Insights
Active Quantitative Equity (AQE)

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Capitalizing on Factor Performance

A diversified approach to factor investing is critical to achieve uniform factor exposure and payoff. Relying on a few lucky names tends not to yield optimal outcomes.

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During February, value factors were additive to the Active Quantitative Equity (AQE) team's portfolio performance in almost every region across equities. This prompted a series of questions for the team: Would the same observation be made for value style investing more generally? Would a fundamental manager with a value style and a concentrated portfolio also perform well? Not necessarily, we concluded. Stock selection always matters, though. When a factor performs "well" there is always nuance. The way the factor exposure transfers into portfolio holdings matters. Here we will highlight some of the results' nuances and illustrate how those nuances could lead to decidedly different outcomes for portfolios.

Value Versus Growth: Ambiguous in February

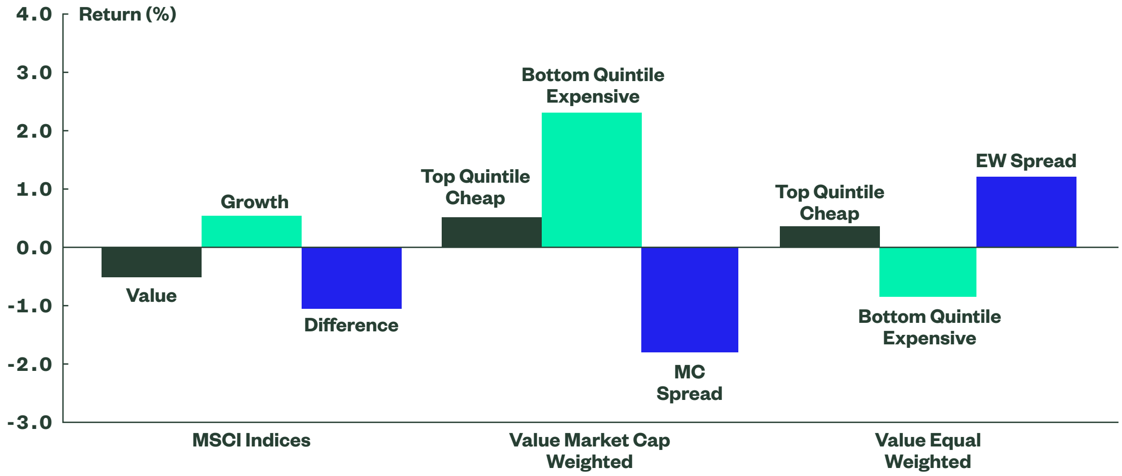
On the face of it, February looked like a month where the performance of value versus growth was not meaningful. In fact, if one was to compare two well profiled market capitalization-weighted (cap-weighted) indices — The MSCI World Value Index (returning -2.92%) and the MSCI World Growth Index (returning -1.87%) — one would conclude that growth outperformed value. From a cap-weighted perspective this observation would be true. However, this picture is clouded by a small number of large, high-profile names, and if evaluated on a more diversified basis, value signals performed quite well.

Keeping in line with the cap-weighted approach that drives index performance, we can compare the market cap-weighted quintile spread return of Value using our proprietary signal. Although the top quintile or cohort of good value names did outperform the broad market, it underperformed the most expensive group by 1.8% (market cap-weighted spread or MC spread in Figure 1). Does this mean that value did underperform growth? Upon further evaluation, we would say no, actually. If we take a more diversified and uniform approach to evaluating the signal strength of Value using an equal-weighted approach, we discover a positive return for the month, up 1.2% (equal-weighted spread or EW spread in Figure 1).

Return spreads are one way to assess the efficacy of a factor. Another way is by looking at the information coefficient of a signal. This is done by calculating the correlation of the factor with the realized forward stock returns. A positive information coefficient means the factor did a good job in predicting outperforming and underperforming stocks over a period. In February the information coefficient for Value was significant at +0.06. Quintile spreads provide a good indication of the success of the most extreme ends of a factor and the magnitude of those returns, whereas information coefficient is a higher breadth measure of factor effectiveness.

During February, the distribution of stock returns in developed markets had slightly positive skewness, and (as is usual for stock returns), fat tails (large extreme returns). With regards to growth versus value, the strong performance of companies such as NVDIA, Tesla, and Meta (to name a few) was significant in driving the difference between the cap-weighted versus equal-weighted return of the value theme.

Figure 1
Index, Quintile, and Spread Returns



Source: State Street Global Advisors, MSCI. Data as of February 28, 2023. All figures are returns for the month of February 2023.

The Bottom Line

The dynamics that played out in February are an example of how the transfer of factor exposure plays a key role in a strategy's ability to capitalize on factor performance. A high breadth exposure to value would have outperformed, whereas a concentrated exposure may well have underperformed. A diversified approach to factor investing is critical to achieve uniform factor exposure and payoff. Relying on a few lucky names tends not to yield optimal outcomes.

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