WORTH MAGAZINE
ESTABLISHED 1992

WORK \ FINANCE \ LIFE

W

Would You Buy a $16 Cup of Coffee?; Ray Dalio Gets Principled; The 10 Best New Power Lunch Spots

F

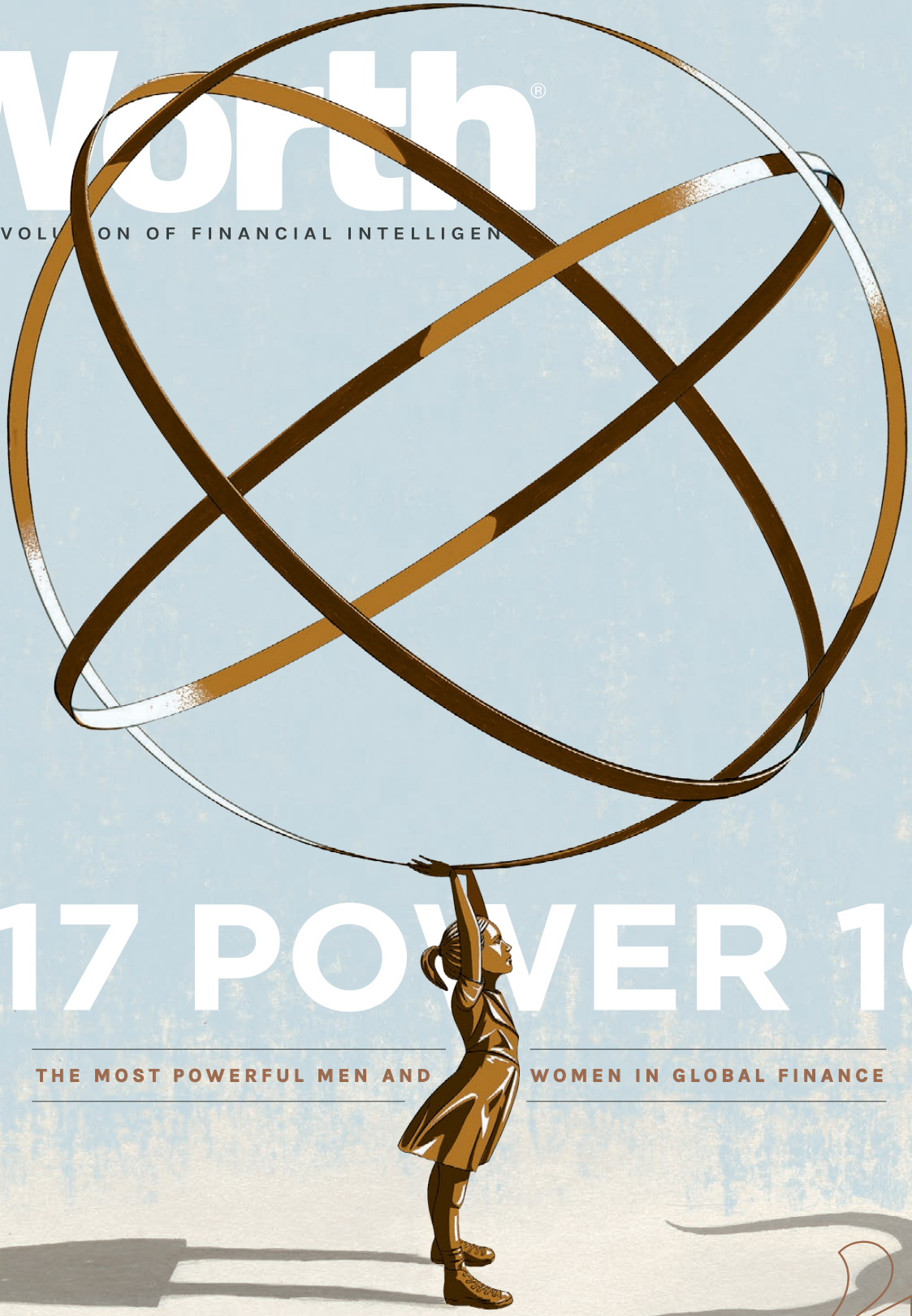
Kirsten Gillibrand on Taking Power; What's Next for the Mooch?; Philanthropy for a New Generation

L

The Breeders' Cup Comes to San Diego; Five Astonishing Performance Cars; *Worth*'s Holiday Gift Guide

Worth®

THE EVOLUTION OF FINANCIAL INTELLIGENCE



2017 POWER 100

THE MOST POWERFUL MEN AND WOMEN IN GLOBAL FINANCE

WORTH.COM

19

VOLUME 26 | EDITION 04

How can factor-based investing better position a portfolio for success?

BY MICHAEL J. NATHANSON

Standing, left to right: *Elisabeth Talbot, Stephen R. Stelljes, Nadine Gordon Lee;* seated: *Michael J. Nathanson*

THE COLONY GROUP | Massachusetts | New York | Virginia | Florida | Colorado | 800.758.8200

FEATURED ADVISORS

Michael J. Nathanson, JD, LLM, Chairman, Chief Executive Officer, President

Nadine Gordon Lee, CPA, CFP®, PFS, Managing Director—Metro NY Offices; President, Colony Group Family Office

Stephen R. Stelljes, JD, CFP®, President of Client Services

Elisabeth Talbot, CFA®, CPA, Managing Director, Senior Financial Counselor

FINANCIAL SERVICES EXPERIENCE

Michael, 26 years; Nadine, 36 years; Stephen, 23 years; Elisabeth, 31 years

PROFESSIONAL SERVICES PROVIDED

Financial planning, tax, investment advisory, asset management, family office and institutional consulting services

PRIMARY CUSTODIANS FOR INVESTOR ASSETS

Fidelity, Schwab, TD Ameritrade, SunTrust

COMPENSATION METHOD

Fixed and asset-based fees (planning services); asset-based fees (investment services)

EMAIL

mnathanson@thecolonygroup.com
nlee@thecolonygroup.com
sstelljes@thecolonygroup.com
ltalbot@thecolonygroup.com

WEBSITE

www.thecolonygroup.com

ILLUSTRATION BY KEVIN SPROULS

Traditional asset allocation theory calls for constructing portfolios comprised of multiple asset classes, such as fixed-income, equities, alternative investments and real assets. Ideally, the allocation among these asset classes reflects an investor's objectives, constraints and tolerance for risk, while also offering opportunities to generate performance and mitigate risk in a variety of market environments. In this sense, asset allocation has always been a complex exercise in balancing risk versus reward.

More recently, some firms have begun to integrate factors into this risk-reward exercise. *Factor-based investing* may leave some wondering whether it is an enhancement or simply just a new trend or buzzword.

What is factor-based investing, and what are some common factors? Factor-based investing involves a deeper-than-usual analysis into the underlying factors that drive returns. By harnessing the premiums associated with select factors, advisors seek to enhance a portfolio's return stream over time.

In short, factors are premiums earned by investors for accepting incremental risks. Importantly, factors exist in nearly all asset classes. For the remainder of this article, however, we will focus on some of the most common factors within the equity markets, as they are more recognizable and widely accessible to investors. According to several studies, while the factors in the list below do not always outperform their respective benchmarks in the short term, all have outperformed those benchmarks over extended periods of time.

- **Quality.** Stocks of companies with stronger financials tend to perform better over time.
- **Momentum.** Stocks that have performed well over time tend to continue to perform well.
- **Value.** Stocks that are undervalued relative to earnings and other measures tend to perform well over time.
- **Size.** Small-cap stocks tend to perform well relative to large-cap stocks over time.
- **Dividends.** Stocks with higher dividend yields tend to produce favorable returns over time.

There are others, but a well-constructed portfolio will focus on those factors that satisfy certain requirements over extended periods:

- They persistently offer **favorable return characteristics** in different market environments.
- They are **broadly observable across markets,** sectors and geographies.
- They are **logically explainable.**

In this regard, many investors favor specific exposure to the factors of quality, momentum, value and size.

How can a factor-based strategy be implemented? Factor-based investing can be implemented in a variety of ways. Most commonly, it is implemented by introducing into a portfolio:

- Individual securities that reflect the select factors best suited to the remainder of the portfolio
- Single-factor funds designed to produce direct exposure to select factors
- Funds or strategies that are specially managed to offer exposure to multiple factors that can work well together based on principles such as diversification and correlation

Importantly, factor-based investing should not relieve an investor from the need to observe basic principles of prudent investing, including diversification and a long-term perspective. This method of investing is best applied as a component to a larger, longer-term asset allocation strategy.

> "Many observers view the systematic nature of factor-based investing as a concept that can bridge the gap between active and passive investing."

Is factor-based investing just another new trend? As the debate continues to rage between proponents of active and passive investing, many observers have begun to view the systematic nature of factor-based investing as a concept that can bridge the gap between the two approaches.

Some of these people oversimplify the advantages of active or passive investing; but, in our view, these are not—and need not be—binary concepts. Moreover, factor-based investing is not a particularly new phenomenon. Indeed, the concept has been around for many years, though new and more efficient ways of implementing it have begun to pervade the marketplace.

In sum, we believe that exposure to factors that are properly evaluated for persistence, breadth and logic can enhance a well-diversified portfolio and help investors successfully meet their specific needs and goals. ●

ABOUT US

FOUNDED IN 1986, THE COLONY GROUP IS AN INDEPENDENT, FEE-ONLY FINANCIAL ADVISORY FIRM THAT SEEKS TO PROVIDE PEACE OF MIND TO CLIENTS. ITS TEAM OF TRUSTED EXPERTS DELIVERS OBJECTIVE FINANCIAL ADVICE, STRIVING TO PROVIDE CLIENTS WITH THE HIGHEST LEVEL OF PERSONALIZED SERVICE. The Colony Group works with high net worth individuals and families, corporate executives, athletes, professionals, entrepreneurs and institutions, providing deep expertise that goes beyond investment management. The firm's clients have access to a full suite of investment-management, financial-counseling and institutional-consulting services, including tax, estate, retirement and philanthropic planning, asset allocation and cash and risk management. ●

Michael J. Nathanson, JD, LLM
Chairman, Chief Executive Officer, President

Nadine Gordon Lee, CPA, CFP®, PFS
Managing Director—Metro NY Offices; President, Colony Group Family Office

Stephen R. Stelljes, JD, CFP®
President of Client Services

Elisabeth Talbot, CFA®, CPA
Managing Director, Senior Financial Counselor

The Colony Group
Massachusetts | New York | Virginia | Florida | Colorado
Tel. 800.758.8200

mnathanson@thecolonygroup.com
nlee@thecolonygroup.com
sstelljes@thecolonygroup.com
ltalbot@thecolonygroup.com
www.thecolonygroup.com

REPRINTED FROM
Worth®
THE EVOLUTION OF FINANCIAL INTELLIGENCE