Analyst Forecasts to Transcend the Value–Growth Dichotomy (Part 1),” which reviews the definition of the factor. The article reveals that analyst growth forecasts explain future growth better than other measures such as profitability, historical growth, and most valuation measures.

We hope you will enjoy reading this set of articles and find ways to apply many of the concepts in your portfolios.