TD Global Investment Solutions

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Try and Catch the Wind

In recent years, many investors have taken to thinking about their equity holdings primarily in terms of their style factor exposures, such as size, growth, or value. Investing in “factors” seemed to offer a cleaner way to generate returns, without the messiness of worrying about individual stocks and their idiosyncratic behavior. In our 2018 white paper, The Limits of Theory, we gave our own perspective on this way of thinking:

> *But many investment practitioners have become so enamored of this theoretical framework that they reverse cause and effect in the way they think about the world. They seem to think that a stock did well because it had exposure to certain factors that did well, as if the factor returns have an independent existence of their own out in the cosmic ether, apart from the success or failure of the underlying companies. But stocks are more than a collection of statistics such as mean return, variance, or a set of factor exposures...[T]hey are actual businesses. Their success or failure as businesses, which is dependent on their ability to meet the needs of customers and to allocate their cash flow sensibly, ultimately drives their stock price higher or lower. And it is the success or failure of actual businesses in the real world that creates the theoretical factor returns through the resulting stock price movements. That is, company stock price movements drive factor returns; factor returns don’t drive company stock price movements. Or to put it yet another way, markets don’t reward or punish abstract factors; they reward or punish companies because of how well or poorly their business is doing, and that in turn creates what we end up measuring as “factor returns.” But we should never lose sight of the fact that those factor returns are a derivative. They are not the starting point.*

Last year provided a stark example of the limitations of focusing on factors rather than businesses. When market historians talk about 2023, the phrase that will undoubtedly pop up most often will be “magnificent seven.” Seven already well-known, already large-cap stocks generated returns ranging from 49% to 239% for the year, all well ahead of the MSCI World Index return of just under 24% (and ahead of the Russell 3000 Index’s 26% return in the U.S. as well). All seven stocks fall into the category of what people commonly refer to as “growth stocks,” and sure enough, the Growth sub-indices beat the Value sub-indices in both the MSCI World Index and the Russell 3000 Index by very wide margins, as a result of of the strong returns generated by the magnificent seven. MSCI World Growth was up 37%, compared to a 12% return for MSCI World Value. In the U.S., the Russell 3000 Growth Index gained 41% and the Russell 3000 Value Index rose 12%.

And yet…

When we look at 2023 through the lens of style factors, we find, rather remarkably, that "growth" as a factor had a negative return, and "value" had a positive return, at least as measured in the Axioma risk models. In the Axioma global equity risk model, the return to the growth factor for 2023 was -0.5%, while the return to the value factor was 3.9%. In the Axioma U.S. equity risk model, the return for the growth factor was -0.3% and the return to value was 5.1%. How do we reconcile these seemingly contradictory facts, and what does the answer to that question tell us in turn about "factor investing?"

The answer to the first question harks back to what we wrote six years ago. You can't buy factors in isolation; you can only buy stocks. And every stock comes with all sorts of baggage: not just its exposure to a single factor like value, but a whole set of factor exposures, not to mention industry exposure and plenty of stock specific risk. When you focus only on one factor and buy stocks with high exposure to that factor, you are getting all sorts of other exposures, whether you want them or not. And in the end, the impact of those other exposures, whether they be to factors, industries, or stock specific risk, can easily overwhelm the impact of the one factor exposure you were focusing on. That is exactly what happened in 2023 to the Value indices within the MSCI World Index and the Russell 3000 Index.

Figure 1: Performance Attribution: MSCI World Value Index vs. MSCI World Index December 31, 2022 – December 31, 2023

MSCI World Value
Benchmark: MSCI World
Reporting Currency: USD
Risk Model: Axioma World-Wide

Portfolio Return: 11.51
Benchmark Return: 23.79
Total Archive Return: -12.27

Factor Attribution

	Ending Managed Exposure	Ending Benchmark Exposure	Ending Active Exposure	Average Active Exposure	Compounded Factor Return	Compounded Factor Impact
Market	1.00	1.00	0.00	0.00	NA	-0.01
Style	0.59	0.34	0.24	0.07	NA	0.35
Dividend Yield	0.51	0.04	0.47	0.50	0.81	0.41
Earnings Yield	0.16	0.01	0.15	0.18	2.79	0.58
Exchange Rate Sensitivity	-0.01	0.06	-0.07	-0.01	-0.67	0.09
Growth	-0.19	-0.02	-0.17	-0.20	-0.52	0.15
Leverage	0.02	0.01	0.01	0.08	0.08	0.04
Liquidty	0.15	0.16	-0.01	0.01	2.46	0.00
Market Sensitivity	-0.24	0.04	-0.28	-0.31	3.23	-0.87
Medium-Term Momentum	0.10	-0.04	0.14	-0.11	1.47	-0.49
Profitability	-0.10	0.05	-0.15	-0.19	1.33	-0.29
Size	0.11	0.19	-0.08	-0.12	4.89	-0.61
Value	0.22	-0.04	0.26	0.29	3.85	1.22
Volatility	-0.15	-0.11	-0.03	-0.06	-0.14	0.12
Industry	1.00	1.00	0.00	0.00	NA	-4.73
Country	1.00	1.00	0.00	0.00	NA	0.01
Currency	1.00	1.00	0.00	0.00	NA	-0.11
Local	0.00	0.00	0.00	0.00	NA	0.00
[Unassigned]	0.00	0.00	0.00	0.00	NA	0.00
Total	**4.58**	**4.34**	**0.24**	**0.07**	**NA**	**-4.48**

Compounded Factor Impact	-4.48
Risk Stock Specific Effect	-7.79
Total Effect	-12.27

Source: Axioma, MSCI Inc.

Figure 1 shows the results of a performance attribution analysis for the MSCI World Value index relative to the MSCI World Index for 2023. The analysis breaks out the sources of relative return for the Value Index into various categories, including the impact of style factors, industry exposures, country and currency exposures, and, lastly, stock specific risk, i.e., anything that can not be explained by the exposures in the other categories. Take a look at the section on style factors. You can see, in the column labeled "Average Active Exposure," that the value index had an average active exposure of 0.29 to the value factor and -0.20 to the growth factor. The value index had positive exposures to two other value-related factors as well, dividend yield and earnings yield, both of which had positive returns as well for the year (see the column labeled "Compounded Factor Return"). And sure enough, the last column ("Compounded Factor Impact") tells us that the positive exposure to the value factor added 1.22% in relative return, and the positive exposures to dividend yield and earnings yield combined added another 0.99%. The negative exposure to growth kicked in another 0.15% in positive relative return. Put these four together and you have 2.36% in positive relative return for the value index's exposures to the various value and growth factors. Woohoo!

Unfortunately, those factor exposures were not the only contributors to relative return. Firstly, there were other style factor exposures which offset much of the outperformance generated by the value and growth exposures. The index had negative active exposures to four other factors – market sensitivity, medium-term momentum, profitability, and size – which combined to detract 2.26% from relative performance. And in truth, the value/growth profile of the index wasn't even close to being the biggest driver of relative performance. Industry exposures and stock specific risk had much bigger impacts, and both were negative. Industry exposures detracted 4.73% and stock specific risk detracted a whopping 7.79%. Value indices tend to have structural industry tilts – e.g., underweight in many technology industries, overweight in energy, financials, and utilities. All four of those tilts worked against the index in 2023. And as for the stock specific risk, the value index did not have positions in

Figure 2: Performance Attribution: Russell 3000 Value Index vs. Russell 3000 Index December 31, 2022 – December 31, 2023

Russell 3000 Value vs. Russell 3000
Benchmark: Russell 3000
Reporting Currency: USD
Risk Model: Axioma U.S.

Portfolio Return: 11.65
Benchmark Return: 25.95
Total Archive Return: -14.30

Factor Attribution

	Ending Managed Exposure	Ending Benchmark Exposure	Ending Active Exposure	Average Active Exposure	Compounded Factor Return	Contribution (% Return)
Market	1.00	1.00	0.00	0.00	NA	0.00
Style	-0.06	0.14	-0.20	-0.40	NA	-4.53
Dividend Yield	0.30	0.03	0.28	0.32	-1.24	-0.38
Earnings Yield	0.08	0.01	0.07	0.09	2.28	0.26
Exchange Rate Sensitivity	-0.14	0.00	-0.14	-0.10	4.47	-0.50
Growth	-0.19	-0.01	-0.18	-0.21	-0.25	0.09
Leverage	-0.10	0.00	-0.09	-0.05	-1.14	0.10
Liquidty	-0.03	0.00	-0.03	0.01	3.38	0.06
Market Sensitivity	-0.27	-0.03	-0.24	-0.29	8.37	-2.07
Medium-Term Momentum	0.11	0.01	0.09	-0.15	1.40	-0.40
MidCap	0.14	0.11	0.03	0.04	0.06	0.02
Profitability	-0.16	0.01	-0.17	-0.22	7.15	-1.69
Size	-0.11	0.01	-0.12	-0.18	7.00	-1.40
Value	0.25	0.00	0.25	0.28	5.24	1.62
Volitility	0.05	-0.01	0.06	0.05	-3.26	-0.24
Industry	1.00	1.00	0.00	0.00	NA	-3.87
Total	**1.94**	**2.14**	**-0.20**	**-0.40**	**NA**	**-8.40**

Compounded Factor Impact	-8.40
Risk Stock Specific Effect	-5.90
Total Effect	-14.30

Source: Axioma, Frank Russell Company ("Russel").

any of the magnificent seven stocks, and they were the seven biggest detractors in this category.

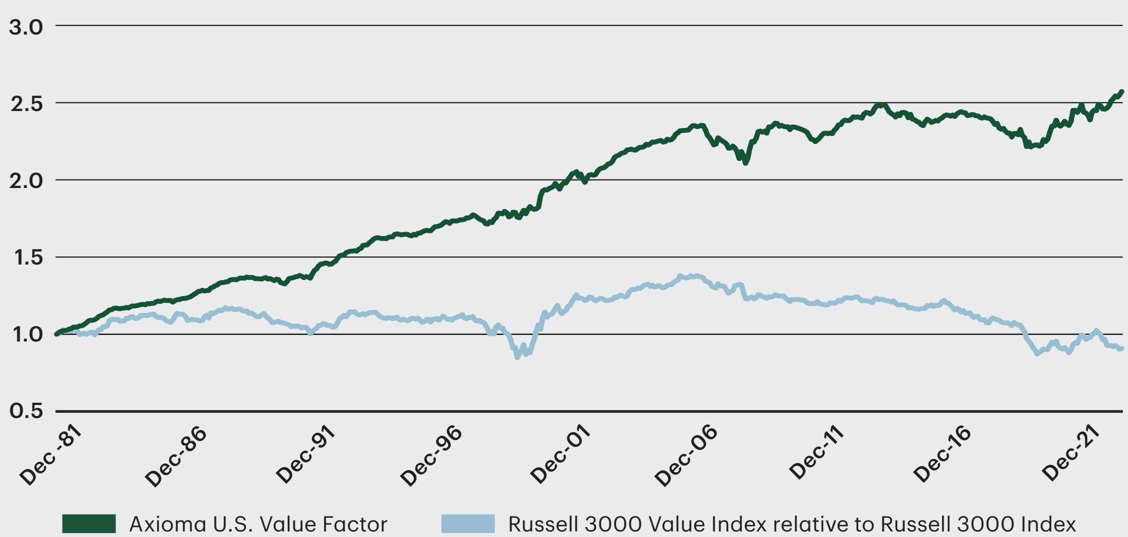
Figure 2 shows a similar analysis for the Russell 3000 Value Index relative to the overall Russell 3000 Index. Once again, the positive exposure to the value style factor was the biggest positive contributor to relative return among the style factors, adding 1.62%. But that influence was overwhelmingly drowned out, even within the style factor section of the attribution. The negative exposures to market sensitivity, profitability, and size combined to detract 5.16% from relative return. And here too, as was the case with the World Value Index, industry exposures and stock specific risk were both significant detractors as well (-3.87% and -5.90%, respectively).

The attribution analysis answers the first question we asked earlier, about how to reconcile the fact that Value indices did so poorly in a year when value as a factor had a positive return. Our second question was, what does this tell us about the concept of "factor investing" itself? To us, the lesson is straightforward: focusing on capturing factor returns in isolation is unlikely to work out well. When you look at what happened in equity markets over any time period, style factor returns are only a part of the picture; an interesting part, to be sure, and one that can provide useful insights, but usually far from the dominant driver of what went on.

In case you are thinking that perhaps we are overstating our case – that 2023 was an unusual year because of the extreme performance of the magnificent seven names, and that over the long run style factors really do explain a lot of what happens - consider **Figure 3**. Here we have plotted the cumulative performance of the value factor in the Axioma U.S. equity risk model. We are showing the U.S. data because it extends back farther than the data in the global risk model, more than 40 years. The chart also shows the cumulative relative performance of the Russell 3000 Value Index versus the overall Russell 3000 Index. You can see that the value risk factor has done quite well over the last 42 years, earning an annualized return of almost 2.3% per year. Yet the Russell 3000 Value Index has underperformed the Russell 3000 Index cumulatively over that span.

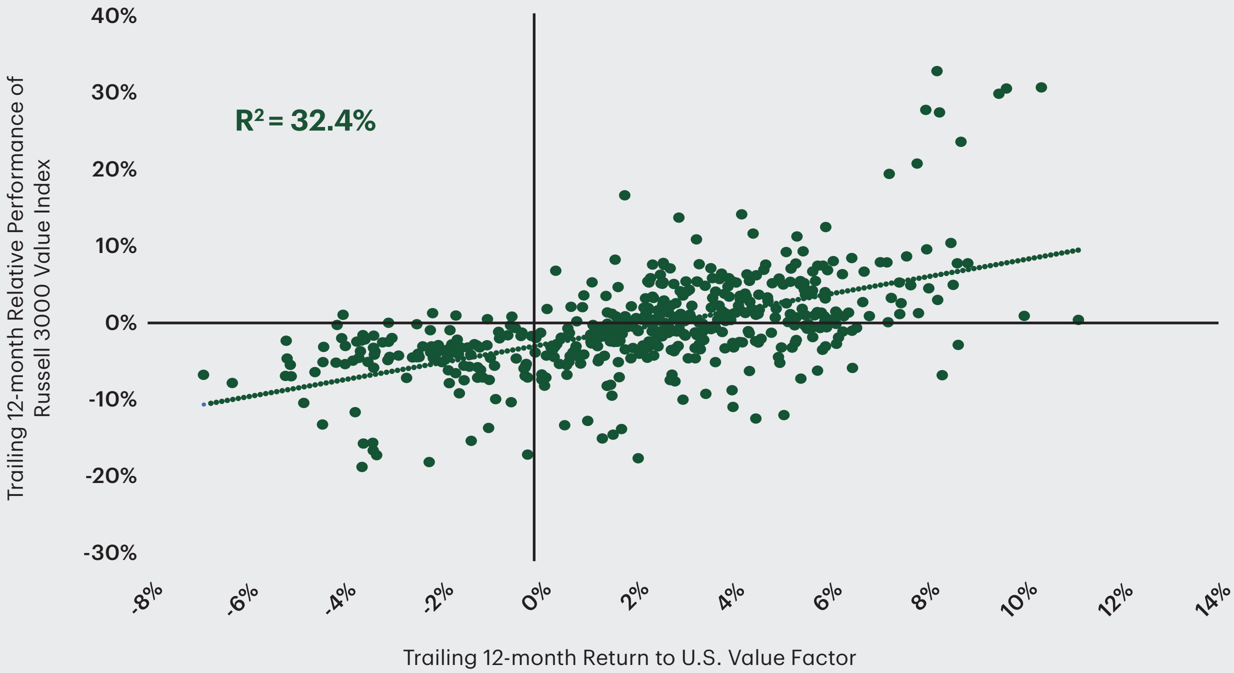
That's not to say that the performance of the value factor has no relationship to the relative performance of the Russell 3000 Value Index. In **Figure 4** we have plotted the relationship between rolling 12-month returns to the value factor and rolling 12-month relative performance of the Russell 3000 Value Index. The Russell 3000 Value Index definitely tends to perform better (relative to the overall Russell 3000 Index) when the value factor does well, and vice versa, as you can see by the trend line. But the R-squared for the relationship is only 32.4%, In other words, the variability in the value style factor returns explains just under one third of the variability in the relative performance of the Russell 3000 Value Index, which means that other things (i.e., industry returns and stock specific risk) explain just over two thirds of that variability. So yes, when you buy the Russell 3000 Value Index, you are definitely getting exposure to the value factor. The problem is, you are also getting exposure to lots

Figure 3: Cumulative Performance of the U.S. Value Factor vs. Relative Performance of the Russell 3000 Value Index.



Source: Axioma, Bloomberg Finance, L.P.

Figure 4: Rolling 12-Month Returns to U.S. Value Factor vs. Relative Performance of the Russell 3000 Value Index



Source: Axioma, Bloomberg Finance, L.P.

of other things, and over the long term, those other things have had twice as much influence on the relative performance of that value index as the value factor itself, and they have completely negated the positive return associated with value as a style factor.

As we wrote back in 2018, in the end you are buying businesses, not factors, and you should not lose sight of the fact that it will be the successes and disappointments of those businesses that will ultimately drive your portfolio's returns, more so than any common stylistic factor exposures we can tease out across different companies. To us, the whole idea of investing in factors brings to mind the lyrics that the pop singer Donovan sang many years ago: "Ah but I may as well try and catch the wind."

Learn more about TD Global Investment Solutions

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