Factor investing foundations: Looking beneath asset class labels

September 2026

Key takeaways

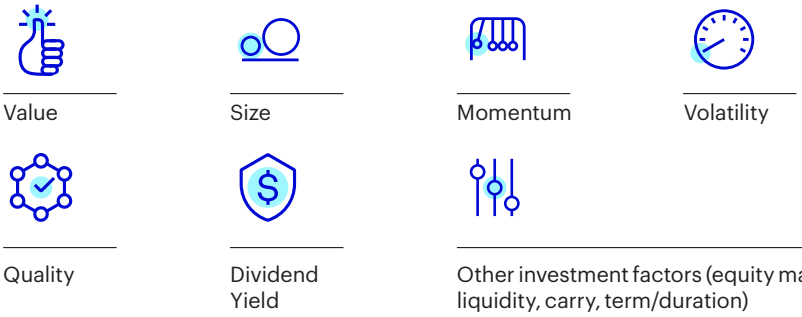
- Factors are measurable characteristics that can help explain differences in securities' risk and return.
- A credible factor needs an economic rationale, robust risk and return evidence, validation across sectors, regions, asset classes and macro regimes as well as a practical route to implementation.
- Factor investing is best viewed as a systematic complement to market-cap-weighted indexing and fundamental active management.

Traditional portfolio analysis often begins with asset classes: equities, bonds, cash and alternatives. While this framework remains useful, it can conceal the forces that drive outcomes. Two portfolios with similar asset class weights may behave differently because their exposures to economic growth, inflation, interest rates or investment styles are not the same. Systematic invesing uses a disciplined, rules-based process to select and weight securities using measurable data, rather than relying primarily on discretionary judgement. Factor investing is one form of systematic investing. It seeks to identify measurable characteristics that help explain why groups of securities have behaved differently over time.

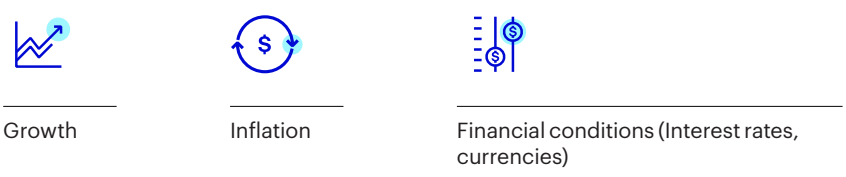
What is a factor?
A factor is a characteristic that can be observed across many securities and used systematically in portfolio construction. Some factors are macroeconomic - growth, inflation and interest rates can affect several asset classes at once. Others are style factors, such as value, size, momentum, quality and volatility. These distinguish securities within an asset class by using information including valuation, market capitalization, recent performance, profitability, balance-sheet strength or variability of returns.

Figure 1: Examples of style and macro factors

Style factors: Investment factors that can be expressed in investment strategies



Macro factors: Broad and systematic factors that impact asset prices but may not be expressible directly using securities



Source: Invesco. Illustrative examples of macro and style factors.

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A useful investment factor should have a credible economic explanation rather than being a statistical coincidence. Ultimately, a solid rationale for a factor premium is required. Evidence should be persistent over long periods with consistent risk and return profiles visible across markets, sectors or asset classes where relevant, and robust to different definitions and parameter changes. It should also be distinct from other factors and practical to capture after trading costs, liquidity limits and portfolio constraints.

This discipline matters because the expansion of quantitative research has produced a large "factor zoo". Backtests can identify patterns that appear compelling in a particular sample but fail in live portfolios. This trend has become more prominent in the wake of unstructured and alternative data sets. Investors would therefore need to distinguish between an interesting signal and an investable factor.

Why can factor premiums be expected?
There are three broad explanations as to why factor premia exist. The first is compensation for risk. For example, smaller companies may be less liquid or more economically sensitive, so investors may require additional expected return for holding them. The second is behavioral. Investors may overreact, underreact, follow trends or anchor to past information, allowing mispricing to persist. Momentum is often linked to gradual information processing and herding, while value may partly reflect excessive pessimism toward unpopular companies.

The third explanation is structural. Regulations, benchmarks, leverage constraints and institutional preferences may create recurring demand patterns. The low volatility effect, for example, may partly arise because investors unable or unwilling to use leverage seek higher-returning, higher-volatility securities, leaving lower volatility securities relatively overlooked and thus incorrectly priced.

No single explanation needs to account for every factor in every market. What matters is that the rationale is plausible, evidence is broad and implementation does not erase the expected benefit.

Figure 2: Why can factor premiums be expected?

Risk premiums	Compensation for additional risks versus the broad market, that is, for an undesirable return pattern.
Behavioral psychology	Markets are inefficient due to the behavioral characteristics of investors. - Anchoring - Action bias - Loss aversion
Market structure	Markets can be inefficient due to restrictions and limitations.

Source: Invesco. Simplified schematic representation for illustrative purposes only.

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A third pillar—not a passive shortcut

Factor investing is often placed between traditional active management and market-cap-weighted indexing. Like indexing, it generally follows a repeatable process across a diversified universe. At the same time, it deliberately departs from the market portfolio to pursue a defined objective like active investing. The distinction is therefore not simply "active versus passive". It is about the source of the decision.

A fundamental manager may select a concentrated group of securities using company research, judgement and security-specific insight. A factor strategy applies consistent rules to many securities that share chosen characteristics. A market-cap-weighted index, by contrast, allows market value to determine portfolio weights. Each approach can serve a different role, and investors may combine all three.

From research to portfolio reality

Transparency is one attractive feature of factor investing. Investors can often see which exposure is being targeted and how securities are selected. Yet rules alone do not guarantee a good outcome as definitions can vary. Value may be measured using price-to-book, earnings, cash flow or several metrics. Quality may combine profitability, earnings stability and leverage. Portfolio construction choices—including rebalancing, turnover controls and sector constraints—can materially change results.

Factor returns are also uneven. A factor with strong long-term evidence can lag for years, and no approach can guarantee a premium. This is not a flaw unique to factor investing; it is part of bearing differentiated risk. It does mean that governance, time horizon and tolerance for benchmark-relative underperformance are central to any allocation.

Where the series goes next

The next article examines the five widely used equity style factors—value, size, volatility, momentum and quality—and considers what each captures, why it may persist and where its vulnerabilities lie. The final article then brings those building blocks together, exploring single- and multi-factor portfolios and active and index-based implementation.

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