IQIC - Building a Strategy

#3: Signals & Factors

What are Signals & Factors

A **signal** is a measurable variable used to help decide what to buy, sell, or hold

A **factor** is a broader characteristic associated with differences in asset returns

Examples include:

- Recent price performance
- Valuation
- Profitability
- Growth

Why use them: They turn investment ideas into consistent, measurable rules.

Momentum

Momentum measures an asset's recent price performance.

Simple example:

1. Calculate each stock's return over the past 6 months
2. Rank stocks from highest to lowest
3. Favor stocks with stronger recent performance

Hypothesis behind momentum: Assets that have recently performed well may continue to outperform over a future period

Constraint: Momentum can reverse quickly and does not guarantee continued performance

Value

Value signals compare an asset's market price with the measures of the underlying business

Common metrics:

- Price-to-Earnings (P/E)
- Price-to-Book (P/B)
- Earnings Yield

Example:

Stock A: P/E = 12
Stock B: P/E = 30

Stock A is cheaper relative to its earnings, but that **doesn't automatically make it a better investment**

Quality & Growth

Quality signals look for financially strong companies

Examples: High profitability, stable earnings, manageable debt, etc.

Growth signals look for companies whose businesses are expanding.

Examples: Revenue growth, earnings growth, etc.

A company can score highly on both, either, or neither.

Combining Signals

A strategy can combine multiple signals

Stock	Momentum	Value	Quality	Overall
A	High	Low	High	Strong
B	Low	High	Medium	Medium

Example: **40% Momentum + 30% Value + 30% Quality = Combined Score**

Combining signals can capture different sources of information, but adding more signals does not automatically improve a strategy.

Key Takeaway: Multiple complementary signals can provide a broader view of an investment.

Choosing a Signal

There are thousands of different signals to use. Before using a signal, ask:

1. **Why:** Is there a logical reason it might affect returns?
2. **Evidence:** Does the relationship appear across different periods?
3. **Reliable:** Does it survive realistic assumptions in testing?
4. **Relevant:** Does it fit your strategy's objective and time frame?

Additional Resources

1. **MSCI - Factor Investing:** Guide Link
   a. An educational overview of major investment factors and factor-based strategies work