INTERVIEW

Creating the best playlist for your portfolio

Andrew Ang

Head of Factors, Sustainable and Solutions, BlackRock Systematic

Interviewed by

Jamie MacDonald, ex-portfolio manager, Point 72

Jamie: Andrew, thank you so much for joining us today.

Andrew: Thank you for having me.

Jamie: We're here to talk primarily about factor investing. Is it the case that factor investing has always been a very lucrative way of investing going back decades?

Andrew: Well, this is what is interesting is that they've always been with us. I think the great investors have always wanted to look for bargains. They've wanted to identify and participate in trends. We call those value and low momentum. We want high quality companies and would prefer companies that are smaller and more nimble or low sized. And then, finally we want to gravitate to safety which we can do in minimum volatility strategies. The difference is investors can allocate to them directly today in a way that wasn't possible a few decades ago. When I was growing up, I remember these actual cassette tapes.

Jamie: Me too.

Andrew: And you know, we had these records and LPs. And you had to buy the entire LP, right? You might only listen to one or two tracks, but you had to get the whole thing. And what's really happened today is that you can watch anything whenever you want to, at whatever time. And you can watch videos, you can listen to music, you can engage how you want to. Before, we had to package all of these market or index returns together with factors, and together with the pure alpha components. You had to buy the entire album and what's happened today is that you don't need to do that anymore, you can create the playlist that you want. And if you're feeling a little down and you want a song to cheer you up, or you want to celebrate something, you want a romantic mood. Well, now with ETFs and all these other investment vehicles, we can actually create our own playlist for our portfolios.

Jamie: Okay. So, we are the one making the album now. We don't have to buy the one that somebody else made.

Andrew: And I think it's really democratised access to these sources of returns, these broad and persistent drivers of value, momentum, quality, minimum volatility, and small size. And then, we can also better identify the true alpha opportunities in excess of these broad and persistent factor returns.

Jamie: So, walk us through the specific factors and what exactly, or how exactly do you define them.

Andrew: Intuitively, they have much more in common than differences. But there are some implementation choices that each provider will have to make. Value at its heart looks at low price stocks.

Jamie: Price to book specifically or just, whatever, price to earnings?

> AI or machine learning is just the latest incarnation. We've been using these techniques for quite some time in our proprietary definitions of factors. I'll give one example, corporate culture.

Andrew: Yes exactly. So, we can observe prices, but you'd have to proxy fundamental value. So, sometimes you could take that as book value, but we could also take it as the amount of earnings that a company would generate. Perhaps, I actually would like something more solid and actually look at cash flows themselves, particularly cash flow from operations. So, these are all metrics that originally date back to a book written in 1934 by two accounting professors, Graham and Dodd. They were actually professors of my institution that I taught at for many years, Columbia University. So, these have decades worth, almost, you know, 100 years of history. But we can also take more proprietary definitions if you're thinking about fundamental value. A lot of value in a company today is not reflected on balance sheets or earnings statements. So, we might look at some intangible measures. Patents are valuable. You can buy them, you can sell them, you can license them. But they don't usually appear on balance sheets. They're the result of a lot of culmination of research and development. And so, you can look at these unstructured or alternative data sets as well. They range the gamut.

Jamie: Andrew, you mentioned indices just now and the fact that there's a sort of implicit active decision made with indices in terms of market cap weighting, liquidity and things. How efficient are indices at representing the business economy that they do? And another part to that question is, to what extent is an index just naturally a momentum play? I mean, right now we're in 2023, we're seeing some of these companies get so big that they make up such a big part of these indices. That, you know, the bigger they get, the more effect they have on the index itself, and it becomes a sort of self-fulfilling prophecy. So, if you could talk a little bit about those two things.

Andrew: Yes, so the first one is basically looking at what's actually in the market compared to what's in the real economy. And there are some differences. But the bulk of market activity in the economy, in the US and certainly absolutely in the world, most of it is actually private rather than public. And so, it's not surprising that the profile of the publicly traded securities actually look different from the bulk of the mainstream economy.

Jamie: Yes, that's a good point.

Andrew: And so there are sector biases. There's a lot more tech that we see in listed companies, than what we see in the real economy. And you actually might think about an investment strategy that looks at the differences between those two. What's traded in the market versus a proper reflection of the underlying economic activity.

Jamie: Yes.

Andrew: And some researchers have actually done that.

Jamie: I'd never thought about it before. But where I'm from in the UK, I mean, our entire health service is effectively nationalised, unlike the US where so much of it is not. So, I mean I'd never thought of it before, but it makes so much sense.

Andrew: And I think you can go a little bit further than that as well. So, it's not only the industries or the sectors that these companies have, but internationally there will be differences as well. I think companies, they tend to go public much earlier in the United States. Now, we actually have a lot more listings of IPOs especially in China, and some of the other emerging markets. But you need to be a pretty established company, right? To actually be a publicly traded company. Even by definition, to be able to list on some of those exchanges. So, that also means, I think, a lot of private markets and public markets, you certainly can have public market equivalents of these private industries, but they're going to look a little different than a pure vanilla market cap-based index of public companies.

Jamie: So, I wanted to ask about the market environment. When it comes to factor investing, is the idea that you have allocation to each one of the factors, and you should be pulling those levers as you see fit? Or is it that you are sort of more recommending that you should follow, use factor investing to invest in one theme?

Andrew: I think you're better off investing in a balanced portfolio over all factors. And have that really as the core part of your portfolio. I think over the long run, we do want value momentum, high quality companies. Those should form the basis of a core portfolio holding. But around that, one might think about tactically or dynamically shifting those factor exposures. And here I think single factor types of strategies are quite useful. So generally, if we're in a downturn, or late economic environment or a recession, then you prefer the more defensive factors, particularly quality minimum volatility. They give you this payoff that tends to perform well during these relatively poor economic conditions. In the very early part of the economic cycle, pro-cyclical factors like small stocks and value strategies, those tend to do better. If we're in the late cycle, then the trends have been established in the economy. And so, momentum strategies tend to fare well. So, if you're looking at around your core, then potentially these factor rotation or factor tilting strategies, they may be important too.

Jamie: What do you think is the biggest driver of the stock market over the next 6 to 12 months? I see people talk about the fact that you just need to look at the size of the Fed's balance sheet and basically as it expands that will just take asset prices with it. Others say, well if the Fed keeps tightening towards the end of the year, then that's going to bring markets down. What are the things that people need to be focused on when deciding where to, how to allocate them their money?

Andrew: Well, I think over, and not only over the next year, but I think over the next five to ten years, this is now the era of the return. It's like the "Empire Strikes Back."

Andrew: It's the return of macro risk.

Jamie: Right.

Andrew: And factors, these are long-term rewarded sources of, or drivers of return. And macro risk is, well, you get compensated for bearing that risk. Some examples, so, inflation is now back. You know, the great moderation is over. Okay, inflation, we might have reached peak inflation, but I think we still have some ways to go before we go back to 2% or below.

Jamie: It's not going to low single digit. We're going to hang around.

Andrew: I think so. And that's a change. It really is a change from the period from the 1980s to 2020. I also think that there are three things that have also changed today compared to previous decades that will lead to a higher inflation environment. We see extreme weather, right? All of the build back for destructive effects of extreme weather.

Jamie: That's interesting.

Andrew: All of that is inflationary. I don't think we're going to go to a de-globalised world, but I think the gains for further globalization probably muted or very close to zero. And so, building robustness into supply chains, the reshoring elements that are now happening, those are inflationary tendencies as well. And then finally, there is some debate on this, but researchers like Charles Goodhart would say that aging populations, those tend to be inflationary. In his summary, basically you would have larger proportions of retired people. Retired people, they consume but they don't produce.

Jamie: Right.

Andrew: And so, therefore those tend to be the higher proportions of this inflationary effect. So, inflation, I think it's going to be with us. Real rates, I think this was the big unsung event for 2022. Yes, we had markets come down by 15 to 20% in equities and bonds, but one of the other big developments was that we saw the real interest rates change from minus 1, minus 1 1/2 to now plus 1 ½.

Jamie: Yes.

Andrew: You know, plus two. Those were massive changes. And so, we have positive real rates now. Discount rates are back. You know, associated with all of those. There's much more uncertainty. We're going away from quantitative easing, right? The Fed will shrink its balance sheets. There are very large government deficits now worldwide, but certainly we have the highest GDP to, our debt to GDP ratios since World War two in the United States. Macro risk is back. And all of that, I think sets the stage for a lot of these factor or style factor risk premiums.

Jamie: Final question, Andrew. I just feel looming over all of this is the topic of AI and how deflationary it could be. Do you have a particular view on the impact that AI could have? Because typically innovative tech is quite disinflationary. Where do you sit on that?

Andrew: Well, I think it's not so much, at least this is my opinion for being an effect for deflation. But I think we will see large productivity gains in fact.

Jamie: Okay.

Andrew: We'll all be better off. There will be the flip side of that, there'll be some unfortunate increases in inequality and we do need to address those. But I want to say that factor investing has always been at the forefront of incorporating the latest data and the latest quantitative techniques. So we started off, I mentioned in 1934 with Graham and Dodd, right? No one actually looked systematically at these companies. Even for something as simple as a book to market ratio. They were the first ones. Factor investors at the forefront of using financial reports. All these balance sheets and earnings statements in the 1970s and 1980s. That was the big data of its time, right? And then, we looked at all the development of indexing with all the data that's used there in the 1990s that kind of really became widespread. I think AI or machine learning, this is just the latest incarnation. But we've been using these techniques for quite some time in our proprietary definitions of factors. And I'll just give one example, corporate culture. So, this was one of the best performing signals for our proprietary factors. And we treat it as a form of quality. It's a non-financial measure of quality. It was one of the best performers during our COVID years of 2020 and 2021. And we use an algorithm called embedding, word embedding, to develop a dictionary over a training sample of words related to corporate culture.

Jamie: Wow.

Andrew: And then with that dictionary, we can then analyse a conference call information. And after the machine has done that, we've now got a quantitative score for a concept that tends to be much more qualitative.

Jamie: Amazing.

Andrew: In nature. You know, we're pushing now with large language models like ChatGPT for versions of sentiment. But we've always wanted to get the best data and the best quantitative techniques to bring all of these sources of returns to people's portfolios.

Jamie: Pioneering stuff, Andrew. Listen, Andrew, this has been such an insightful and interesting conversation. I want to say thanks for your time.

Andrew: Thank you.

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Tokyo +81 3 6441 1430

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