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# Smart Beta

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## Background:

Traditional passive investment strategies track indices, such as the ISEQ or FTSE 250. The advantages of passive investing are that it is a transparent, low cost and predictable method of accessing a well-diversified portfolio and hence it's increasing popularity among investors over the last 10 years.

The indices referred to above weight equities according to their market capitalisation (i.e. the current market price multiplied by the number of shares outstanding). The limitations of such market cap weighted indices or strategies are often highlighted as follows:

1. They tend to be backward-looking. When markets rise sharply these indices consequently own more of the stocks that have outperformed.
2. The indices are prone to risk of concentration at a regional, sector or stock level.
3. They are prone to mispricing or, at an extreme, asset price bubbles, such as that of Japanese equities in the late 1980s or that in the global technology sector in the late 1990s.

While this type of indexing still dominates the world of passive strategies, investors globally are increasingly seeking strategies that enhance returns or minimise risk relative to these traditional market-cap-weighted benchmarks. These strategies are encapsulated by a number of different terms such as smart beta, advanced beta, alternative beta.

## Issues to Consider:

**Factors**

The strategies employed by investors within the smart beta space are primarily one of those listed below – they seek to exploit many of the same sources of return that active managers target.

- Value. Over the long term, low valuation (cheaper) stocks have outperformed high valuation (expensive) names. Indices incorporating this factor use scoring or weighting by fundamental or financial metrics.
- Size. Equal weighted indices weigh all the stocks equally which effectively increases the exposure to the smaller cap stocks in an index. Over time, small-cap stocks have historically tended to outperform their large-cap peers.
- Low Volatility. Creating a portfolio with lower volatility or tilting towards lower risk stocks can likely generate a higher risk-adjusted return than traditional financial theory would suggest.
- Quality. Intuitively it makes sense that better quality companies are rewarded with stronger share prices because they may be better at deploying capital and generating wealth. Investing in higher quality companies has been shown to deliver greater downside protection.
- Momentum. Supporters of efficient market theories believe that stock prices have no memory but empirical evidence shows something else: stocks that have done well recently tend to carry on doing well in the near term. This factor is more difficult to capture through a passive, rules based approach and it tends to be a higher turnover strategy which leads to higher trading costs.

Some investors who are comfortable with the concept of smart beta may use more than one of the above strategies.

## Considerations for Investors

Evidence produced shows that some investors are using smart beta strategies to replace active management strategies whereas other investors are using it to complement their traditional passive portfolios. Regardless of where these strategies fit into a given portfolio or how they are funded, i.e. from an active or passive allocation, the following should be considered by investors in advance:

- Factor exposures. Investors need to understand how they can access various factors and the potential outcomes of investing in those factors. For instance lower volatility stock portfolio can lead to sector bias (to utility stocks for example).
- Fees. Investors should consider the fees (investment management and index licence fees) versus both active and passive management
- Transaction costs. Turnover of stocks is likely to be higher than traditional passive portfolios and lower than active portfolios.
- Out/underperformance. Investors need to be aware that smart beta strategies will perform differently to cap-weighted indices at different times. For instances cap-weighted indices will outperform in periods such as the experience during the tech bubble.

## Use of Smart Beta Strategies in Europe

A Morningstar study as at 31st December 2014 shows that Advanced Beta in Europe has experienced growth of 3,550% in the last 10 years (an increase from €2bn to €73bn in a decade) across all asset classes. In particular, the Global Financial Crisis prompted many investors to become more focused on controlling risks rather than simply maximising their returns. In terms of assets the strategies that are most popular are Low Volatility/Equal Weight, followed by Dividend and Fundamental Weight/Value strategies.

## Fixed Income Smart Beta

Similar to equity markets, standard government bond indices adopt a market capitalisation weighting scheme. This methodology gives higher index weights to the most indebted issuers with the greatest amount of outstanding debt. For instance global bond indices have a high allocation to Japanese issues and in euro government bond indices there is a high relative weight to Italy. Some investors seek to avoid these limitations by capping exposure to a specific issuer or adopting an equally-weighted mix between different issuers.

## Summary:

As a complement to index investments, or as a replacement for active, smart beta strategies can offer investors significant benefits in terms of greater return potential and/or improved diversification. However it does require appropriate governance from investors before proceeding with these strategies to understand the potential benefits and implications for the long term performance of a total portfolio.

## More Information:

Readers should also reference The Active - Passive Investment Decision paper issued by the IAPF when considering this subject: http://www.iapf.ie/informationlibrary/investmenttopics/default.aspx?iid=586