



Advisor Views

A feature from **Kemper Capital Management LLC**. *Advisor Views* offers timely investment news and market updates designed to keep you informed, while enhancing your overall investment experience.

Factor Investing: Revisiting Market, Size and Value

In a previous *Advisor Views* article, we introduced the concept of “Factor Investing.” As you may recall, we believe that “factors” are sources of investment returns that are accessible in the capital markets. While factors can be positive, or negative, we attempt to benefit from those that historically have been sources of greater returns, or return “premiums” over time.^{1*} But what are these factors, and where do they come from?

While many investors have historically believed that greater returns could only be achieved with the help, knowledge and skill of professional money managers, decades of academic research has identified various factors that appear to exist in the capital markets, and they seem to assert themselves primarily as the result of investors assuming certain risks in their portfolios, the consequences of investor behavior, or both.

But how were different factors discovered, and how might they be leveraged for the benefit of investors? Typically, factor premiums have come to light as a by-product of active portfolio management. While an active manager may appear to have a recipe that enables him or her to beat the markets in certain time periods, we believe this outperformance may actually be the result of exposure to certain factors that are already present in the marketplace. In an effort to identify the sources of these potentially greater returns, the academic community has extensively analyzed the financial data in order to isolate what they consider to be true factors from the extraneous “noise” that may be part and parcel of an actively managed approach.

As factor investors themselves, Symmetry seeks to build broadly diversified portfolios that seek to capture the return opportunity of multiple factors. To be relevant to their portfolio construction strategy, however, the factors must be well-established and thoroughly vetted as

plausible by academe, they must be persistent over time, and perhaps most importantly, Symmetry must be able to capture and implement these factors through tradable securities that are liquid and cost efficient.

While numerous factors may exist in the marketplace, Symmetry offers varying degrees of exposure to several equity-specific factors including the market risk premium^{2*}, the small cap^{3*} and value^{4*} premiums, as well as momentum^{5*} and profitability.^{6*} In this discussion, we’ll review the equity factors with which most Symmetry investors are already familiar – market, small and value – and in the coming months, we’ll explore additional factors and their role within Symmetry portfolios.

As we mentioned, many of you are already acquainted with the notion of factor premiums as, for years, Symmetry has discussed the greater return potential that has historically been available when assuming the greater risks of investing in stocks over bonds, value stocks over growth stocks, and small company stocks over the stocks of larger corporations. In fact, Symmetry seeks to capture the return potential of these factors over time by applying strategic tilts, or overweightings, toward these factors within broadly diversified portfolios.

With respect to the greater return potential of stocks vs. bonds, history has shown that stocks are a riskier asset class compared to bonds, and therefore subject to greater volatility. Logically, in exchange for assuming the greater risk of loss that comes from owning stocks, equity investors may be seeking additional compensation in the form of higher returns, and this exactly what the market has historically provided. Over the time period 1927 to 2013, equities have delivered an additional 8% per year on average over the returns of risk-free Treasury Bills;^{7*} an excess return known as the market premium.

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When comparing value stocks to growth stocks, history has shown that value stocks – those with a low market value compared to the aggregate value of the company’s building, equipment, and similar assets - have provided greater returns over time, besting growth by almost 4.9% per year on an annual basis on average.^{8*} Given that value stocks may be distressed, or out of favor, compared to their growth counterparts, those in the risk camp would likely hold that in exchange for the greater risk of owning value stocks, investors should expect a greater return. From a behavioral point of view, however, the value premium may be explained by simple investor preference; investors may tend to overvalue stronger growth stocks given their prospects for the future, while undervaluing value stocks.

When considering the small cap premium, there’s little doubt that the stocks of small companies, such as a start-up internet firm, tend to be riskier than the stocks of large, well-established firms such as Google. While the additional

compensation for owning this riskier asset class has likely played an integral role in the 3% average annual excess return that small cap stocks have enjoyed over large^{9*}, there may be a behavioral component to the outperformance as well. For example, as a whole, investors may prefer to own large company stocks over small caps. If so, the prices of large caps may become inflated relative to small caps over time, thereby lowering the future return potential in the large cap market.

While the market, value and size factors may be the most well-known and prominent factors in Symmetry portfolios, additional equity factors such as momentum and profitability are similarly present in varying degrees within their Structured models. Stay tuned as we’ll explore these additional factors a little more closely when we continue our discussion of factor investing in the months ahead.

Please contact us if you have questions, or if we can be of assistance in any way.

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* Symmetry Partners’ investment approach seeks to enhance returns by overweighting assets that exhibit characteristics that tend to be in accordance with one or more “factors” identified in academic research as historically associated with higher returns. Please be advised that adding these factors may not ensure increased returns over a market weighted investment and may lead to underperformance relative to the benchmark over the investor’s time horizon. Please see below for additional information regarding these factors.

¹ Ang, Andrew. “Asset Management: A Systematic Approach to Factor Investing.” Financial Management Association Survey and Synthesis Series. Oxford University Press: 2014, Chapter 14.

Bender, Jennifer; Briand, Remy; Melas, Dimitris and Raman Aylur Subramanian. “Foundations of Factor Investing,” MSCI Research Insight, December 2013.

² Sharpe, William F. “Capital Asset Prices: A Theory of Market Equilibrium under Conditions of Risk.” The Journal of Finance, Vol. 19, No. 3 (Sept. 1964), 425-442.

³ Banz, Rolf W. “The Relationship Between Return and Market Value of Common Stocks.” Journal of Financial Economics, 9 (1981), 3-18.

⁴ Fama, Eugene and Ken French. “Common Risk Factors in the Returns on Stocks and Bonds.” Journal of Financial Economics, 33, (1993), 3-56.

⁵ Jegadeesh, Narasimhan and Sheridan Titman. “Returns to Buying Winners and Selling Losers: Implications for Stock Market Efficiency.” The Journal of Finance, Vol. 48, No. 1, (March 1993), 65-91.

⁶ Novy-Marx, Robert. “The Other Side of Value: The Gross Profitability Premium.” Journal of Financial Economics, 108(1), (2013), 1-28.

⁷ Source: Dimensional Fund Advisors. Return of the U.S Market minus the return of U.S. Treasury Bills, 1927-2013.

⁸ Source: Dimensional Fund Advisors. Return of U.S. Large Value minus U.S. Large Growth, 1927-2013.

⁹ Source: Dimensional Fund Advisors. Return of U.S. Small Caps minus U.S. Large Caps, 1927-2013.

Higher potential return generally involves greater risk, short term volatility is not uncommon when investing in various types of funds including but not limited to: sector, emerging markets, small and mid-cap funds. International investing involves special risks such as currency fluctuation, lower liquidity, political and economic uncertainties, and differences in accounting standards. Risks of foreign investing are generally intensified for investments in emerging markets. Risks for emerging markets include risks relating to the relatively smaller size and lesser liquidity of these markets, high inflation rates and adverse political developments. Risks for investing in international equity include foreign currency risk, as well as, fluctuation due to economic or political actions of foreign governments and/or less regulated or liquid markets. Risks for smaller companies include business risks, significant stock price fluctuation and illiquidity. Investing in real estate entails certain risks, including changes in: the economy, supply and demand, laws, tenant turnover, interest rates (including periods of high interest rates), availability of mortgage funds, operating expenses and cost of insurance. Some real estate investments offer limited liquidity options. Investing in higher-yielding, lower-rated bonds has a greater risk of price fluctuation and loss of principal income than U.S. government securities, such as U.S. Treasury bonds and bills. Treasuries and government securities are guaranteed by the government for repayment of principal and interest if held to maturity. Investors should carefully assess the risks associated with an investment in the fund.

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