ALPHA THRIVES WHEN MARKETS MISBEHAVE

WHEN WILL FACTOR INVESTING LOSE ITS ADVANTAGE? WHEN MARKETS STOP MISBEHAVING. WHICH MAY BE NEVER.

Convention goes that once enough investors become wise to an investing advantage that creates alpha, they act rationally by piling on quickly and ruining it. So why hasn’t that happened to factors, which have been producing alpha for decades? For one, factor investing is difficult. It takes years of experience and the right approach. But just as important, investors are human, and human nature doesn’t perish easily.

WHY DO FACTORS WORK?

Research shows that certain kinds of stocks have outperformed the broad market on a risk-adjusted basis over the past 50 years. These include companies that are undervalued or small, have consistently rising stock prices, are less volatile, or are efficiently managed and consistently profitable. In other words, five important equity factors: value, small size, momentum, low volatility and quality.

But this is a case where the “what” is relatively easy, and we think investors will feel even more comfortable if they understand “why.” The answer is admittedly more of a challenge. There are a number of theories...
thrown around but we think the underlying forces are behavioral. Investors simply don’t act as rationally as they should. This is hotly debated, since it’s against the assumption in modern finance that investors are always rational. But we think if investors were always rational, then the factor advantage would have been finished a while ago. Here are some of the most common behavioral explanations for the five factors, based on our survey of research:

- **Value**: Investors think recent bad stock performance means the worst is yet to come. They are ignored, and so the stock falls further to the point of being undervalued. The mispricing eventually reverts, resulting in outperformance.

- **Small size**: Investors in equity funds have a preference towards stocks with high visibility and low transaction costs, causing small-cap stocks to be undervalued relative to large caps.

- **Momentum**: Hot stocks create a herd mentality, pushing the stock prices even higher even when not warranted by fundamentals. Excitement around the performance may cause investors to ignore new negative information about the companies and outperformance persists.

- **Low Volatility**: Investor overconfidence in the ability of high volatility stocks to earn outsized returns means they are over-valued versus lower volatility stocks, which become undervalued. Restrictions against investors using leverage to enhance performance also may lead them to over-value higher beta stocks to increase returns.

- **Quality**: Investors over-value lower quality companies that expand and grow quickly, which may result in too much debt and low cash earnings. As a result, slower-growing but fundamentally solid quality companies fall under the radar and become undervalued.

**FACTORS HAVEN’T LOST THEIR ADVANTAGE**

We think these investor biases should add to investors’ understanding of the continued outperformance of select factors versus the broad equity market over the long-term. Still, factor investing requires skill, as they do suffer from **cyclicality** and **noise** that may dilute their effectiveness. To make these long-term behavioral advantages work in a portfolio, **factor strategies** should be cost-efficient, perform as designed, take intentional compensated risks and improve asset allocation through purer factor exposures.

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Learn more in our new paper *Foundations in Factors* for a detailed analysis on the evolution of factors, implications for investors, the perils of cyclicality, and diversity within and across factors.