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Pragmatic Perspectives

Completion Portfolios: Let's Factor in the Bigger Picture

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Summary

A completion portfolio is a powerful tool designed to fill specific gaps or inefficiencies within an existing larger portfolio; targeting alignment with an investor's broader objectives. A particularly effective tool for investors allocating across diverse asset classes and managers, completion portfolios are designed to complement core holdings by adding exposures that enhance diversification, optimize risk-adjusted returns, or fulfill strategic allocation needs.

A key consideration in completion portfolios, factor tilts often emerge from active exposures. While unintended factor tilts may derail performance, research shows certain factors have historically delivered risk premia demonstrating the potential value of intentional factor tilts. V-Square's approach to completion portfolios begins with a deep understanding of an investor objectives, allocation framework, and existing exposures. Comprehensive portfolio attribution analysis, alongside a thorough review of portfolio holdings, is necessary for identifying areas for allocation adjustments. Leveraging exposure analysis and factor exposure mapping, we aim to identify potential exposure gaps as we craft tailored solutions designed to align investors with targeted exposures.

Portfolio Blind Spots

> "Absence of Evidence is not Evidence of Absence."
>
> – Carl Sagan

Conventional reporting tools which primarily focus on the makeup of a portfolio (e.g., sector and country allocation), may overlook factors that can significantly influence performance (e.g., size, style and momentum).

Many investors receive a snapshot of their holdings from widely used reporting tools, however, may be unaware of blind spots, caused by unintended over- or under-exposures to critical factors, that can quietly derail performance.

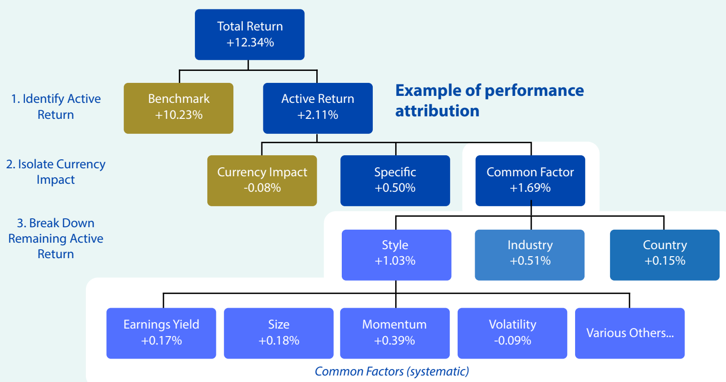
Marking one of the most substantial momentum runs in the past three decades[1], some portfolios underperformed in 2024 due to an inadvertent underweight momentum factor exposure, which significantly impacted equity returns in that year as high-momentum stocks outperformed their low-momentum counterparts by approximately 23%. Similarly, over the past five years, overexposure to the value factor may have resulted in underperformance relative to benchmarks. A dominance of technology and innovation-driven companies within portfolios, combined with historically low interest rates, created an environment where value stocks, often characterized by a lower price-to-earnings ratio and higher dividend yields, struggled to keep pace with broader equity markets. Portfolios heavily tilted toward the value factor may have experienced weakness relative to broader equity markets over this period.

Without a precise understanding of factor exposures and their impact on performance, investors risk being caught off guard by market moves. Indeed, disappointing results could be due to poor asset selection or manager performance, however factor tilts could often play a role as well. Investors must be proactive in knowing their portfolio, continuous monitoring, real-time portfolio attribution, and a holistic approach considering both factor-based and asset-class perspectives.

Breaking Down Equity Returns:

There are various ways to break down equity returns, be it proprietary tools or utilizing data providers, most follow a similar process:

1. Identify Active Return – the portfolio's performance relative to its benchmark,
2. Isolate the Impact of Currency Movements,
3. Break Down the Remaining Active Return into Common Factors vs. Specific Risks:
    a. Common Factors (systematic): Broadly applicable return drivers such as sector, industry, region, fundamental characteristics (profitability, growth), or style factors including momentum, value, volatility and size.
    b. Specific Risk (idiosyncratic): Return drivers unique to a security, unexplained by broader factors.



When evaluating performance, investors should consider whether excess returns were driven by repeatable alpha-generation, systematic factor exposure or macro-driven head- or tailwinds. Notably, certain small-cap value managers may outperform; sighting 'growth' and 'size' tilts versus security selection. These strategies may be exhibiting style drift rather than delivering repeatable returns. Similarly, if an international equity manager's returns are largely explainable by currency fluctuations, this should raise concern.

Research supports this view and emphasizes the importance of understanding the drivers of manager returns. In a 2006 study by Busse, Goyal, and Wahal on over 1,400 asset management firms, domestic equity portfolios in the top decile of inflows saw their Fama-French alpha drop from 1.37% per quarter to 0.11% within a year, following a 31.8% AUM increase[2]. With similar findings for international equity managers, this highlights the reality that oftentimes, top-selected investment managers struggle to continue generating levels of performance that brought investors in. Deeper attribution analysis can help investors to better understand potential repeatability of excess returns and potentially avoid placing capital with an asset manager with inconsistent return drivers.

The Role of Factors in Your Portfolio

Many portfolios with underlying active strategies are likely to exhibit factor tilts relative to benchmarks. While some investors aim to neutralize these tilts, we argue that compensated risk factors, grounded in research, should have an intentional place in portfolios, whether through tactical exposures or long-term allocations designed to capture risk premia. The key is being aware of these exposures and aligning them with portfolio objectives.

Factor investing certainly is not new with a variety of factors having been studied extensively. While some managers adhere strictly to one style, investors could potentially achieve better long-term risk-adjusted returns by intentionally introducing factor tilts with well-documented return premium in both research and industry practice. Properly balancing these factor tilts, especially with factors that exhibit low correlation to existing allocations across the portfolio, can enhance risk-adjusted returns. In 2019, Dichtl et al. reinforce this point, identifying three key criteria for a factor to provide persistent rewarded risk premia[3]:

1. The factor must compensate for systematic risk.
2. The factor must be rooted in persistent investor behavior, creating exploitable inefficiencies.
3. The factor should be linked to specific market structures that drive return patterns.

As shown in a wide range of research including that of Bender et al., in 2013, there are a variety of risk factors meeting these criteria and having historically proven associated risk premiums, including value, size, volatility, high yield, quality and momentum as some of the most widely regarded4, which we consider key factors for investors to evaluate in their portfolio construction.

V-Square's Approach on Completion Portfolios and Factor Investing

V-Square's approach to completion portfolios seeks to gain a deep understanding of an investor's objectives, allocation framework, and existing exposures. The first step is assessing broad asset class, geographic, and industry weights followed by a review of portfolio exposures to identify potential gaps or unintended risks.

Key elements of V-Square's approach include:

- **Portfolio Exposure Analysis:** We analyze the existing portfolio to provide visibility into asset class, sector, and regional allocations, reviewing alignment with investment objectives.
- **Factor Exposure Mapping:** We assess factor exposures to identify unintended biases or significant deviations from the intended portfolio structure.
- **Identifying Portfolio Gaps & Enhancements:** We evaluate exposures at multiple levels to help investors align their portfolio with their investment goals while minimizing unintended risks or redundancies.
- **Customization & Implementation:** We work with investors to define goals and refine existing exposures, with the aim of a balanced, risk-aware portfolio.

A V-Square Completion Portfolio is designed to help investors optimize exposures, mitigate concentration risks, and align their portfolio with strategic objectives. For more information or to discuss how our approach could enhance your portfolio strategy, please reach out.

Footnotes/Citations:

1. Bloomberg High Momentum Factor, calculated from long-short difference between 1st quintile and 5th quintile.
2. Busse, J.A., Goyal, A., & Wahal, S. (2006). *Performance Persistence in Institutional Investment Management. Working paper.*
3. Dichtl, H., Drobetz, W., Lohre, H., & Rother, C. (2019). *Active Factor Completion Strategies.* University of Hamburg, Invesco, EMP, Lancaster University Management School.
4. Bender, J., Briand, R., Melas, D., & Subramanian, R.A. (2013). Foundations of Factor Investing. MSCI Research Insights, December 2013.

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