**Styles vs. Factors**

*What they are, how they’re similar/different and how they fit within portfolios*

**Key points:**

- Traditional style indexes – such as growth and value, large and small cap – are designed to represent broad market segments based on investment styles and sets of characteristics that are focused on by professional investment managers, making them excellent benchmarks for evaluating the skill of active managers.

- Factor indexes are designed to capture high levels of exposure to a targeted factor – such as low volatility, momentum, quality or value – and have given investors a new set of tools to assist them in constructing precise portfolios tailored to deliver their desired factor exposures.

- By combining traditional styles and new factor indexes, investors can construct portfolios with broad, diversified and familiar exposures while precisely tailoring their portfolio’s exposures toward or away from desired or undesired risks.

The early 1980s was a time of tremendous innovation as technological advances spurred new products and new thinking across industries, from computing to music to autos to investing. The year 1981 brought us innovations such as IBM’s first PC, the MTV video music network, the DeLorean sports car and the first institutional index fund. A few years later, Russell introduced its U.S. index series, including the Russell 2000® Index, the first small cap benchmark. Soon after, Russell introduced the first growth and value style indexes. Together, these size and style indexes formed the basis for the now well-known “style box” and have shaped the way investors construct portfolios for many years.
Since that time, indexing has grown dramatically and we are now seeing another era of innovation, with the introduction of a wide variety of factor indexes focused on individual factors such as low volatility, quality, momentum and value. Investors are working to understand these new factor indexes: how factors are similar to or different from traditional styles and how investment strategies based on factor indexes can be incorporated into portfolios. Some industry practitioners have asserted that factor investing might replace traditional styles and the style box. Others, however, have questioned the benefits of factor investing altogether, cautioning against potential disappointment down the road.

So, what’s the right answer? As with any new concept, the answer is more nuanced than a simple thumbs-up or thumbs-down. Factor indexes represent new tools that investors can use to construct more precise portfolios based on their unique objectives and tolerance for risk. For many, a combination of traditional styles and new factor indexes may provide an attractive solution for their investment needs.

**Figure 1. Distinguishing factors from styles**

<table>
<thead>
<tr>
<th></th>
<th>Factors</th>
<th>Styles</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market coverage</td>
<td>Focused exposure to stocks with high capture of one targeted factor</td>
<td>Broad exposure to sets of characteristics</td>
</tr>
<tr>
<td></td>
<td>One-sided subset of a market segment, e.g., high momentum, but no low momentum</td>
<td>Splits market segments into symmetrical, two-sided components, e.g., growth and value</td>
</tr>
<tr>
<td>Factor capture</td>
<td>High factor capture</td>
<td>Moderate factor capture</td>
</tr>
<tr>
<td></td>
<td>Significant exposure to targeted factor</td>
<td>Moderate tilt toward factor characteristics</td>
</tr>
<tr>
<td>Weighting</td>
<td>Factor-weighted</td>
<td>Market capitalization-weighted</td>
</tr>
<tr>
<td>Rebalance/turnover</td>
<td>Semiannual, quarterly or monthly rebalance</td>
<td>Annual reconstitution</td>
</tr>
<tr>
<td></td>
<td>Higher turnover</td>
<td>Low turnover</td>
</tr>
<tr>
<td>Active vs. passive</td>
<td>Higher active share¹</td>
<td>Lower active share</td>
</tr>
<tr>
<td></td>
<td>Focused subset of parent index</td>
<td>Broader subset of parent index</td>
</tr>
</tbody>
</table>

Sources: FTSE Russell

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¹ Active share is a widely used term for an aggregate measure of the difference in holdings (constituent inclusion or exclusion or divergence in constituent weights) between a given portfolio (or here, a style or factor index) and the parent or benchmark index. For more information on active share, see Antti Petajisto, “Active Share and Mutual Fund Performance,” 2013 Financial Analysts Journal v. 69 no. 4: [http://www.cfapubs.org/doi/pdf/10.2469/faj.v69.n4.7](http://www.cfapubs.org/doi/pdf/10.2469/faj.v69.n4.7)
What are factors?
Factors are the underlying primary drivers of risk and return within a portfolio of securities or a market segment. Investment portfolios and the markets that underlie them have exposure to multiple factors at varying levels. In stock portfolios, these include common systematic factors such as value, growth, size, momentum, volatility, industry and others. The behavior of a portfolio can be explained in terms of its exposure to these factors plus the idiosyncratic, or stock-specific, behavior of the securities in the portfolio. The portfolio’s exposure to systematic factors can be quantified by decomposing them through the lens of a multi-factor risk model such as those constructed by Axioma or BARRA, two leading providers of risk analytics platforms.

Although factor indexes are a relatively recent innovation in the investment industry, it is important to understand that factor investing has been on the scene for a long time. A wide body of academics and practitioners have conducted research on various factors; this research provides evidence that factors such as value, low volatility, momentum and a few others have had positive payoffs over time, while other factors such as high volatility have had negative payoffs. Similarly to styles, individual factors can move in and out of favor and experience extended periods of both outperformance and underperformance relative to their parent index.

In recent years, a number of index providers have developed factor indexes based on those factors that tend to have positive payoffs over time. These indexes are designed to capture high levels of exposure to the targeted factor and in some cases are optimized to also minimize exposure to other non-targeted factors. Products from ETF providers that are designed to track these indexes have given investors a whole new set of tools for constructing portfolios precisely tailored to deliver desired factor exposures.

What makes an index a factor index?
Some have questioned whether factor indexes truly provide anything new, since indexes focused on small cap, value, etc. have existed since the 1980s. It’s important to recognize, however, that every index has factor exposures at some level. But just because an index has factor exposures, that does not make it a factor index. Factor indexes are specifically designed with the objective of providing a more focused exposure to a specific factor.

Although they are often well-diversified, factor indexes typically consist of a subset of securities from a parent index. This means that factor indexes generally have higher active share, or differences in holdings relative to their parent index, than do traditional style indexes. For example, as of December 31, 2015 the Russell 1000® Volatility Factor Index consisted of 339 securities, compared with 1,000 securities in the parent index and approximately 660 securities in style indexes such as the Russell 1000 Value and Growth Indexes.

2 The FTSE Russell Style methodology assigns stocks to styles proportionately based on a proprietary non-linear probability algorithm. Some stocks are purely one style, that is, for example, 100% value or 100% growth, but some are partially value and partially growth, so are present in some measure in both the value and growth indexes. For more information see http://www.ftse.com/products/downloads/Russell-US-indexes.pdf?32
Another difference is that factor indexes typically weight securities by exposure to the targeted factor, rather than by market capitalization. And because consistent factor exposure is a goal of factor indexes, they tend to rebalance more frequently and to have higher turnover than market-cap weighted indexes.  

**What are styles?**

By contrast, traditional style indexes are designed to represent broader market segments based on the investment styles and sets of characteristics that are focused on by professional investment managers, making them excellent benchmarks for evaluating the skill of active managers. These include styles such as growth and value, large cap and small cap. The astute reader will undoubtedly notice that each of these styles is two-sided – growth/value, large/small, etc. Style indexes are designed to be symmetrical and to split a complete market segment into complementary components that sum to the whole segment. For example, the Russell 1000 Growth Index plus the Russell 1000 Value Index combine to make the Russell 1000 Index.

The symmetrical nature of styles is a key distinction relative to factor indexes, which tend to be one-sided and typically focus only on the direction that has historically exhibited a positive payoff over time. This symmetrical nature of style provides an intuitive measure for understanding relative exposure. In other words, we know that equal dollars invested on each side of the style framework is style-neutral. The same is not necessarily true for factors. Style indexes are also typically market cap-weighted and tend to have lower turnover than factor indexes because they don’t require frequent rebalancing.

**Using factors and styles**

So, with an ever-growing menu of indexes, how should investors select from among traditional style indexes and newer factor indexes in building their portfolios? Today, many investors include allocations to both growth and value and large cap and small cap investments within the strategic core equity portion of their portfolios. These traditional style indexes may continue to form the basis for the core of many investors’ portfolios because of their broad, comprehensive exposures. Factor indexes can be used to assist investors in precisely tailoring their core allocations to include, for example, a low-volatility index, or a satellite allocation to momentum to benefit from its lower correlation with other factors such as value, as illustrated in Figure 2.

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4 The FTSE Russell Growth and Value Index methodology uses one value characteristic, book-to-price ratio (B/P) and two growth characteristics, medium-term forecast earnings growth rate based on I/B/E/S two-year forecasts and sales-per-share growth rate based on five-year historical sales. Small and Large Cap indexes are divided by market capitalization levels, modified by a banding methodology to control turnover, see link above, footnote 2.
**Figure 2. Correlation of monthly excess returns: Russell 1000 Factor Indexes (July 2001 – December 2015)**

<table>
<thead>
<tr>
<th></th>
<th>Momentum</th>
<th>Quality</th>
<th>Value</th>
<th>Low volatility</th>
</tr>
</thead>
<tbody>
<tr>
<td>Momentum</td>
<td>1.00</td>
<td>0.49</td>
<td>-0.22</td>
<td>0.22</td>
</tr>
<tr>
<td>Quality</td>
<td>0.49</td>
<td>1.00</td>
<td>-0.24</td>
<td>0.56</td>
</tr>
<tr>
<td>Value</td>
<td>-0.22</td>
<td>-0.24</td>
<td>1.00</td>
<td>-0.03</td>
</tr>
<tr>
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<td>-0.03</td>
<td>1.00</td>
</tr>
</tbody>
</table>

Source: FTSE Russell, data as at December 31, 2015. Past performance is no guarantee of future results. The Russell 1000 Single Factor Indexes were launched September 28th, 2015; returns before this date reflect hypothetical historical performance using the same methodology as the live indexes. Please see the disclaimer page for important legal disclosures.

For some sophisticated investors, constructing a portfolio purely from a collection of investments tracking factor indexes is also possible. This approach allows for very precise allocations to desired factor exposures and enables dynamic adjustments to specific factors over time as well. Investors taking this approach would be well advised to work closely with a qualified investment professional as it is no simple task to properly construct a factor portfolio or to accurately time factor exposures over market cycles.

For most investors, some combination of investments tracking both traditional styles and new factor indexes may make sense. This approach allows investors to construct portfolios with broad, diversified and familiar exposures while also offering the opportunity to use factor indexes to precisely tailor the portfolio’s exposures toward or away from desired or undesired risks.

**Conclusion: Harmonizing with styles and factors**

In the investment industry, the introduction of indexing did not replace active management, but rather the two continue to coexist. Similarly, both traditional style indexes and new factor indexes will likely remain relevant for investor portfolios for many years. Factor indexes represent an enhancement and new set of tools that investors can use alongside their traditional, familiar style exposures to construct portfolios that deliver their desired exposures based on their unique objectives and risk tolerances.
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