HOW SMART IS SMART BETA?

Strategic Investment Group®

Fiduciary Insights

IN THIS ISSUE OF FIDUCIARY INSIGHTS, WE EXAMINE THE VIRTUES AND LIMITATIONS OF SMART BETA STRATEGIES, QUASI-PASSIVE PORTFOLIOS WITH A BUILT-IN BIAS, PROMOTED FOR THEIR POTENTIAL TO ADD VALUE OVER ORDINARY BENCHMARKS BY EXPLOITING MARKET INEFFICIENCIES. We conclude by illustrating how some of the insights of Smart Beta, if applied judiciously, can contribute to intelligent portfolio management.

Introduction

Smart Beta products are quasi-passive portfolios designed to selectively and systematically tilt their allocations to particular market characteristics in an attempt to outperform traditional capitalization-weighted benchmarks. Encompassing a wide range of strategies and available in several asset classes, they are proliferating and attracting assets at a rapid clip. Equity Smart Beta strategies predominate, and include factor investing, notably value, size, and momentum, and fundamentally weighted portfolios with positions proportional to company fundamentals rather than market capitalization. In the realms of bonds and currencies, Smart Beta includes strategies that focus on capturing maturity and credit premia, implementing carry trades, and rolling down the yield curve. There are also Smart Beta vehicles that seek to mimic hedge fund returns, including products focusing on convertible and merger arbitrage, trend-following strategies, and others that capture the premium of selling options.

Smart Beta products have evolved over time. First generation offerings implemented tilts toward market segments associated with risk premia in asset pricing theory, such as value and small cap stocks. Subsequent products sought to exploit perceived anomalies to standard theory, which are frequently grounded in the insights of behavioral finance. One example is a tilt toward price momentum, which exploits the lagged reaction of investors to new information. The current crop of products often spans asset classes and may combine multiple strategies in a single portfolio. All Smart Beta variants contain elements of passive and active investment management.

In our view, Smart Beta is a misnomer. What the strategies deliver is not strictly beta as it is generally perceived – that is, exposure to the broad capitalization-weighted market. Moreover, the strategies are mechanistic, and often do not take account of relative valuations or broad market conditions, which would be the smarter course of action, in our view. As we explain more fully below, our main concern with Smart Beta strategies is the contention that they will perform well over long periods if consistently adhered to in all markets regardless of relative valuations. There is also reason to doubt that Smart Beta strategies have successfully isolated the actual drivers of their performance. Nevertheless, the strategies grouped under this rubric reflect important insights that can, when used judiciously, contribute to intelligent portfolio management.

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Smart Beta Along the Passive-Active Continuum

Investment strategies have traditionally been classified as either active or passive. Both approaches have their uses and characteristics. Passive strategies offer market exposure at low cost through a

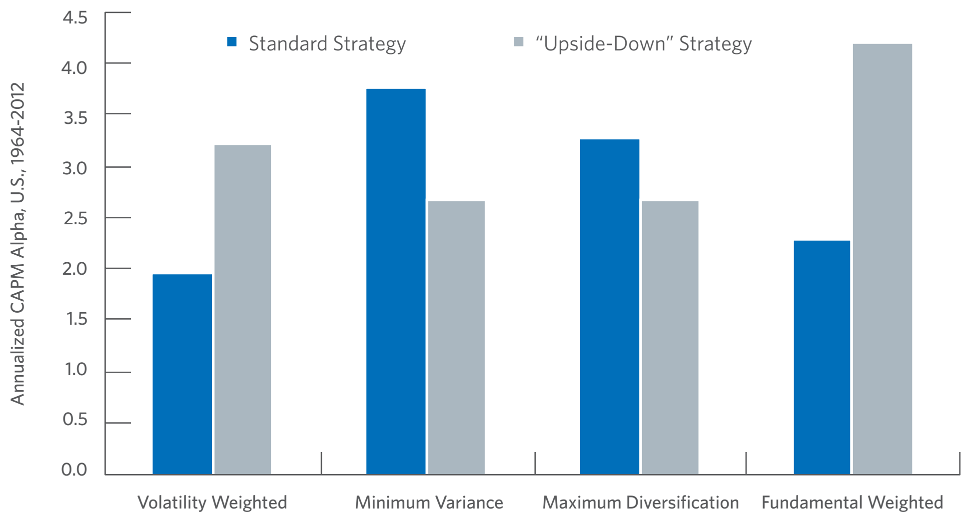
EXHIBIT 1:
Characteristics of Active and Passive Strategies

PASSIVE		ACTIVE
Zero	**Alpha Potential**	High
Low	**Turnover**	High
Low	**Complexity**	High
Low	**Fees**	High
High	**Process Transparency**	Low
Very High	**Capacity**	Low

EXHIBIT 2:

Alphas of Selected Smart Beta Strategies and Their Upside-Down Opposites

Source: Arnott, Hsu, Kalesnik, and Tindall, "The Surprising Alpha from Malkiel's Monkey and Upside-Down Strategies."



In general, the chief contention of purveyors of Smart Beta equity strategies is that specific factor tilts, applied consistently in all market conditions, will tend over time to perform better than a passive exposure to the broad market.

transparent and simple approach to portfolio construction. Active strategies, in contrast, seek to add value and portfolio diversification through a more opaque process that is more costly and complicated to execute (Exhibit 1).

Like active strategies, Smart Beta strategies deviate from market capitalization weights, selectively favoring certain market segments believed to add value over long periods. As with active strategies, the turnover, and hence trading costs, of Smart Beta strategies can be quite high. On the other hand, Smart Beta products also have a number of features more akin to passive strategies, including low complexity, high transparency, large capacity, low fees, and limited potential to diversify traditional portfolios.

Factors and Fundamental Weighting

In general, the chief contention of purveyors of Smart Beta equity strategies is that specific factor tilts, applied consistently in all market conditions, will tend over time to perform better than a passive exposure to the broad market. These factors are not the unique domain of Smart Beta equity strategies. Many traditional active equity managers seek to exploit one or more of these factor anomalies, among other techniques, as elements of their strategy.

- *Value.* By tilting toward stocks with low valuations, value strategies seek to capture the premium offered by cheap stocks to compensate investors for the greater risk of distress, and benefit from the insight that investors tend to overpay for growth. A close relative of a value tilt is fundamental weighting: using corporate fundamentals such as revenues or assets rather than capitalization to assign weights to stocks.
- *Size.* Strategies that favor securities with low market capitalizations aim to exploit the illiquidity and distress premia of small stocks, which may also be undervalued because of the tendency of investors to neglect unfamiliar names.
- *Momentum.* Smart Beta strategies that favor stocks with high trailing returns are based on the observation that investors chase recent return performance, underreact to new information, and are very sensitive to entry price levels.
- *Volatility.* Tilting toward stocks with low beta or low volatility attempts to take advantage of the tendency of investors to prefer, and thus overpay for, stocks that have a lottery-like payoff pattern.

Smart Beta Performance

The marketing of Smart Beta strategies typically includes research papers featuring attractive backtested performance. Sadly, the reasons for this outperformance can be suspect. Lacking support in asset pricing theory, many factor strategies may reflect the increasing sophistication of data mining by academics and practitioners rather than an enduring phenomenon.[1] Much of the value added of Smart Beta strategies is attributable to their portfolio construction and rebalancing methodology, rather than the information content of the factors used. Moreover, many Smart Beta strategies sharing this portfolio management methodology have strikingly similar portfolios and active performance.

One interesting approach to assessing the information content of a Smart Beta factor is to compare its performance to "information-less" strategies that use the same portfolio construction and rebalancing process. For example, the "upside-down test" uses the standard methodology of a Smart Beta strategy, but inverts the key factors used by the strategy to seek to add value. Comparing the returns of Smart Beta strategies and their upside-down counterparts yields the disturbing result that the evil "upside-down" twin also outperforms the market and sometimes even the "right-side up" strategy (Exhibit 2).[2] The proverbial and probably apocryphal "blindfolded monkey test," which constructs portfolios on the basis of where darts thrown by blindfolded monkeys land on a page listing investable securities, yields similarly perverse results.[3] Portfolios randomly generated using the same portfolio construction and rebalancing methodology as the Smart Beta process can also outperform the market and in some cases the Smart Beta strategy as well. These tests suggest that the use of weights that do not float with price, in conjunction with a regular rebalancing process, explains much of the back-tested added value of many Smart Beta strategies.

Assessment of Smart Beta Strategies

The factors said to explain the attractive backtested performance of Smart Beta strategies do not always appear to be the main drivers. Rather, as suggested above, the relative success of many Smart Beta strategies appears to be largely attributable to their portfolio construction and rebalancing methodologies. To the extent that the factors do indeed contribute to the added value of Smart Beta strategies, we are skeptical of the claim that these factors perform well regardless of relative valuations or market conditions. Indeed, the proliferation of Smart Beta strategies seeking to exploit particular factors could result in crowded trades that undermine the factors' viability. The high turnover and trading costs of many Smart Beta strategies are also causes of concern when considering how well backtested results may hold up in practice. Moreover, the use of simplistic rebalancing methodologies can make Smart Beta strategies susceptible to front running.

In general, we believe that superior active managers have the ability to exploit anomalies and advanced portfolio construction techniques more effectively than dedicated Smart Beta strategies. Active managers are better equipped to integrate multiple engines of alpha in a single portfolio and to add value through tactical rotation among factors in response to changing relative valuations. Active managers are also better able to manage risk and execution costs than the mechanically implemented, rules-based portfolio construction approach used by Smart Beta strategies. Our portfolio construction and risk management analytical tools allow us to actively track and manage exposure to Smart Beta factors, as well as other risk factors, embedded in manager portfolios.

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1 The proliferation of papers reporting on market anomalies has led to a commensurate explosion in equity factor discoveries. Some have argued that, given this extensive data mining, a much more rigorous significance threshold should be applied to newly minted factors. The insight that new discoveries should carry a higher burden of statistical proof than traditionally used is also said to apply to medical discoveries. See, for example, Harvey, Liu and Zhu, "… and the Cross-Section of Expected Returns" (April 2014).

2 See Arnott, Hsu, Kalesnik, and Tindall, "The Surprising Alpha from Malkiel's Monkey and Upside-Down Strategies."

3 In actual practice, modern variants of this test replace monkeys with computerized random number generators, leading to high levels of unemployment in segments of the monkey population.

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Intelligent Indexing Over Smart Beta

The combination of favorable elements of passive and active management is a key feature of Smart Beta strategies, and it has important applications. Strategic has developed and implemented a number of innovations that incorporate an intelligent approach to index construction.

One example is our proprietary Quality-Tilted Index, which we designed to favor firms that exhibit high profitability, stable profitability, and low leverage. As of this writing in 2015, this customized index is a core position in our clients' U.S. equity portfolios. As an index that is rebalanced to favor certain security characteristics, Strategic's Quality-Tilted Index incorporates active and passive management. Unlike Smart Beta, however, our current tilt toward quality stocks is a tactical position driven by current relative valuations and market conditions. Indeed, the raison d'être for the quality tilt is that in 2015 quality stocks are less expensive relative to other segments of the U.S. equity market and also less risky than the overall market. When the relative valuation of quality stocks becomes less favorable, we will consider how best to adapt the tilt of the U.S. equity portfolio to new relative valuations and market conditions. An intelligent index of our construction, albeit with different characteristics, could well be the preferred vehicle to adjust the structure of the entire U.S. equity portfolio in an efficient and cost-effective manner.

Another example of our application of intelligent indexing aims to facilitate the implementation of portfolios for clients interested in socially responsible investing. An intelligent index can be customized in accordance with investors' social objectives by eliminating firms whose revenues derive from sources including, for example, the sale or production of tobacco, armaments, coal, or petroleum products. At the same time, it can be adjusted opportunistically – for example, to impart a quality tilt, or to correct for unintended exposures that may result from the application of social screens.

The same analytical tools used to construct intelligent indices also allow us to disentangle the underlying risk factor exposures embedded in each manager. Armed with this analysis, we can track how the exposures of individual managers to Smart Beta and other factors contribute to the underlying risk factor exposures of each asset class as well as the total portfolio to keep these exposures aligned with our tactical targets as relative valuations evolve. We consider that this additional step of assessing how individual manager risk factor exposures combine and interact to affect the expected risk and return of the total portfolio is essential to portfolio management.

Conclusion

Although Smart Beta has its uses, we generally prefer a combination of skilled active managers and intelligent indices. Skilled active managers are more nimble and responsive than Smart Beta strategies in exploiting market inefficiencies. Intelligent indices are a more flexible and less costly means of tilting an entire equity portfolio toward an undervalued market segment. With the nuanced and targeted approach that our proprietary analytics make possible, we can construct intelligent indices that do a more effective job than Smart Beta of managing underlying asset class exposures while also seeking to achieve specific client objectives, including for example, socially responsible investing goals.

Strategic Investment Group

Strategic, a pioneer in dedicated Outsourced CIO (OCIO) solutions since 1987, offers a comprehensive service platform for managing customized portfolios for institutional and private investors. Our proprietary process combines active portfolio management, rigorous risk management, and open architecture manager selection.

Strategic functions as our clients' investment partner and co-fiduciary, effectively becoming an extension of their resources. Clients are then free to focus on their core businesses, while we focus on providing the highly specialized portfolio management expertise that clients need to meet their investment goals. Depending on a client's needs and preferences, Strategic can orchestrate the management of an entire portfolio comprising multiple asset classes, focus on specific asset classes, such as alternatives (e.g., hedge funds, real estate, and/or private equity) or international investments, or manage strategies with high potential for adding value (e.g., portable alpha through investor-friendly turnkey structures). Customized liability-driven investing (LDI) solutions, whether through an integrated total portfolio approach or a targeted long-duration strategy, are also available, as are solutions that address mission-related investment objectives.

We strive to build enduring partnerships with our clients by strengthening their investment programs through a dynamic, value-enhancing investment process, sound governance framework, and world class client service. Our mission is to empower investors through experience, innovation, and excellence.

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