Brett Arends's ROI

‘Multi-factor’ ETFs are missing this one big factor

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Turns out “multi-factor” mutual funds, which were launched last decade with so much promise, have so far been better for the fund managers than they are for your retirement portfolio.

According to new research, these funds, which were supposed to offer high returns with lower risk, broadly failed to do either — even in such slumps as the sharp downturn in late 2018, the COVID crash of 2020, and the bear market so far this year.

Multi-factor funds combine several different “factors” — such as “value,” “quality,” low volatility” and “momentum” — to pick stocks. The theory was that such factors had been shown to produce

outperformance in the past, allegedly producing higher returns for lower risk. And if each factor was good, multiple factors in the same fund much be better. Right?

Oops.

Such funds "have largely failed to outperform market-wide, cap-weighted indexes, or low-cost ETFs that track them, in terms of return, risk-adjusted return, and downside protection," reported Javier Estrada, a finance professor at the IESE Business School in Barcelona, who was writing about U.S. funds open to U.S. investors.

An astonishing 31 out of 32 multifactor funds targeting the U.S. market have done worse since their launch than the S&P 500, and the average has trailed the benchmark index by 3.6 percentage points a year. Compared to the broader Russell 3000 stock index, the results look a little better, but not much: 27 of the 32 still did worse.

These funds "did not protect investors from severe downturns, either; in fact, their maximum drawdowns (ie losses from peak to trough) were far larger" than those of the S&P and Russell indexes.

During the COVID-19 crash in March 2020, for example, "far from mitigating the downside, multifactor funds fell, on average, 7.2% (percentage points) more than did the S&P 500, and 5.9% more than did the Russell 3000."

Oops.

The results for the multi-factor funds, which invest in foreign markets, were a little better, professor Estrada found. A little, but not great. Of the 24 funds in existence, 15 — or more than 60% — have done worse during their existence than simple, low-cost exchange-traded index funds that invest in the same markets.

That's partly because so many global, international and emerging markets ETFs are a high-fee racket of their own. Compared to the underlying indexes, 20 of 24 did worse.

The few that beat their benchmarks did so by narrow margins, averaging 0.8 percentage points a year. The many that trailed their benchmarks did so by about twice as much, or 1.5 percentage points a year.

Oh, and 17 out of 24 fell further than their benchmarks during the COVID crash.

The thing about these "multi-factor" funds is that they piggyback on a lot of questionable research into various "factors," and they allow the fund managers to charge higher fees than on straight index funds.

Many of these factors may or may not have worked in the past. But I notice that academics found so many of these things that two professors a few years ago described the result as a "zoo," and counted more than 400 of them.

I notice that every time someone finds a factor that "has" worked (past tense) they claim that it "works" (present tense), meaning it "will work" (future tense). I also notice – and this is a well-known phenomenon — that factors seem to stop working the moment anyone notices them.

(This, for example, has been true of the so-called "small-cap effect" in the 40 years since it was discovered.)

Logically, as so many people have access to the same data, how can they use it to beat each other? It seems to me it's like trying to win a poker game where all the cards are face up.

The only so-called "factor" that makes any sense to me at all is one that is an "anti-factor." That's equal weighting, where instead of investing more money in the biggest companies in the index (like Apple and Microsoft) you invest equal amounts in all of them. That seems to be more diversified, and avoids the paradox of the standard indexes, which invest most of your money in the stocks that are currently the most popular.

I want a fund that randomly picks 100 stocks from around the world and equally weights and rebalances them once a year. But it's probably tough to get it past the regulars — or charge a lot for it — so I'm not holding my breath.

My husband and I bought a retirement home in 2008, and he died two years later. The condo unit is worth $50,000 more than we paid. Should I sell it now or wait?

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Brett Arends is an award-winning financial writer with many years experience writing about markets, economics and personal finance. He has received an individual award from the Society of American Business Editors and Writers for his financial writing, and was part of the Boston Herald team that won two others. He has worked as an analyst at McKinsey & Co., and is a Chartered Financial Consultant. His latest book, "Storm Proof Your Money", was published by John Wiley & Co.