BLACKROCK INVESTMENT INSTITUTE

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Focusing on factors


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Today's low-return environment poses a challenge to investors. We believe investing through a lens of equity style factors – broad, persistent characteristics driving returns – can potentially help investors increase diversification and enhance returns relative to broad market exposure. We use the U.S. market as an example.

Highlights

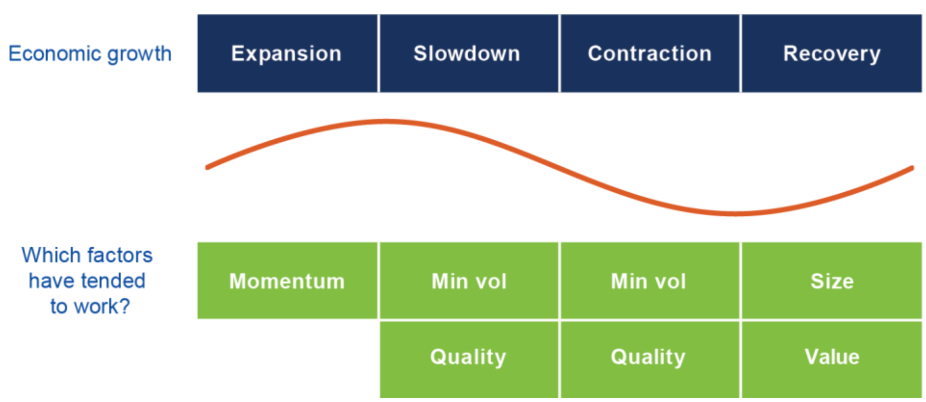
- We advocate "tilting", or adjusting exposure to various factors in a diversified multifactor portfolio. We believe economic regime is the biggest driver of equity style factor performance, although combining this with other indicators such as relative strength, valuation and dispersion can potentially produce better results.
- We prefer momentum (stocks trending higher) in today's economic environment. We also see potential for the value factor (the cheapest corners of the market) to perform well in coming quarters against a backdrop of stable cyclical expansion.
- How investors define factors can lead to different outcomes. Technology has the highest weight in "sector-neutral" value indexes, while the cheapest quintile in the U.S. equity market is dominated by the financial sector, for example.

Economy rules

The major equity style factors – value, quality, momentum, size and minimum volatility (min vol) – have behaved differently depending on the phase of the economic cycle. We believe there may be years left in the current expansion, as detailed in our latest *Global macro outlook*. Investors have historically been best rewarded for exposure to momentum in such phases, our analysis of factor performance since 1990 suggests. See the illustrative *In and out of style* chart. We also see potential for the value factor to perform well in the current environment. In periods of stable growth, market trends have historically tended to persist while confidence in value stocks rises.

In and out of style

Economic regimes and equity style factor performance



Source: BlackRock Investment Institute and BlackRock's Factor-based Strategies Group, May 2017.
Note: This is for illustrative purposes only and does not represent any actual fund or strategy performance. We define each factor above and throughout this piece using the relevant MSCI indexes: The MSCI USA Momentum Index (momentum), MSCI USA Minimum Volatility Index (min vol), MSCI USA Risk Weighted Index (size), MSCI USA Sector Neutral Quality Index (quality) and MSCI Enhanced Value Index (value).

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Collective power

Investors can potentially benefit from exposure to all five major equity style factors for diversification, but returns can be enhanced by tilting, or adjusting these exposures through the cycle, research from BlackRock's Factor-based Strategies Group suggests. Factor tilting, rather than short-term in-and-out timing, can help balance opportunities with the aim to improve returns without disrupting the long-term benefits of a diversified factor portfolio, in our view.

We use four indicators to determine whether to tilt toward or away from each factor in a multifactor portfolio. The first and most powerful of these is the *economic regime*, or the phase of the economic cycle, we believe. We identify the economic regime by analyzing a variety of coincident and leading economic indicators. The BlackRock GPS, which combines big data insights with traditional macro indicators, is one tool we use to keep track of the state of the economy.

In addition, we look at *valuation* to see whether the factor is expensive or cheap relative to its own history. *Relative strength* measures whether the factor has had strong recent performance. And lastly, *dispersion* measures the size of the opportunity set for each factor. More dispersion potentially creates more opportunities to generate excess returns.

Each of the four indicators we look at is valuable on its own, but we believe it is even more effective to combine these four insights into a composite indicator. This tells us whether to under-, over- or neutral-weight each factor, while still maintaining diversified exposure to *all* the factors over time. It is all about tilting, not timing, we believe.

About style factors

Style factors are broad, persistent forces driving returns of stocks, bonds and other assets. We focus on five equity style factors:

Value: securities that are inexpensive relative to fundamentals.

Momentum: securities with improving prices or market sentiment.

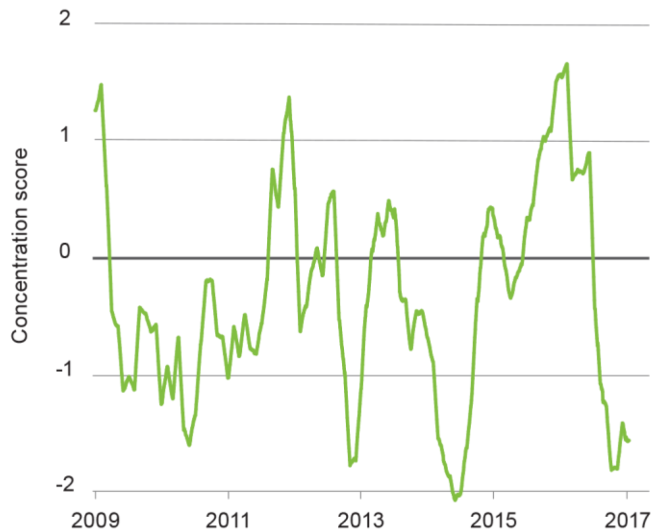
Quality: securities with stable and high-quality earnings.

Minimum volatility (min vol): securities with lower volatility.

Size: favoring smaller companies over ones of larger capitalization.

Good for momentum

Momentum concentration score, 2009-2017



Sources: BlackRock Investment Institute and BlackRock's SAE team, May 2017. Notes: The score is a measure of the concentration of an illustrative momentum-based stock selection strategy. We analyze typical drivers of stock momentum such as country, industry and interest rates. High concentration means the momentum trend is highly concentrated in a small number of these drivers. Low concentration implies a broader set of drivers behind the trend, making it more robust. The score is a regression of stock-level momentum exposures versus a number of potential drivers over the post-crisis 2009-2017 period. The score is in standard deviations, a measure of the dispersion around the historical mean. This is for illustrative purposes only and does not represent any actual fund or strategy performance.

Time to shine

Today's expansionary economic regime favors risk-seeking factors over defensive ones, we believe. Momentum's prospects have brightened again, after underperforming in 2016 due to several sharp rotations in market leadership, analysis by BlackRock's Scientific Active Equity (SAE) team shows. We see an unusually broad set of drivers (low concentration) behind momentum today, showing a stronger trend behind the factor. See the *Good for momentum* chart. Steady growth could potentially help extend such strength.

We also like the value factor and see it regaining favor over coming quarters thanks to a stable economic outlook. Value, as represented by the MSCI Enhanced Value Index, has been the best performer of the five major style factors since 2001, beating the MSCI USA by some four percentage points annually, MSCI data show. Yet it has lagged other style factors this year, partly on lower expectations for fiscal stimulus and a rotation toward long-term growth themes.

Momentum and value have had a small negative correlation over the past two decades, our analysis of MSCI index data shows. Yet the relationship is not static – and we see the current economic regime supporting both factors in coming quarters. We see the valuations of both factors as fair. Quality and min vol have historically tended to outperform in economic decelerations, as the chart on the first page shows. But we believe these factors can provide some diversification throughout the cycle to cushion against volatility. The performance of size may depend on U.S. politics. Further delays in tax reform could dampen interest in these more domestically geared companies.

Under the hood

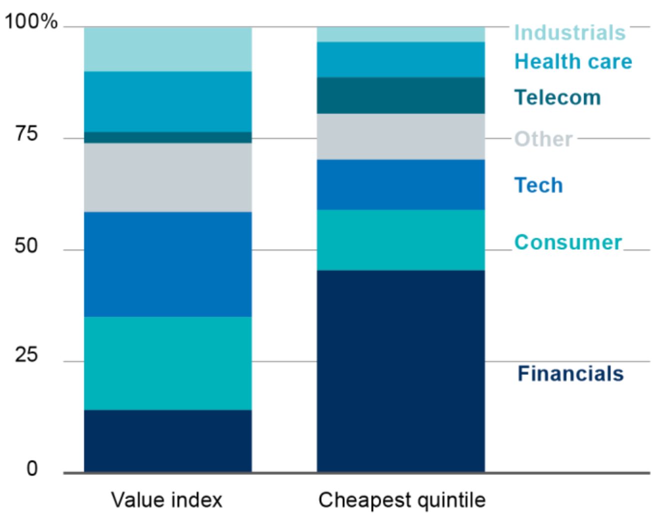
How investors define and implement style factors can lead to very different outcomes. Take the value factor. A simple approach might be to pick the cheapest stocks in the market based on metrics such as price to earnings, price to book, and enterprise value to operating cash flow. The cheapest quintile in the MSCI USA Index had 46% of its weight in financials at end-April, compared with the 14% weight the sector had in the overall index, MSCI data show. Investors who expect higher interest rates, steeper yield curves and deregulation in the U.S. to back earnings growth in financials may consider exposure to value defined this way.

Investors seeking to avoid concentrated sector bets and to isolate a factor's characteristics could consider tracking a "sector-neutral" index such as the MSCI USA Enhanced Value Index. This index roughly mimics the sector weights of the MSCI USA Index, and selects the cheapest stocks *within* each sector. Technology took over as the largest sector on this value index due to its dominance in the parent index. See the *Finding value in financials* chart. The MSCI USA Sector Neutral Quality Index applies the same framework on stocks with low leverage, stable earnings and high profitability. We prefer the sector-neutral approach for value and quality, as adopted by the MSCI indexes, as it isolates the specific characteristics of the two style factors.

Investors in momentum and size traditionally seek to gain exposure to these factors without regard for sector concentration. Unlike for value, quality and min vol, the MSCI indexes for these factors do not aim to be roughly sector-neutral. As a result, the sector weights for these two factors may vary significantly from market-cap weighted indexes.

Finding value in financials

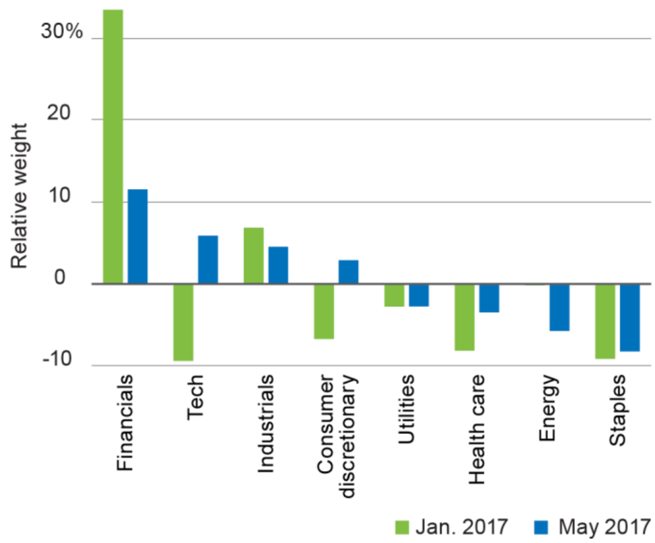
MSCI USA cheap quintile vs. value index sector share, 2017



Source: BlackRock Investment Institute, MSCI and Thomson Reuters, May 2017. Notes: The cheapest quintile refers to the cheapest quintile of stocks in the MSCI USA Index, calculated based on the composite z-score of 12-month forward price-to-earnings, price-to-book, and enterprise value to cash flow from operations ratios of the index's components. Value index refers to the MSCI USA Enhanced Value Index. Consumer includes consumer staple and discretionary. Other includes real estate, utilities, energy and materials.

A fickle factor

MSCI USA momentum quintile relative sector weights, 2017



Source: BlackRock Investment Institute and MSCI, May 2017. Notes: Each bar indicates the sector's market weight in the highest-momentum quintile of the MSCI USA Index minus its weight in the MSCI USA Index. A positive number indicates the sector has a higher weight in the highest-momentum quintile than in the overall index.

Gauging the risks

The semi-annual rebalancing of momentum indexes can change their sector weights dramatically as market leadership swings rapidly. There can be big shifts between these rebalancings. Financials made up 47% of the highest-momentum quintile of the MSCI USA Index at end-January, over 30 percentage points higher than their share in the overall index, our analysis shows. By May, financials' relative sector weight had been cut by two-thirds. See the *A fickle factor* chart.

So what are the risks? Momentum investors should keep an eye on market breadth, we believe. This is a measure of the sustainability of the market trend, which measures the number of advancing stocks relative to the number declining. Our analysis shows that nearly 80% of the names in the each of the major U.S., European and Japanese markets were trading above their one-year moving average as of mid-May. U.S. equity markets have posted solid gains in the six to 12 months following this level of breadth, our analysis of S&P 500 data since 1990 shows. We find similar results for other markets. Robust earnings growth in the first quarter reinforced our view that the breadth of equity performance can be sustained.

We see an unexpected economic regime change as the major risk to value. Lower growth and inflation would weaken the fundamental outlook for cheaper stocks. Other risks: a derailing of U.S. tax reform and a slump in already low corporate investment. Business investment crept up in the first quarter, but at below the 5-6% annual pace seen in the years after the financial crisis, U.S. Department of Commerce data.

Our bottom line: We believe factor tilting is worth considering as a strategy aimed at boosting returns and diversification. We prefer the momentum and value factors in the current environment, but caution that how investors implement them could lead to different outcomes.

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