

FACTOR 101



iShares
by BlackRock

The What, Why and How of Factor Investing

Factors are everywhere...

They are not new; and they have explained large parts of market returns in the past, and as a result, also in your portfolio. Conscious investors are aware of their factor tilts and use them to enhance returns, reduce risk, or seek greater diversification in their portfolios. But **what** are factors, **why** do they exist, and **how** can investors deliberately target them?

In the world of investing, we often focus on tangible elements like sectors, industries, countries, and currencies. These are easy to understand - when you buy a stock, you know its currency, the country where it's listed, and the sector and industry in which the business operates. But there's another element that's equally important yet sometimes overlooked: factors.

Unlike sectors, industries, or countries which are binary relations—a company belongs to one sector and not others, one industry and not others, and is domiciled in one country and not others—factor exposures aren't just one or zero. This means you can have positive exposure across all factors or negative exposure across all factors.

Over the long run, positive exposure to rewarded factors have historically been associated with higher returns.

Factors are expected to yield a premium in excess of broad market returns because they are based on economic rationales.

What are factors?

Factors are broad and persistent sources of returns that explain the performance of different stocks, bonds, and other assets.

Factors are intuitive investment styles that investors have long used to seek excess returns. Traditionally, the best investors have always sought to find cheap stocks, stocks with high quality earnings, and stocks with prices that are trended up. Investors have also traditionally preferred to gravitate to safety with minimum volatility strategies and to have exposure to smaller stocks that have historically had higher returns.

These investment styles are the five style factors that BlackRock makes available in low-cost, transparent ETFs.¹

Value: Investors have always loved a bargain—lower relative-priced securities






Small size: smaller firms

Quality: more profitable companies with more stable earnings

Momentum: stocks with upward-trending prices

Minimum volatility: firms with lower volatilities

Therefore, factor exposures should be measured, managed, and made explicit rather than being an implicit by-product of your portfolio.

	Factor	Rationale	Measured By
	Value	Inexpensive stocks relative to fundamentals	<ul style="list-style-type: none"> •Low price/ forward earnings •Low price/book •Low enterprise value/cash flow from operations
	Quality	Companies with healthy balance sheets	<ul style="list-style-type: none"> •High return on equity •Low earnings variability •Low debt to equity
	Size	Smaller, more nimble companies	<ul style="list-style-type: none"> •Low market capitalization
	Momentum	Stocks on an upswing	<ul style="list-style-type: none"> •High 6-month price momentum •High 12-month price momentum
	Min Vol	Lower risk, more stable stocks	<ul style="list-style-type: none"> •Low stock price volatility

iShares.com

¹See Ang, A., 2014. Asset Management: A Systematic Approach to Factor Investing, Oxford University Press.

Why do factors exist?






Factors are not new concepts. They have been studied and documented by academic researchers for decades, and have been used by sophisticated investors for generations. In fact, six Nobel prizes in economics have been awarded to researchers who have contributed to the field of factor investing.

Understanding the economic rationale behind a factor’s past existence can help determine its likelihood of persisting in the future. Without this underpinning, a “factor” may merely be an artifact of data mining and unlikely to persist. There are three economic reasons why factor premiums have been historically observed:

Reward for bearing risk: Some factors, like the value factor, have high long-run returns to compensate investors for bearing short-term cyclical losses at some periods of time. Such a drawdown for value has happened during the covid drawdown in 2020.

Structural impediments: Market structure or restrictions on institutions’ investment strategies can lead certain types of stocks to be weighted more heavily in portfolios. For example, certain investors have high return targets leading them to over-weight high volatility stocks giving rise to the minimum volatility factor

Behavioral bias: Individuals can exacerbate trends by not fully reflecting all available information. This can give rise to the momentum premium. Investors might also mistake past high growth and over-estimate future growth potential, leading to the value premium.

Economic rationales	
 Value	<p>Rewarded risk: Value firms may have lower investor expectations and/or to have higher fixed costs, making them less flexible in the short-term</p> <p>Behavioral bias: Investors can mistake past performance for future prospects or over-estimate growth potential</p>
 Quality	<p>Behavioral bias: Not all earnings are created equal, and investors may be distracted from consistency and composition by top-line earnings or perceived growth potential</p>
 Momentum	<p>Rewarded risk: Momentum sometimes crashes when price trends reverse</p> <p>Behavioral bias: Investors overreact to their own success/failure and pile in/out of trends</p>
 Minimum Volatility	<p>Structural impediments: Lower-risk stocks can be underpriced due to leverage-constrained investors</p> <p>Behavioral bias: Lower-risk stocks can be overlooked as investors look for the “next big thing”, also called the “lottery effect”</p>
 Low Size	<p>Rewarded risk: Smaller companies can be more exposed to business cycle contractions and are typically less liquid than large stocks</p>

How can investors know if they are exposed to factors?

It’s important to understand that your portfolio already has factor exposure. For instance, if you hold an active portfolio of value managers, then potentially adding quality or minimum volatility—exposures that typical value managers don’t have—can be diversifying. When you invest in the S&P 500, that index currently has larger exposure to quality because of that index’s higher concentration in the technology sector, which typically scores well on quality metrics. Conversely, the MSCI EMU provides greater exposure to value.

Therefore, whether you realize it or not, factors are already in your portfolio. The question is whether you choose to deliberately allocate to these premiums or control for them. For those interested in exploring this further, a free BlackRock tool called [“What’s in your Benchmark”](#) can provide insights into which factors your Benchmark is currently exposed to.

How can investors access factors?

Investors can access factors in a variety of ways, with their methods often dictated by their individual objectives, preferences, and constraints.

While the investment insights behind factors—buying cheap, finding trends, holding high-quality stocks, stocks with lower risk, and smaller companies—are decades old, what is new today is the availability to harvest these factor premiums in low-cost, transparent funds and ETFs.

To intentionally access factor tilts "on-demand", many investors opt for the convenience of ETF wrappers. Factor ETFs function similarly to any other Equity ETF, in that they track indices designed to capture the performance of specific factors or combinations thereof in multi-factor ETFs. The unique aspect here is the intent to enhance returns or reduce risk relative to the broad market (for example, the MSCI Europe for European Factor Strategies).

Factors provide differentiated portfolio outcomes



Factors are not without risk

Factors also carry inherent risks. It's important to state that not everyone can invest in factors—for every value investor who holds cheap stocks, there must be an investor who holds expensive stocks. Factor investing, by its very nature, deviates from market weights. If everyone were to invest in factors, with no one willing to take the opposite stance, prices would adjust until they aligned with market weights, causing the premium to vanish. Hence, the economic rationales are so important for factors—they give structural reasons why these factor premiums may continue to exist.

Style factor premiums are not a risk-free source of higher returns. Instead, they offer compensation for bearing additional risk or unpopular characteristics associated with it. In other words, the economic underpinnings give a reason that some investors avoid holding stocks associated with these factors. For instance, let's consider the value factor. Some stocks that are cheap remain cheap. Some cheap stocks experience short-term drawdowns. These are potential short-term risks for a value investor—but being exposed to these potential losses may lead to higher returns in the long run.

Conclusion

Factors are everywhere in the financial markets, but they are oftentimes overlooked. By using a factor-based approach to portfolio construction, investors can

- **better understand the drivers of their returns,**
- **be more explicit about their exposures,** and
- **build more robust and resilient portfolios.**

Factor investing is not a fad—it is a rational and evidence-based way of enhancing return, reducing risk, or enhancing diversification in the long run.

While sectors, industries, countries, and currencies do matter, factors are equally and sometimes even more important. Factors are vital components in your portfolio because historically they have been rewarded with higher returns.

So next time you're considering your investment strategy, don't forget to factor in... well, factors!

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