Factor investing foundations: Five equity factors

September 2026

Key takeaways

- Value, size, momentum, volatility and quality use different signals and may respond differently to market conditions.
- Each factor has a plausible rationale, but may not necessarily be implementable in a straight-forward fashion or has periods when it can underperform.
- Definitions and portfolio construction are as important as the factor label.

The first article introduced factors as measurable characteristics that may help explain differences in securities' risk and return. This article moves from the framework to the building blocks. Five factors appear repeatedly in equity research and live strategies: value, size, momentum, volatility, and quality.

Figure 1: Key systematic style factors

	Seeks to capture	Commonly captured by
Value	Excess returns to securities that have low prices relative to peers with higher prices in the long run	P/B, P/E ratio, cash flow yield, P/B, P/E ratio, cash fiow yield, duration hedged yield in bonds
Size	Excess return of smaller firms (by market cap) or issues in bonds relative to their larger counterparts	Market capitalization (full or free float) for equity and issue size in bonds
Momentum	Excess returns to securities with stronger past performance	Relative returns (6mth, 12-mth, usually with last 1-mth excluded), earnings revisions
Volatility	Excess risk-adjusted returns to securities with lower than average volatilty or beta	Standard deviation (1-yr, 2-yrs, Standard deviation (1-yr, 2-yrs, 3-yrs), downside standard deviation, standard deviation of idiosyncratic returns, beta
Quality	Excess returns to stocks that are characterized by low debt, stable earnings growth, profitability. and other "quality" metrics	Return on equity, earnings stabillty, dividend growth stability. strength of balance sheet, financial leverage or for bonds short duration, high credit quality or low volatility

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

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Value: paying less for fundamentals
Value strategies favor securities priced at a discount relative to measures of fundamentals. Common metrics include earnings, book value, dividends and cash flow. The rationale is intuitive: investors may overpay for attractive growth stories or become too pessimistic about companies facing temporary difficulties. Alternatively, cheaper companies may carry greater economic or financial risk, and the prospective premium may compensate investors for bearing it.

The main challenge is distinguishing a mispriced company from one whose low valuation reflects deteriorating fundamentals. Accounting measures may also become less informative for businesses built around intangible assets. For this reason, many strategies combine several valuation measures and introduce quality or momentum checks to reduce exposure to potential "value traps".

Size: looking beyond the largest companies
The size factor tilts toward smaller companies. Possible explanations include lower liquidity, less analyst coverage and greater sensitivity to financing conditions or the economic cycle. Smaller companies may also have more room to grow, although growth alone does not ensure attractive returns.

The academic evidence for size is less consistent than for some other factors and can depend on how micro-cap stocks, liquidity and quality are treated. Low Size strategies tend to load higher on equity market beta, which explains large parts of a potential Size premium. Furthermore, implementation at scale is limited for the factor given the comparatively low size of the stocks and thus liquidity of the strategy. Size could nevertheless influence portfolio construction by reducing the dominance of the largest companies and broadening the opportunity set. Investors should examine whether a strategy is capturing a genuine small-company effect or simply taking unintended liquidity and quality risks.

Volatility: challenging a simple risk-return assumption
Volatility strategies favor securities whose prices have fluctuated less than those of their peers. Historically, low volatility equities have often delivered stronger risk-adjusted returns than a simple model would suggest. One explanation is that leverage constraints encourage investors seeking higher returns to buy high-beta securities, making them relatively expensive. Benchmark pressure and a preference for exciting stocks may reinforce the effect.

Low volatility portfolios could develop sector or interest rate sensitivities because defensive industries often dominate the eligible set. They may also lag sharply in fast, speculative rallies. The objective is not to eliminate loss, but to reshape the pattern of equity risk. Construction constraints are important if investors want lower volatility without excessive concentration.

Momentum: following persistent trends
Momentum favors recent winners and reduces exposure to recent losers. It is commonly linked to behavioral biases: investors may absorb new information gradually, anchor to old expectations or follow existing trends. Earnings revisions may provide a related signal because changing analyst expectations may precede full adjustment in market prices.

Momentum may diversify value because the two often favor different securities. However, it could involve high turnover and may suffer abrupt reversals when market leadership changes. Signal diversification, trading discipline and controls around crowded positions are therefore particularly important.

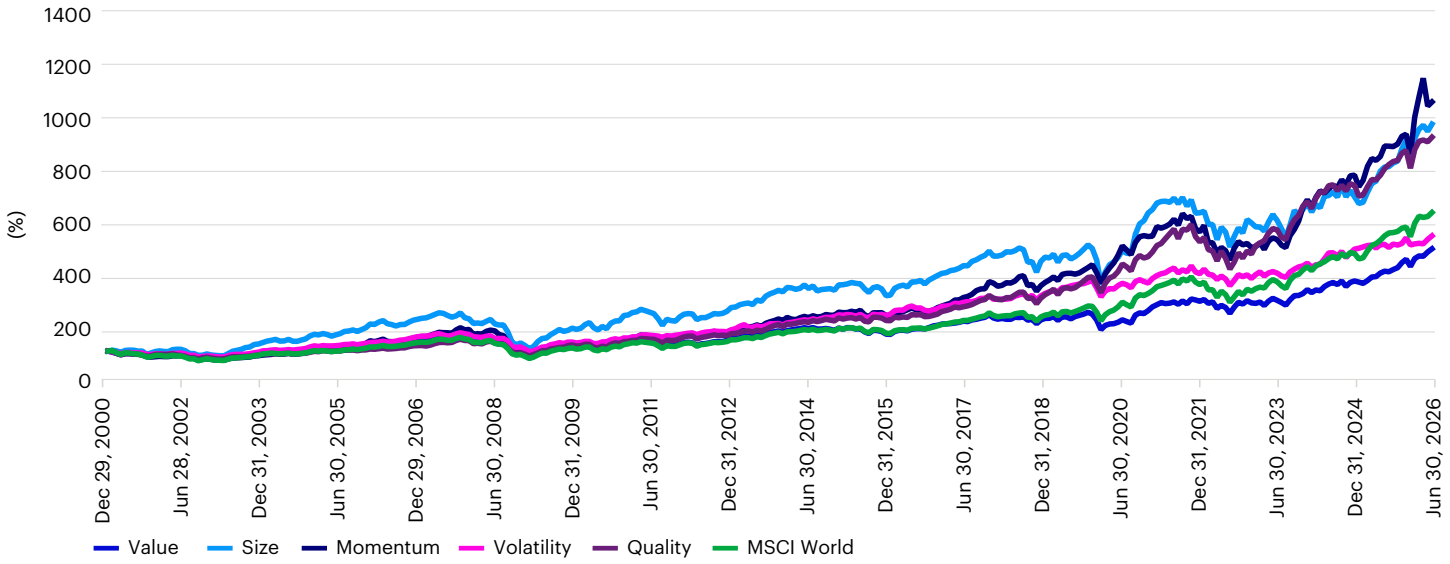
Quality: focusing on resilient businesses
Quality strategies seek companies with characteristics such as strong profitability, stable earnings, healthy cash generation and conservative balance sheets. The rationale is that markets may underappreciate the persistence of good businesses or overpay for more speculative opportunities. Quality may also provide resilience when economic conditions weaken.

Quality is harder to define than its label implies. Brand strength, management capability and competitive advantage may be economically important but difficult to quantify. A narrow screen can also exclude young companies that are reinvesting heavily. Robust strategies therefore tend to use multiple observable measures while recognizing what the data cannot capture.

Why definitions matter
Two strategies carrying the same factor label may have materially different portfolios. A value strategy based on book value may differ from one based on cash-flow yield. A quality portfolio focused on profitability may not resemble one built around low leverage. Rebalancing schedules, sector limits, security weighting and transaction-cost controls create further differences.

Investors can therefore look beyond labels and ask three questions: What is the signal? How is it translated into holdings? What risks emerge from that process? This due diligence helps separate intended factor exposure from unintended bets.

Figure 2: Factor strategies - Historical index data shows outperformance potential



Source: Invesco, MSCI from Dec 29, 2000, to Dec 31, 2025 (total return, in USD). For illustrative purposes only. Indices: Size = MSCI World Small Cap; Momentum: MSCI World Momentum; Value = MSCI World Value Weighted; Volatility: MSCI World Min. Volatility; Quality = MSCI World Quality. All of the factor indices shown have been created comparatively recently, and therefore, contain elements of hindsight and selection bias. All information presented prior to the inception dates are back-tested. Back-tested performance is not actual performance but is hypothetical. Although back-tested data may be prepared with the benefit of hindsight, these calculations are based on the same methodology that was in effect when the index was officially launched. Index returns do not reflect payment of any sales charges or fees. **Performance, actual or hypothetical is not a guarantee of future results**. An investment cannot be made in an index.

No factor leads in every environment
Factors may experience long periods of relative weakness. Value may struggle when investors favor rapidly growing companies. Momentum may reverse when market leadership turns abruptly. Smaller companies may be vulnerable when liquidity tightens. Low volatility and quality may lag in strong risk-on rallies. These patterns are observations, not reliable timing rules. Economic turning points are difficult to identify consistently in advance.

This uneven behavior creates the bridge to Article 3. If factors are distinct and leadership rotates unpredictably, investors need to decide whether to hold a single factor, combine several, or use factors to complement existing managers. The final article addresses those choices and focuses on implementation rather than labels.

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