Getting Smart on Smart Beta

Insight into the rise of smart beta strategies

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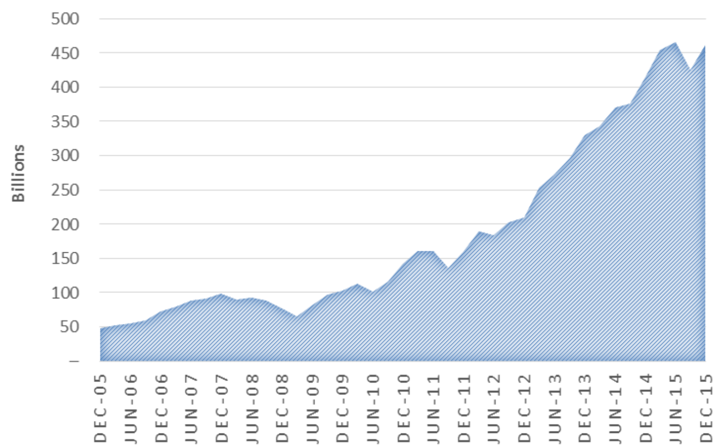
- Smart beta strategies have received significant attention from the marketplace in recent years with assets nearly doubling from 2012 to 2015.
- Factor investing, which is a key idea behind the creation of smart beta, dates back several decades but the rise of passive investing has given new focus to the systematic allocation to certain factors.
- Effective factors should exhibit the ability to produce excess return through time and should each have a reasonable economic rationale.
- Unintended outcomes must be considered during the portfolio construction process since a particular stock will exhibit more than one factor at a time.

Assets invested in smart beta strategies have grown significantly in recent years as these strategies gathered increased attention from both institutional and retail investors. In fact, smart beta assets have risen from \$49 billion in 2005 to \$462 billion at the end of 2015.[1] Growth in assets more than doubled from 2012 to 2015 as market participants shifted away from traditional actively managed strategies.[1] To date, Morningstar has over 450 distinct Strategic Beta Indices. The "smart beta" adoption progressed significantly in 2013 when Towers Watson coined the term and introduced the idea as a formidable competitor to active management (Towers Watson, 2013). Its place in the investment world was further supported by the launch of Morningstar's "Strategic Beta" classification system in 2014 and continues to be an area of rapid adoption among asset allocators and retail investors.[2]

Figure 1: Smart Beta AUM



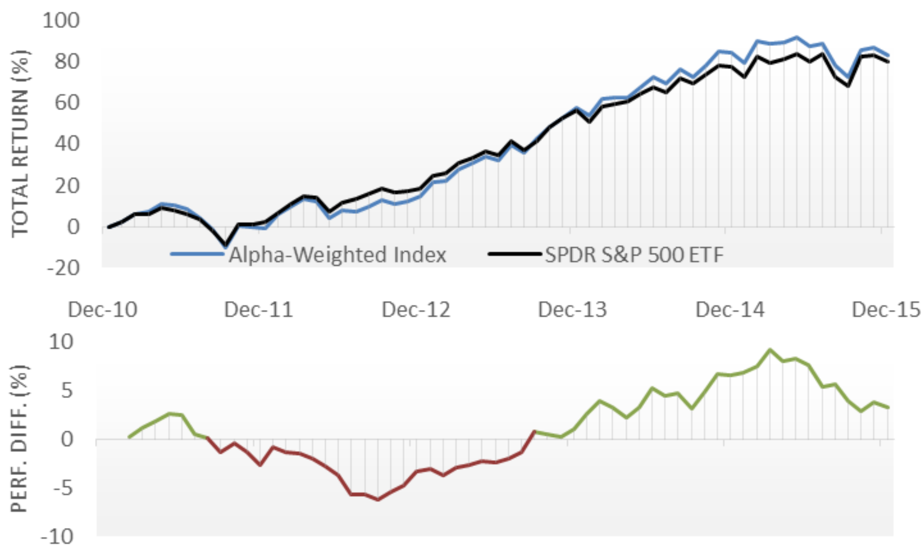
Despite the fresh term of "smart beta", the concept of systematically exploiting investable themes to achieve outperformance relative to a traditional market capitalization weighted index is far from new. One can argue that factor investing has been around since Benjamin Graham wrote

[1] Morningstar Direct, Strategic Beta ETF Category AUM
[2] "Understanding Smart Beta," Towers Watson, July 2013

his seminal work *The Intelligent Investor* in 1949 and advocated that buying inexpensive stocks would result in investors outperforming the market (i.e., the value factor). As time progressed, more systematic approaches were applied to the concept, including the work of Eugene Fama and Ken French in the early 1990s when they introduced the Fama-French Model. This model demonstrated that size (i.e. smaller capitalization stocks) and price (i.e. inexpensive or value stocks) are riskier as measured by volatility and therefore should command higher return over time when compared to stocks with the opposite characteristics. Through additional academic and market applied research, a number of additional factors were developed including momentum, quality and low volatility.

Factors are often sought in order to systematically weight a portfolio to produce a higher level of return per unit of risk relative to a market cap-weighted benchmark. While a number of more commonly accepted factors are discussed above, it is important to understand the difference between achieving excess return and proving an economic rationale for that return. To prove this point, Figure 2 shows the total return of the SPDR S&P 500 ETF (SPY) compared to a "smart" reweighted index. In this example, the "smart" index is composed of all S&P 500 constituents reweighted alphabetically based on ticker symbol with rebalancing occurring at the end of each year. Using this "methodology", Agilent Technologies (A) received the highest weight in the portfolio simply due to its place alphabetically. Despite zero economic rationale whatsoever, the alphabetically-weighted index outperformed the SPY over the five year period ending December 31, 2015 by an annualized amount of 40 basis points. The result of this example leads to an important point: as an increasing number of factor-based indexes come to market, it is important for investors to conduct their own analysis to understand why there is persistency and efficacy in the investment methodology that is being utilized.

Figure 2: Alphabetically Weighted Index



Once a factor is established as a sound and rational source of excess return relative to the market capitalization weighted index, the next question one should ask is: *how does an investor go about buying this specific factor?* Stocks generally do not exhibit just one factor. Therefore isolating single factor characteristics may be a challenging exercise. For instance, a value stock may have quality characteristics or a quality stock may have high price momentum. The ability to extract and exploit a single factor from a stock can be a difficult exercise and has potential to grant investors unintended exposures when seeking a single factor. It is important to understand exactly what a portfolio's exposures are and how they might affect future performance.

For example, Figure 3 displays two popular low volatility emerging markets ETFs that have had notable differences in performance over the last three years. The dispersion of returns from the two portfolios attempting to exploit the same factor in the same market illustrates the unintended outcomes that can arise from factor investing.

Figure 3: Dispersion of Returns (as of 6/30/2016)

	1 Year		**3 Years**	
	Return	**Std Dev**	**Return**	**Std Dev**
iShares Edge MSCI Min Vol Emerging Mkts ETF	(9.1%)	17.4%	(1.3%)	13.3%
PowerShares S&P Emerging Mkts Low Volatility ETF	(9.9%)	18.4%	(4.4%)	14.1%
Difference	*-0.82%*	*1.02%*	*-3.10%*	*0.80%*

This example serves as a reminder that while an idea may have a solid rationale in an academic sense, implementation can differ significantly. Thus, due diligence on any strategy is required to understand both the concept and the implementation of that concept.

Factor investing can bridge an important gap between active and passive investing by introducing an active investment concept with a passive, rules-based implementation process. Whether the rise in smart beta strategies is a response to investors who have grown frustrated with the higher fees and/or sporadic outperformance of active managers or some other reason, smart beta can offer differentiation from active and passive options with fees that are often between those of active and passive peers.

Despite the benefits, factor-based implementation has its own set of drawbacks. We caution investors from taking a passive approach to selecting smart beta investments. Diligence is necessary to understand a factor's economic rationale and the efficacy of process behind its extraction. These components are critical to investors experiencing the risk and return pattern they seek and are important considerations as smart beta and factor investing become a growing part of the investment conversation.

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