Northern Trust | Matt Peron: Market Trends Shaping Up for Factors

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Our return expectations for major asset classes like equities, bonds, and hedge funds have declined over the past several years. In 2012, we expected a portfolio of 60% equities, 30% bonds, and 10% alternatives to generate a return of about 6.2%. Since then, that figure continued to drop and is now well short of the return targets used by most pensions, foundations, and trusts. Importantly, our equity forecast has dipped below 6% for the first time in recent history. However, there are ways we can address this.

Based on our research, equity factor performance has historically been best when market returns are lackluster and interest rates are trending up. In these conditions, factor exposures like quality, value, and low volatility can potentially add to equity performance, thereby narrowing the gap between realized and target returns. Good factor performance in a slow market and rising rate environment may seem somewhat counter-intuitive.

People may think that factors such as value and momentum are most likely to outperform in strong markets. However, very strong markets require the preponderance of stocks to be moving in the same direction-- up. In other words, individual stock returns are highly correlated and dispersion is low. The story changes when markets slow. Dispersion among stock returns tends to increase, which gives factors more opportunity to exceed benchmarks.

The current monetary regime of gradually rising rates plays into this dispersion. When central banks increase rates, they're engineering a slowdown that causes investors to be more discerning. The impact will vary considerably by sector, industry, and individual company, thus generating a broad and varying dispersion.

Again, this kind of dispersion has historically help factors outperform. We think factors are entering their prime as the various stars are aligning-- low market return expectations, contractionary central bank policy, and gradually rising long-term interest rates over the coming years. For many investors, the best hope of meeting equity performance goals may be found by taking a tilt to equity factors instead of broad market exposure.

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