LEARNING MADE EASY

Factor Investing

for dummies®
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Use factor investing to build a cutting-edge portfolio

Beat the market without "timing" it

Manage risk and ride out market ups and downs

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by James Maendel and
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Factor Investing For Dummies®

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Introduction

Factor investing has been flying under the radar for decades as professional money managers have successfully used them for better investment portfolio management and performance. But now anyone can find out about what they are and how they can successfully improve your investment success. Many financial planners, advisors, and portfolio managers have turned to factors so they’re not flying blind in volatile and uncertain markets. A factor-based approach has the power to level the playing field.

Factor Investing For Dummies helps you make sense of what has been a tested and proven approach that professional money managers have kept secret for nearly a half century and still popular and proven in today’s turbulent markets.

About This Book

Factor investing is generally new to the public and it can be so valuable to anyone managing an investment portfolio, especially stocks and stock-related funds. This book is laid out so you can go from learning what factors are to how to use them and which ones work best in varying economic conditions.

The early part of the book goes in the basics of factors and the different kinds there are. There are factors designed to do well in periods of economic growth and those that hold up well in bad times. Style (or microeconomic) factors are tied to the strength of the individual stocks (and their underling companies), while macro factors are tied to the general economic environment. Stocks and funds with macro factors have a a better chance of succeeding versus the general stock market.

The book doesn't stop at just factors; it rounds out a more complete picture so you don't miss a beat with your overall factor-based investing approach. You will find out that factor-based ETFs and mutual funds can be an easy way to incorporate factors in your investment picture. Need income? See how factors can help you generate dividend income or use call and put options for added income from your portfolio. We don't want you to just generate good gains and income from your factor-based approach; we also want you to keep the fruits of your investment labor by showing you how to use brokerage orders and tax strategies. Lastly, the book offers a wealth of resources and sites so you can keep learning about the new innovations, strategies, and tactics for successful factor-based investing long after you read your last chapter.

Foolish Assumptions

In writing this book, we wondered what a potential reader would need to know to find this book interesting. Here are some of the assumptions we came up with about you:

- You have an interest in getting better at investing.
- You are a novice or intermediate portfolio manager seeking reliable ways to enhance portfolio performance.
- You have experience with the stock market but want to do better.

- You are a financial planner or financial consultant seeking better ways to manage stocks and ETFs for yourself or a client.

Icons Used in This Book

In the margins of the book, you'll find these icons helping you out:

TIP Whenever we provide a hint that makes an aspect of factor investing easier or potentially more successful, we mark it with a Tip icon.

REMEMBER The Remember icon marks paragraphs that contain a friendly reminder.

WARNING Heed the paragraphs marked with the Warning icon to avoid potential disaster.

Where to Go from Here

This book is designed so that you can quickly jump to a specific chapter or section that most interests you. You don't have to start with the first chapter — although if you're new to factor-based investing, we recommend that you do so. Understanding the foundation of factor-based investing (which we explain in the early chapters) helps you better apply the techniques that you learn in the later ones to the specifics of your investment activity.

The great thing with this book is that even if you are still not sure how best to incorporate factors in your investing approach, we include coverage of factor-based exchange-traded funds (ETFs) that could do the heavy lifting for you.

You can also find the cheat sheet, complete with additional nuggets of information, for this book by going to www.dummies.com and searching for "Factor Investing For Dummies cheat sheet."

Part 1

Starting with Factor Investing Basics

IN THIS PART ...

Getting the lowdown on what factors are.

Get insights on why you should consider factors.

Learn which factors can work best for you.

Using factors without needing to time the market.

Chapter 1

Counting on Factor Investing

IN THIS CHAPTER

- **Understanding what factor investing is**
- **How factor investing can benefit you**
- **Identifying the various factors used**

In recent years, the strategy approach of factor investing has been catching on and it may be something that could boost your personal approach in the financial markets. Factor investing takes into account decades of portfolio experience and market research regarding effective approaches to portfolio management that can remove the guesswork about which types of securities are best able to meet a particular investor's needs.

Perhaps the simplest explanation for factors is that they can act like guard rails in your portfolio management choices. The growth in factor investing's popularity is evident in the world of portfolio management. Financial assets managed under the mantle of factor investing grew from under $400 billion in 2013 to exceeding US $1.2 trillion in 2021. In this chapter, you see what the appeal is.

The Essentials of Factor Investing

Factor investing is an investment portfolio general strategy that favors a systematic approach utilizing factors or “shared characteristics” of individual stocks (and other assets such as bonds) that have a historical record of superior risk and return performance.

These factors can range from individual characteristics such as the company’s sales (revenue indicated on the company’s income statement) or debt (total liabilities indicated on their balance sheet) to their performance in macro environments such as inflation or economic growth. A *factor* is a trait or characteristic that can explain the performance of a given group of stocks during various market conditions.

There are two main categories of factors: style and macroeconomic factors. (Both of these are covered later in the section “Introducing the Factor Groups.”)

- *Style factors* seek to identify the relevant characteristics of the individual securities (sometimes referred to as *microeconomic* traits or characteristics). Examples are the stock’s volatility, market size, and valuation.
- *Macroeconomic factors* refer to the general market’s environmental and economic aspects. Examples are GDP (Gross Domestic Product) growth and inflation (for more details, see chapter 11).

Introducing the Factor Groups

There are two main category types of factors: *style* (sometimes referred to as *microeconomic*) and *macroeconomic*. Style factors are associated with the company (or investment vehicle) itself while macroeconomic factors are about the company's economic environment. In both cases, the factors act as drivers for the returns (for the company's stock appreciation, for example) for that particular asset.

Style factors

Style factors take into account characteristics of the individual asset such as its market size, value and industry/sector, volatility, and growth versus value stocks. Style factors help to explain or identify characteristics that drive that asset's price performance in the marketplace.

These factors are also referred to as microeconomic because they are an individual security or asset that drives its performance as a singular member or participant of the overall market and economy.

Value

Looking at value means typically looking at the company's fundamentals. The fundamentals are the most important financial data of the company such as the company's sales and net profits, balance sheet (assets and liabilities), and important ratios such as the price-earnings (P/E) ratio.

Looking at public companies (as through their common stock) through the lens of value factors is one of the most important factors because value investing has survived and thrived ever since they were initially codified by the work of Benjamin Graham during the Great Depression years. (For more details, see Chapter 6.)

TIP Value investing is a very important discipline for those seeking a safer, long-term approach to stock investing success. Many aspects of it are covered in *Stock Investing For Dummies* (written by one of the co-authors of this book) because value investing strategies (and their relevant factors) should be a prime consideration for long-term investors. *The Intelligent Investor: The Definitive Book on Value Investing* by Benjamin Graham — known as the “father of value investing” — is well worth reading, too.

One of the most important reasons to embrace value as a primary factor (especially for beginning investors) is the emphasis on stocks that are undervalued, which makes them safer than other stocks. Undervalued means that all the key fundamental financial aspects of the company (such as book value or the price-earnings ratio) generally indicate that the price of the stock is not overpriced, meaning that you will not pay an excessive stock price versus the value of the underlying company and its intrinsic worth. The reason becomes obvious in market data; overpriced stocks are more apt to decline more sharply in a correction or bear market versus reasonably priced stocks.

The bottom line is the fundamentals of a stock mean a safer bet and a better chance at long-term price appreciation.

Size

The size of the asset, in this case public company, is a reference to its market size based on market cap or capitalization (total number of shares outstanding times the price per share). The most common cap sizes used are small cap and large cap. If you're seeking growth, lean toward the small-cap factor.

Large-cap assets may be safer but typically don't exhibit the same growth or price appreciation relative to the small-cap stocks. The historical data generally bears this out.

Quality

Quality is certainly joined at the hip with value. This factor should definitely be among your top three considerations — especially if you're more risk-adverse as a long-term investor.

Quality is a reference to the financial strength of the company and you would see this through factors such as low debt-to-asset ratios, a high return on equity, and stable earnings growth.

Dividend

Dividends are payouts to shareholders from the company. They are typically paid quarterly and are a sign of long-term financial health when the company has been paying dividends over an extended period of time (years and decades), and these dividends are paid reliably and are increased over time.

Dividends should be among the prime factors considered, especially if you seek income and also want to reduce risk and volatility. Dividend payouts are typically seen as a tangible expression of financial strength and during times of market decline and stress, dividend-paying stocks tend to rebound well.

Additionally, the long-term market studies strongly point out that dividends over an extended period of time tend to match or exceed the rate of inflation so this factor tends to add the bonus feature of dealing with inflation (a macroeconomic factor).

Growth

The growth factor highlights the measure of change in sales and earnings by the company in relation to its group (such as in individual industries or sectors). Is the stock growing better than its peers? If so, this factor should be considered.

As the historical market data suggests, companies with growing sales and revenue show stronger relative stock price appreciation, since investors notice the growth and buy up the stock.

Volatility

Market research over an extended period of time suggests that low-volatility stocks tend to earn a better return over the long term compared to high-volatility stocks. Given that, this factor will be beneficial.

TIP

> A useful indicator to look at is beta, which is listed at many popular financial websites for a given stock. The beta indicates how much more (or less) a given stock is volatile versus the general market (based on recent market trading data).

For beta, the stock market itself is assigned a value of 1. A stock with a beta that is less than 1 is less volatile than the general stock market while a stock with a beta greater than 1 is more volatile than the general stock market. A stock with a beta of 1.2, for example, is considered 20 percent more volatile than the general stock market. A stock with a beta of, say, .9 is 10 percent less volatile than the general stock market.

A good example of a stock that has low volatility would be a large-cap public utilities company. A good example of a high-volatility stock would be a small-cap technology firm. If you’re a retiree, you would most likely benefit from this factor to ensure getting low-volatility stocks.

Momentum

This type of factor is a better consideration if you’re an experienced investor and/or speculator seeking short-term results.

Momentum is the reference to how well the stock’s price has moved upward in a given period of time (such as six months or a year) versus its peers in that particular category. Some short-term focused investors and speculators believe that if a stock is performing much better in a bullish trend (stock market prices are trending upward) that it will continue to do so in the near term. In that case, it would provide superior short-term gains versus its peers.

WARNING Although the momentum factor certainly bears this out, long-term investors should be wary. Just because a particular stock exhibits above-average upward movement, it doesn’t mean it will stay that way. It also doesn’t mean that the stock is an appropriate selection. In the past, there have been many poor-quality stocks that have exhibited great momentum in the short term but then declined significantly.

Internet and high technology stocks exhibited powerful momentum during 1999–2001 but had stomach-churning declines during late 2001 to early 2002. Some went bankrupt.

Macroeconomic factors

You could compare stocks and the stock market/economy to fish in a pond. You can analyze the fish and choose great fish (using, for example, style/microeconomic factors). But you should also analyze the pond (macroeconomic factors). You could choose the greatest fish in the pond, but what if the pond is polluted? Then even the great fish will underperform (putting it mildly). Shrewd investors will find a different pond.

For investors, the U.S. economy and stock market represent the "biggest pond" on the global financial scene. So if you're going to participate, you should understand the good, the bad, and ugly of this marketplace. (Chapter 11 goes into more detail).

Economic growth (GDP)

Gross Domestic Product (GDP) is one of the most watched economic indicators by investors and non-investors alike. It's a broad measure of the *economic output* (value of products and services) in a given timeframe (typically a calendar quarter or year) by a nation's economy.

When GDP is growing, companies (and their stocks) are doing well. In fact, when the economy is growing and doing well, the stock market tends to outperform other markets (such as the bond market). Factors tied to economy growth such as GDP offer profitable guidance for investors.

Given that, the major investing sites regularly report this and related economic data so that this factor helps investors optimize the returns in their portfolio.

Inflation

Inflation is a key factor. Most folks look at *price inflation* (the rising price of consumer goods and services). However, price inflation is not a problem. It's a symptom.

Many people don't understand the cause of inflation (including many government officials and economic policy makers unfortunately).

The cause is *monetary inflation* (the overproduction of a nation's currency supply) that precedes the price inflation. When too much money is created and when that supply of money is chasing a finite basket of goods and services, then the price of these goods and services will rise. The goods and services didn't become more valuable the *currency* lost value (due to overproduction).

A complicating factor is the supply shortage issues during late 2021–2022 that augurs in cost-push inflation. When shortages occur (supply issues) and consumers contain to purchase the products in question (demand), the price inflation is further exacerbated.

In early 2021, when the federal government and the Federal Reserve were increasing the money supply (by spending trillions of dollars), this was the cue for alert investors to consider the inflation factor. This factor would have guided portfolio managers toward securities that would have outperformed in an unfolding inflationary environment.

Interest rates

In early 2022, the Federal Reserve (America's central bank) is (and likely will be) raising interest rates. Interest rates are essentially the price of borrowed money, and a factor on interest rates is key to making more optimal choices in your portfolio.

In general (and all things being equal), low interest rates are good for the economy while high (or rising) interest rates tend to be negative. Because so much economic activity (both business and consumer activity) is tied to credit (business loans, credit cards, home mortgages, and so on), rising interest rates tend to dampen or diminish economic activity while low or decreasing rates tend to do the opposite.

Given that, factors tied to interest rates can help you avoid stocks (and bonds) that would be harmed by rising interest rates so that your portfolio can continue to perform satisfactorily.

An Example of a Factor-Based Portfolio

You probably wonder how using a factor-based portfolio may differ with a traditional (or non-factor) based approach.

For decades, one of the simplest portfolio construction was 60 percent stocks and 40 percent bonds. After that simple diversification of two different asset classes, there may be diversification with each asset class.

The stock portion may have a mix of large-cap stocks (stocks with a market valuation, for example, exceeding $50 billion), mid-cap stocks (stocks in the $10–$40 billion range),and small-cap stocks (stocks with a market valuation under $10 billion). The bonds may be a mix of investment-grade corporate bonds.

The factor-based approach would make portfolio choices based on investment characteristics that have performed better than a random mix of securities. The stocks would be selected based on style factors such as value and quality so that selections are more optimal given the general market conditions at that time. If the general market was experiencing inflation, then inflation factors would be used to select stocks that perform better than average in an inflationary environment. The inflation