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Factor Investing: 2018 Landscape

Growth expected to continue

The factor investing landscape has proliferated in recent years. Today, the factor industry is $1.9 trillion in AUM and has grown organically at around 11% per year since 2011.[1]

We project it will grow at a similar organic rate over the next five years, reaching $3.4 trillion by 2022. The expanding industry has seen significant new numbers of players, with assets largely dominated in three major market segments: smart beta, proprietary factors, and enhanced factor strategies.

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What are factors?

Factors are broad, persistent drivers of return, characterized by long-run excess returns within and across asset classes. Factor-based investing targets these intuitive investment styles, taking advantage of economic insight, diversification, efficient execution, and advancements in data and technology.

Factors have the potential to revolutionize the investment landscape. Just as the indexing revolution equipped investors and advisors with the tools to engage in strategic asset allocation, factors have the same potential to transform the way that investors allocate capital, diversify risk, and seek long-term performance.

How are factors used?

Today, most institutions allocate investments in their portfolios along asset classes. This approach can double count risks and often does not lead to the true diversification that investors need. The portfolio of the future will be constructed in a much more factor-aware way. Based on the questions we have been fielding from clients, we expect that most institutions will complement their asset views with a factor lens within five years — and a significant fraction will be using factors directly to construct more robust portfolios and to meet specific investment outcomes.

Although quantitative techniques are essential in harvesting factors, factor investing differs from systematic alpha-seeking strategies in that factor investing targets academically established, broad and persistent sources of returns. In the case of Smart Beta, these factors can be captured using transparent, index-based strategies; while proprietary and enhanced factor offerings build upon that approach in dynamically managed strategies.

In contrast, systematic alpha-seeking strategies use unique insights, unstructured data and advanced quantitative techniques in targeting additional returns above and beyond factors.

Today, the factor industry is $1.9 trillion in AUM and is projected to grow at a similar organic rate on top of potential future market appreciation over the next five years, reaching $3.4 trillion by 2022. There are a series of structural tailwinds fueling the growth of factor investing. Factor investing leverages transparent, low-cost, proven drivers of long-term returns. These qualities are increasingly important given our slower long-term growth environment, as well as greater client and regulatory scrutiny on fees and transparency. The academic foundation of factors makes them well suited for today's environment, emphasizing well-defined, intuitive investment processes, repeatability, and scale.

As with any future projections, anticipated growth is contingent upon the continuation of these industry trends in stimulating client interest and demand. Actual growth into the category may also be hampered by significant under-performance of factor strategies versus market capitalization benchmarks, among other potential market or structural influences.

Dive into factors

Factors are broad and persistent drivers of return. All factors have an underlying economic rationale that has driven their historical performance. These are:

1. **Rewarded risk:** Earning higher long-term returns as a reward for taking on more risk
2. **Structural impediment:** Finding opportunities created by market rules or constraints on certain investors
3. **Investors' biases:** Uncovering contrarian opportunities generated by investors not acting rationally

There are two major forms of factors:

Macro factors

Macro factors, such as economic growth, inflation and real rates, explain return variations across asset classes. Macro factors are reflected in the returns of broad asset classes where, for example, both developed markets and emerging market equities tend to do well when global economic growth is strong. The effects of real rates and inflation are observed in both public fixed income markets and private real estate.

Style factors

Style factors explain return variations within asset classes, referring to the tendency of certain groups of securities to outperform the market on a risk-adjusted basis. For example, securities with low prices relative to intrinsic value (value investing) or trending securities (momentum) have tended to outperform the market and their effects are observed in equities, fixed income, foreign exchange, and commodities.

Six key macro factors in explaining major return patterns across asset classes:

Economic growth: Taking on the risk of economic uncertainty

Credit: Taking on default risk

Real rates: Taking on the risk of interest rate movements

Emerging markets: Taking on political and sovereign risks

Inflation: Taking on the risk of changes in inflation

Liquidity: Holding illiquid assets

Style factors in explaining major return patterns within asset classes such as equities, fixed income and commodities:

Value: Buying securities at a discount to their fundamental value

Size: Thinking that small companies tend to outperform large ones

Momentum: Following upward price tends

Minimum volatility: Investing in lower-risk securities

Quality: Seeking financially healthy companies

Carry: Getting an income incentive to invest in riskier securities

Types of factor investing

The factor investing space is one of the fastest growing areas in asset management. It has experienced 11% organic asset growth over the past five years in comparison to low single digits for the asset management industry as a whole.[2]

There are three major forms of factor investing:

Smart Beta

Factor investing implemented with transparent, rules-based index exposures, which are largely ETFs but include custom index exposure mandates

Example: smart beta ETF

Sample client need:
May be used to seek enhanced returns or reduced risk relative to a market-capitalization benchmark or to replace underperforming traditional mutual funds

Proprietary Factors

Implemented in a long only fashion and dynamically managed rather than following pre-set index rules. Insights driven by the provider's own research in defining and constructing factor strategies to seek excess returns

Example: factor-based mutual fund

Sample client need:
Similar to smart beta, may be used to seek enhanced returns to complement traditional active and index strategies

Enhanced Factors

This category, which includes risk parity and style premia funds, is dynamically managed and may be long-short and multi-asset

Example: absolute return, long-short, multi-asset style premia fund

Sample client need:
May be used when seeking lower- or zero-correlation returns in portfolio context or used to replace hedge fund allocations

The smart beta and proprietary factor market segments are primarily concentrated in equities, but the multi-asset applications are growing, especially in fixed income.

Market dynamics and trends

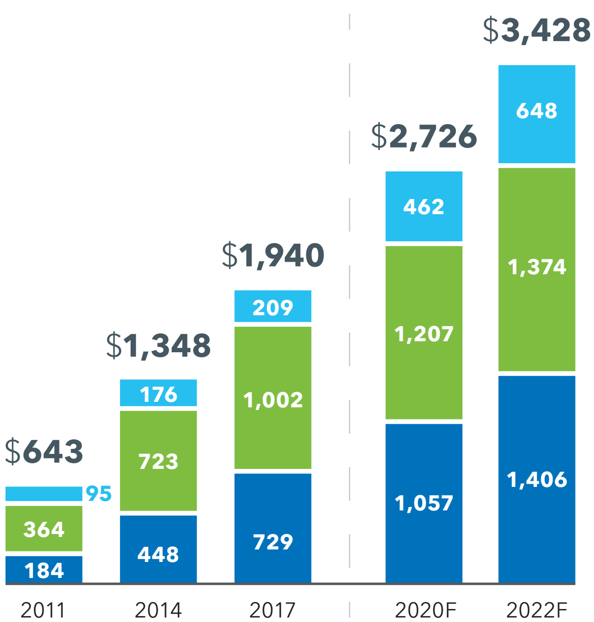
We forecast future growth of the factor industry at least at the same, and likely higher, than current growth rates. Independent of future market movements, we anticipate that the factor industry will grow at a similar organic rate over the next five years, reaching $3.4 trillion by 2022.

- Besides organic growth, we believe growth into the factors industry to be contingent upon three key drivers:
  - Shifting from traditional market capitalization index into factors
  - Shifting underperforming alpha-seeking strategies to factors
  - Making factors an essential element of portfolio construction

The first two drivers have elevated growth thus far, but in the future, we expect that integration of factors into portfolio construction will be a significant driver. Traditional portfolio construction currently centers around asset classes and manager selection. Making factors an essential aspect of portfolio construction will introduce factors to a whole new universe of clients, and allow factors to be used at the core of the portfolio – complementing or replacing market-capitalization strategies or underperforming alpha-seeking products.

The increasingly competitive factors industry has experienced double-digit growth, with particular strength in equity smart beta

Industry factors AUM ($B)



Organic growth	'11 - '17	'18 -'22F
Enhanced	14%	20%
Prop. Factors	6%	7%
Smart Beta	19%	14%
Total	**11%**	**12%**

Source: BlackRock, Simfund for mutual fund data, BlackRock for ETF data, eVestment and Preqin for institutional and alternative data. Mutual fund and ETF data as of 12/31/17, eVestment and Preqin as of 9/30/17. Excludes fund of funds. Enhanced factors data is likely underrepresented given limitations of institutional and alternative data sources. Projections exclude the impact of beta.

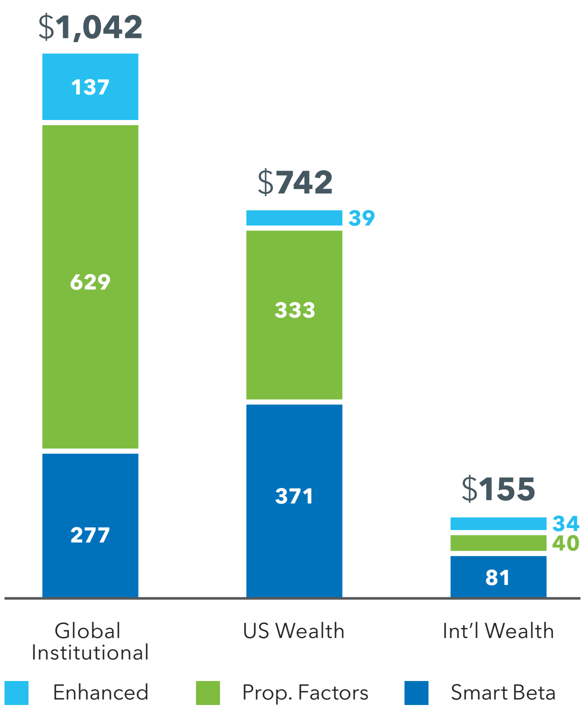
In contrast to more traditional areas of asset management, the bulk of investment in factors tends to be in a handful of firms, with the top five players constituting nearly 60% of industry AUM.

This is particularly true in the Proprietary Factors category (where the top five players hold nearly 90% of AUM) and Enhanced category (where the top five players hold 80% of AUM). The Smart Beta category is slightly more fragmented given the proliferation of entries into the smart beta ETF space, with 67 new smart beta ETFs launched since 2017 alone. That said, the top five players still hold over 50% of AUM. There is no one player who has a significant presence across all three categories.[3]

Channel dynamics

The industry landscape is split between global institutional assets (54% share), U.S. Wealth (38%), and International Wealth (8%). Factor product adoption differs in each market.

Industry factors 2017 AUM by channel ($B)



Source: BlackRock, Simfund for mutual fund data, BlackRock for ETF data, eVestment and Preqin for institutional and alternative data. Mutual fund and ETF data as of 12/31/17, eVestment and Preqin as of 9/30/17. Excludes fund of funds. Enhanced factors data is likely underrepresented given limitations of institutional and alternative data sources.

- The Global Institutional ($1 trillion AUM) channel accounts for a disproportionate share of Enhanced Factor Strategies. Global Institutions may use Proprietary Factor Strategies to seek absolute returns or to complement or replace hedge funds and traditional equities.
- U.S. Wealth ($742 billion AUM) is the fastest growing channel due to the dominance of rapid smart beta ETF adoption. Smart beta ETFs are being used to replace underperforming alpha seeking managers, and seek enhanced returns or reduced risk versus core equities.
- International Wealth ($155 billion AUM) is a smaller but growing market with a mix of all three forms of factor products.

CONCLUSION

In closing, factors are broad, persistent drivers of return that have the potential to transform the way investors achieve their long-term objectives in the most cost-effective and risk-conscious manner.

Both structural and cyclical forces have driven rapid adoption in recent years, and factors are expected to continue their trajectory of growth, given a projected slower long-term growth environment, as well as greater client and regulatory scrutiny on fees and transparency.

These forces, coupled with the academic foundation of factors, which emphasizes well-defined, intuitive investment processes, repeatability, and scale, make today's environment particularly exciting for factor-based strategies.

Want to know more?

blackrock.com/factors

1 Source: BlackRock, as of 12/31/17. **2** Source: BlackRock analysis with data from McKinsey, Simfund, iShares, eVestment and Preqin. **3** Analysis of factor investing firms is BlackRock's, using data sources for chart on page 5.

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