

# Not All Factor-Based Investment Strategies Are Created Equal—and Here’s Why

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Over the past few years, investors have become increasingly interested in factor-based strategies, which seek to increase returns, manage volatility, increase diversification and lower costs.

When considering factor-based strategies, investors ask, “Are all factor portfolios the same? Aren’t they really just commodities?” Our answer is a firm “no.”

Though factor-focused portfolios might have similar names, decisions made by the strategy’s management team can dramatically change the composition of the portfolio’s equities and, accordingly, performance. The differences in factor-based strategies can be illustrated by comparing their varied performance. The following is the trailing monthly performance of the indexes underlying five U.S. quality factor funds.

## PERFORMANCE OF FIVE US QUALITY FACTOR-BASED INDEXES

	S&P 500 Quality Index	MSCI USA Sector Neutral Quality Index	JP Morgan US Quality Factor Index	Fidelity US Quality factor Index	Russell 1000 Quality Factor Index	Russell 1000	Difference Best - Worst
9/30/2018	1.84	1.11	0.71	0.15	0.85	0.38	1.70
10/31/2018	-7.04	-7.48	-6.15	-6.65	-7.31	-7.08	1.33
11/30/2018	-0.05	1.01	2.35	1.94	1.19	2.04	2.40
12/31/2018	-8.26	-8.71	-7.67	-8.37	-8.46	-9.11	1.03
1/31/2019	7.21	8.41	6.59	7.49	7.95	8.38	1.81
2/28/2019	4.99	4.34	4.56	3.45	4.00	3.39	1.54
3/31/2019	3.05	2.59	1.98	1.70	2.20	1.74	1.35
4/30/2019	3.55	3.80	2.61	3.53	3.03	4.04	1.19
5/31/2019	-6.49	-6.60	-5.72	-6.38	-6.68	-6.37	0.96
6/30/2019	6.91	7.19	6.35	6.35	6.98	7.02	0.84
7/31/2019	1.08	1.35	1.61	1.75	1.87	1.55	0.78
8/31/2019	-1.15	-1.69	-0.76	-1.43	-1.42	-1.83	0.93
12-month cumulative	5.87	5.94	6.69	3.93	4.48	4.82	2.77

Source: Cadence, FactSet, Morningstar, Bloomberg. Past performance is no guarantee of future results. Results are in USD. You cannot invest directly in an index.

A couple of observations can be made from these performance numbers. First, the five indexes’ monthly returns always differed from each other, at times considerably (approaching 2.5% between the best and worst strategies). Second, not all products provided the same downside protection during months when the Russell 1000 Index experienced negative returns (look, for example, at October 2018, December 2018, and May 2019).

## REASONS BEHIND THE DIFFERENT RETURNS

A major reason behind the performance variation of the five indexes can be traced to the word “quality” embedded in their name. “Quality” doesn’t have a standard definition in investing and is interpreted differently by each investment manager.

Another cause of differing performance: varying sector weights among the five indexes. For example, one index holds more than 40% in information-technology equities. Another example: some have invested in utility companies while others have passed entirely on that sector.

## INVESTMENT MANAGERS USE DIFFERENT QUALITY-DRIVEN METRICS TO CHOOSE STOCKS

Weightings as of 8/31/2019	S&P 500 Quality Index	MSCI USA Sector Neutral Quality Index	JP Morgan US Quality Factor Index	Fidelity US Quality factor Index	Russell 1000 Quality Factor Index
Communication Services	0.1	10.3	6.6	10.5	11.2
Consumer Discretionary	9.2	10.5	11.3	9.6	11.1
Consumer Staples	11.0	7.3	8.3	6.2	7.8
Energy	5.1	4.7	5.5	5.7	7.6
Financials	4.4	12.6	12.9	14.4	3.4
Health Care	20.1	13.3	14.1	14.2	17.2
Industrials	8.3	8.9	9.6	9.5	10.7
Information Technology	40.5	23.3	23.9	21.1	26.0
Materials	0.4	2.6	2.2	2.7	2.0
Real Estate	0.9	3.3	2.8	3.3	1.9
Utilities	-	3.3	2.7	2.9	1.2

Source: Cadence, FactSet, MSCI, Bloomberg and Standard & Poor's. Past performance is no guarantee of future results. Results are in USD. Sectors are defined by the Global Industry Classification Standard (GICS). You cannot invest directly in an index.

Other decisions surrounding the subjective definition of “quality” investing and portfolio construction can also lead to contrasting performance, including:

- Starting universe of stocks used to select securities
- The standardization of metric weights over the full universe or by sector
- The manner in which the quality metrics are weighted
- The methodology for weighting stocks in the portfolio (market-cap weighted, equal-weighted, etc.)
- The maximum and minimum position size allowed within the portfolio
- The sell-discipline the strategy employs

## THE BOTTOM LINE

Strategies within the same factor-based category can vary widely, underscoring that factor-based strategies are certainly not commodities. It's important to remember that details matter in factor-based investing and any number of decisions might impact returns.

Because of this, we believe an off-the-shelf, one-size-fits-all approach is unlikely to be an ideal solution for most investors. At Cadence, we seek to partner with our clients to help them understand the details that inform the portfolio manager's decisions and to assist them in developing an allocation to factor-based strategies that best suits their specific goals and needs.

Please contact us if you'd like to discuss this further or to discuss Cadence's quality factor based strategy.

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Founded in 1988, Cadence Capital Management LLC is a quantitatively oriented global equity manager specializing in factor focused strategies across U.S., international and emerging markets and in actively managed U.S. small and midcap strategies. Cadence is an SEC registered investment adviser and a subsidiary of Pacific Global Asset Management, the investment unit of Pacific Life Insurance Company.

Cadence operates as an independent investment advisor with the support and partnership of Pacific Global, which offers us access to a broad set of administrative tools and business infrastructure. Our clients benefit from our shared commitment with Pacific Global to innovation, exceptional service and helping investors achieve their financial goals. Further, our clients can rest assured that we are backed by a high quality, 150 year old company.

Cadence provides investment advisory services to institutional and professional clients and does not sell securities.

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## FOR FURTHER INFORMATION

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