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Director

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**BlackRock**

# **A Factor-Based Investment Framework for Reserve Managers**

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# **Factor:** A broad and persistent driver of return

## **Macro Factors**

*Across asset classes*

- Economic Growth
- Real Rates
- Inflation
- Credit
- Emerging Markets
- Liquidity

## **Style Factors**

*Within asset classes*

- Value
- Quality
- Momentum
- Minimum Volatility
- Size
- Carry

Source: BlackRock April 2021.

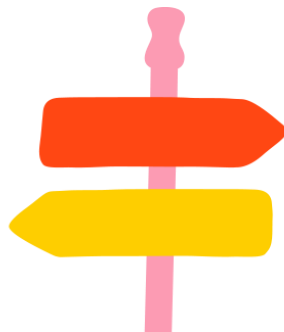
# What does good governance look like?



## Three Distinct Levels

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Explicit separation of roles between an **oversight board**, an **investment committee** and **day-to-day portfolio management**.



## Investment Philosophy

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A **written statement** of an institution's approach to investment



## Aligned Ownership

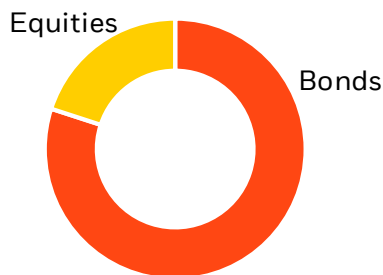
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Each level should be aligned with a **specific timeframe** and **investment objective**. Performance should be **measured** and **reported** accordingly.

Source: BlackRock April 2021.

# A Factor-Based Risk Budgeting Framework

## 1 Reference Portfolio



### Oversight Board

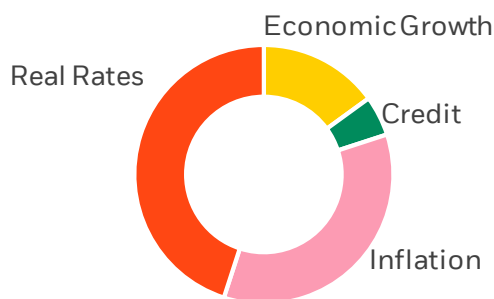
Simple, passive, liquid, inexpensive portfolio that sets the risk and return targets

Used to define appropriate, feasible risk target

Sets baseline for performance measurement

*Review: 3-5 years*

## 2 Strategic Portfolio



### Investment Committee

Long-term vision for the asset allocation of the portfolio

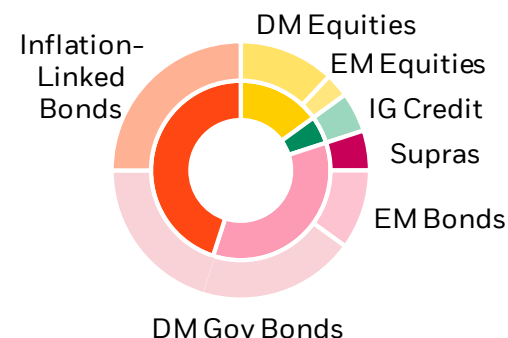
Introduces a factor approach

Seeks to diversify factor exposures instead of focusing only on asset classes

Aims to outperform the reference portfolio

*Review: Annually*

## 3 Investment Portfolio



### Portfolio Managers

Sets allocation bands for asset classes, style factors, and geographic composition

Incorporates medium-term views and strategic tilts or opportunities

May include tactical tilts

*Review: Ongoing*

Source: BlackRock April 2021.

# Some of the potential benefits

## **Ease of Communication**

Simple structure allows for ease of communication across a wide range of stakeholders

## **Enhanced Diversification**

Looking through traditional asset class labels to the underlying factor exposures provides better understanding of the drivers of risk and return in the portfolio

## **Clear performance measurement**

Delineated structure provides a framework with which to measure decisions across the appropriate time frame

## **Compatible with other types of investing**

The factor-based approach is compatible with other types of investing, including sustainability/ESG

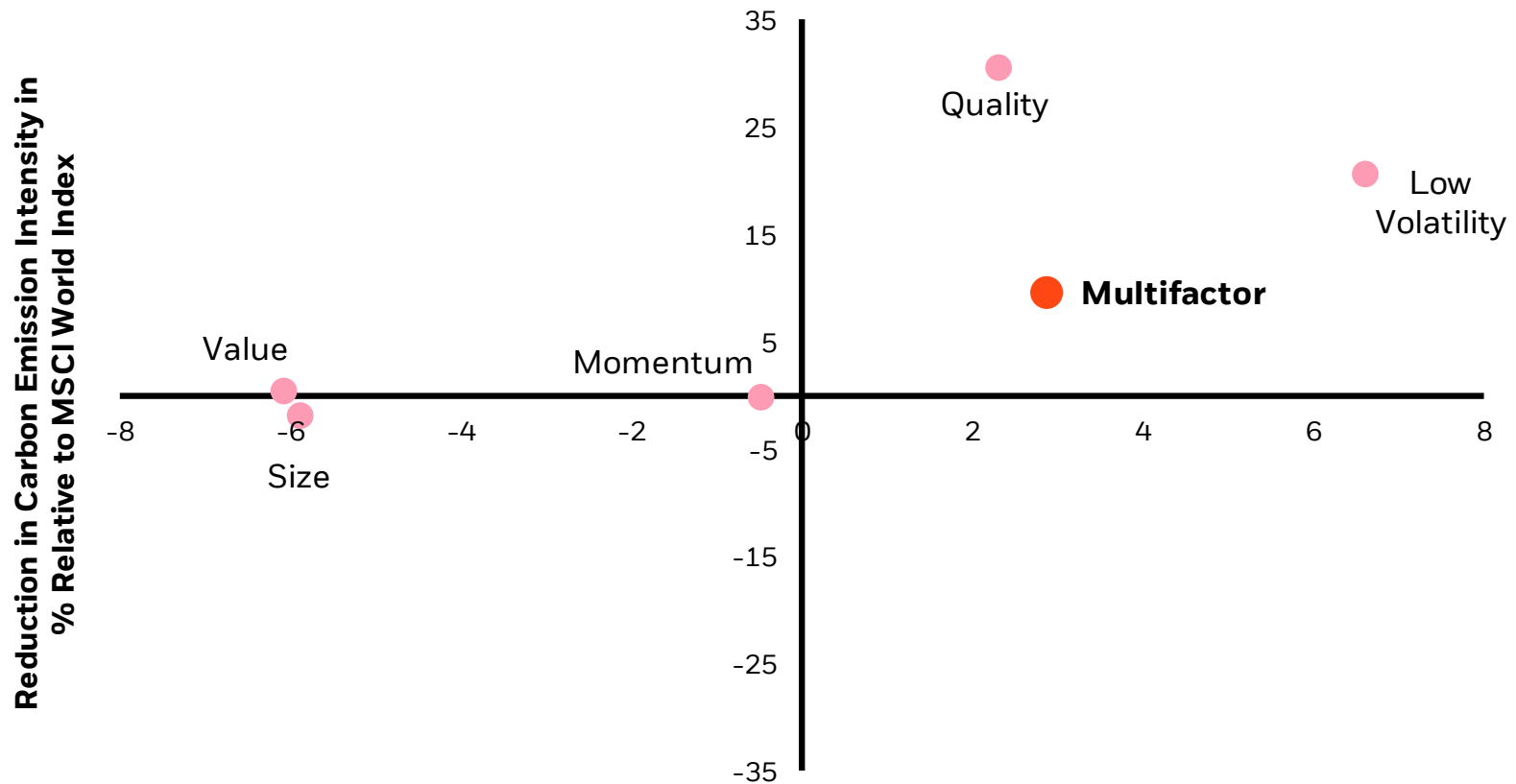


Source: BlackRock April 2021.

# Factors can be ESG friendly

# ESG Scores: Factors vs. the benchmark

## ESG Score and Carbon Emission Intensity of Benchmark Factor Portfolios



### ESG Score improvement in % Relative to MSCI World Index

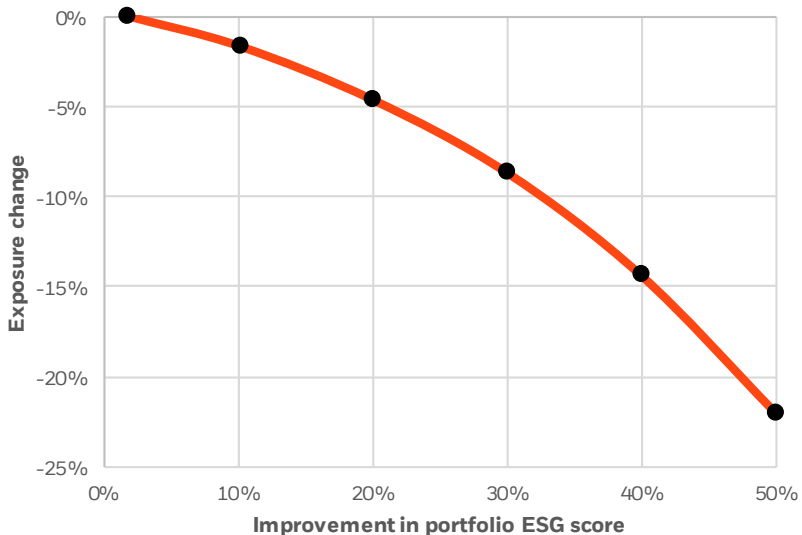
Source: BlackRock, May 2020. Data from Worldscope, IBES, MSCI ESG and Barra. Chan, Ying and Hogan, Ked and Schwaiger, Katharina and Ang, Andrew, ESG in Factors (January 19, 2020). Available at SSRN. The chart summarises the ESG and carbon scores of the benchmark factors relative to the MSCI World market portfolio over January 2015 to September 2019. The origin represents the market portfolio, so the ESG scores represent percentage improvements relative to the market on the x-axis and we plot percentage carbon emission reductions on the y-axis. Thus, those factors in the top right-hand quadrant represent factors that have improved ESG scores and lower carbon emissions than the market as represented by the MSCI World Index.



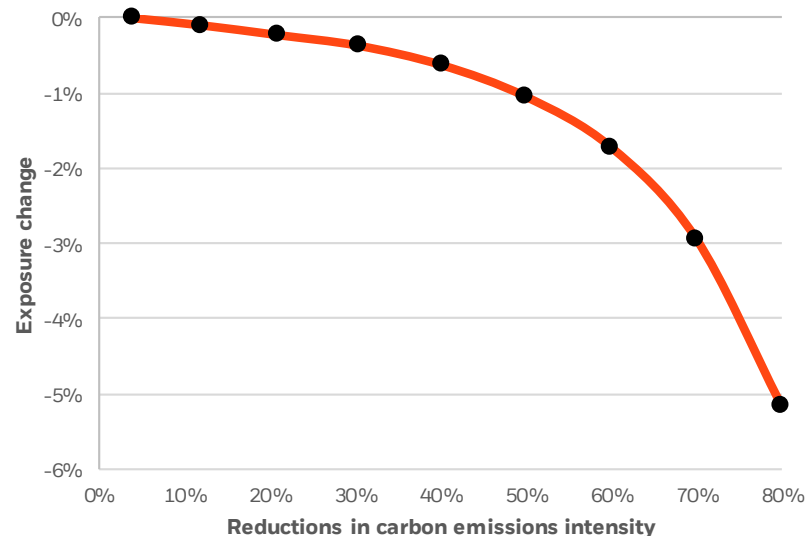


# Combining factors with ESG

## ESG improvement and portfolio exposures



## Carbon improvement and portfolio exposures



Source: BlackRock, as at September 2019. For illustrative purposes only. Portfolio exposure based on up to 50% ESG improvement. (left). Portfolio exposure based on up to 80% carbon improvement (right). The chart shows a multifactor portfolio's active factor exposure resulting from an improved ESG score/carbon emission intensity relative to the market. On the y-axis, we plot the percentage difference in active factor exposure between the optimal portfolio with ESG/carbon constraints and the optimum without constraints. This gives us an indication of how much the additional constraint (x-axis) moves us away from the optimal factor exposure. There are no assurances that the hypothetical portfolio's objectives will be met. Additionally, there are frequently sharp differences between a hypothetical performance record and the actual record subsequently achieved. Another inherent limitation of these results is that the allocation decisions reflected in the performance record were not made under actual market conditions and, therefore, cannot completely account for the impact of financial risk in actual portfolio management. The performance shown does not represent any existing portfolio, and as such, is not an investible product



# Key Takeaways

1

**Good governance** is at the heart of good investment management

2

**A factor-based framework** can facilitate **easier communication**, more **intentional diversification**, and **clear performance measurement**

3

Factor-based investing is compatible, and often synergistic, with many other types of investing, including sustainability

Source: BlackRock April 2021.

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