Factor-based investing

How factors fit into Vanguard's investment philosophy

Amma Boateng: So we had a question come in from Jim in Missouri. He asks, "Does the addition of our factor-based products water down Vanguard's long-standing messages about portfolio construction?" Doug, how about you take this one first?

Doug Grim: Yes, sure. I'm glad Jim asked this one. This is important. I mean for us, our longstanding investment philosophy remains the same. I mean, if you think about the four investment pillars of our philosophy, it's, number one, goals. First and foremost, we want advisors to sit down with their individual clients, understand their needs, what they're looking for, and identify that. The second one, important one, is balance, right? It's making sure that it's a diversified portfolio across multiple asset classes to weather the storms, that inevitably build portfolios. The third, which is very popular for Vanguard, is making sure that whatever you're using to implement that asset location is low cost. And the fourth is discipline, it's maintaining discipline. We know that asset classes, active strategies go in and out of favor over time. But one important thing—and I'm sure advisors have heard this through Advisor's Alpha work—of the importance of behavioral coaching is to try to keep clients in there for the long term through that discipline.

So, now, from that construct, [what] you say is "how do you fill those asset classes?" You fill them with either index or active strategies. And active has been rooted in our philosophy forever. If you think about when we launched our first index product in the '70s, all we had at that time was active products. And we've been launching active products ever since then.

So for us it's been, they have to be delivered in a low cost way; and the active products aren't necessarily for everybody. We think indexing is a great starting place, cap-weighted broad indexing. And we think that for active, there's a couple things that you need to be able to do. You need to be able to have strong thorough due diligence to be able to assess the people, the process, etc., access to the low cost, and then be patient with it. And so for us the difference with factors is it's just another type of active strategy. You've got traditional active, bottom up stock selection, or quantitative active where you're using proprietary signals to try to generate alpha over time. Factors is really more transparent, more rules-based, targeting well known characteristics that are out there that have been well-documented, and trying to do it in a more risk-controlled way. And we think it fits as a result of that; it fits very well within our philosophy.

Amma Boateng: Okay, so it sounds like it's just another tool in our tool kit.

Doug Grim: Another tool in the tool kit.

Meet the speakers

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Factor funds are subject to investment style risk, which is the chance that returns from the types of stocks in which the fund invests will trail returns from U.S. stock markets. Factor funds are subject to manager risk, which is the chance that poor security selection will cause the fund to underperform relevant benchmarks or other funds with a similar investment objective.

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