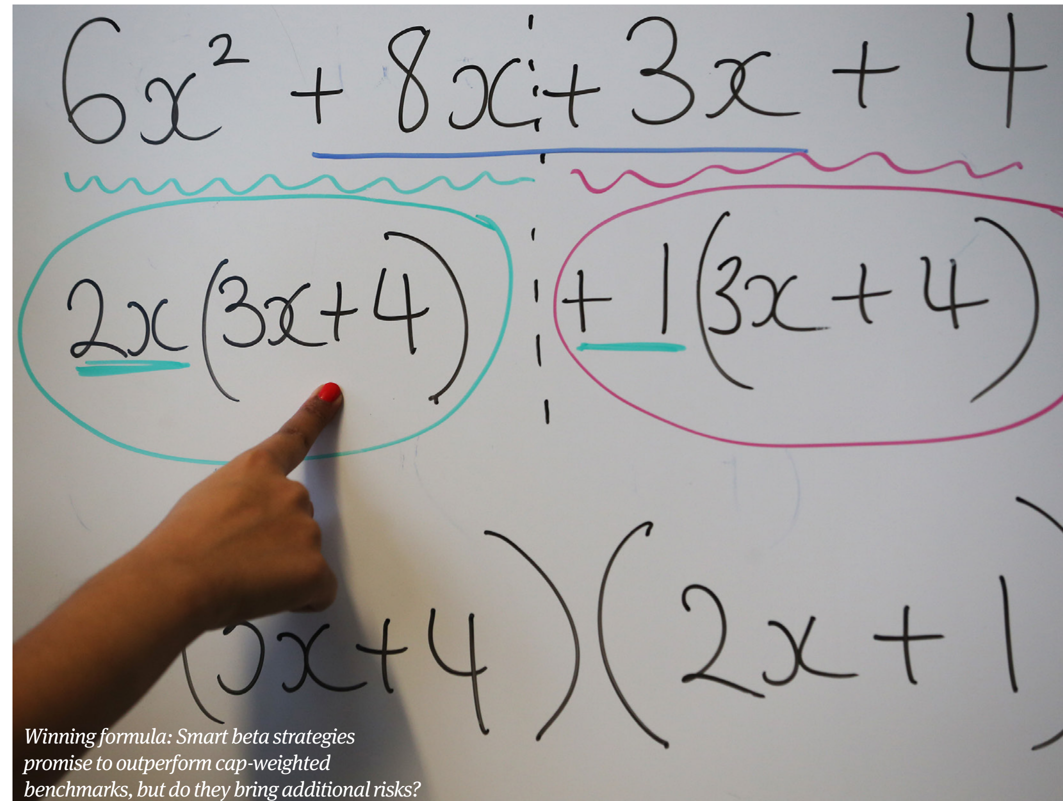
Is smart beta a wise strategy for private investors?



Winning formula: Smart beta strategies promise to outperform cap-weighted benchmarks, but do they bring additional risks?

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NO

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Judgment is the golden rule for implementing smart beta solutions in private investor portfolios. Smart beta offers an elegant alternative to pure market-weighted indexing but does have limitations, which can ultimately be misleading for private investors seeking readymade solutions.

While it remains suitable for institutional investors with strong financial risk capabilities, despite its apparent simplicity, smart beta cannot be seen as the ultimate solution for private investors due to a number of absolute and relative risks.

Smart betas carry some absolute or relative risks inherent to their construction, both explicitly (in the case of factor investing) or implicitly (in the case of alternative-weighting schemes). In academic literature, factors determining expected returns are becoming so numerous and exotic that the University of Chicago's John Cochrane referred to smart betas as a "zoo" in his 2011 presidential address to the American Finance Association.

Capitalisation-weighted indexes are known to be strongly dependent on past trends and the criticism of exotic betas is mainly based on their anomalies and the factors. Indeed, many anomalies often disappear following their disclosure.

Among the numerous pseudo-factors cited in academic literature and within the industry, only a few of them are real systematic risk factors. Campbell Harvey, former editor of the *Journal of Finance*, recently concluded that only a handful of the 314 factors in the "zoo" are actually statistically significant. These include market value, low volatility, illiquidity and momentum factors.

In the same vein, David McLean and Jeffrey Pontiff state in a forthcoming *Journal of Finance* article that the risk-adjusted returns associated with newly discovered characteristics decreased by more than half after they were disclosed. This may indicate that the market eliminates mispricing and that the remaining effects correspond to real risks.

Some of the hidden risks of alternative-weighting schemes are often omitted by smart beta providers. The so-called persistent anomalies at the origin of the strategy would, in fact, be risk factors that generate returns in specific market and economic conditions but lead to lower returns under other circumstances. Consequently, by departing from cap-weighting, smart beta indexes introduce new risks for investors: tracking-error risks (related to deviation from the cap-weighted benchmark), estimation risks (linked to accounting ratio, volatility and correlation parameters) and systematic risks (the rules underlying the strategy may cease being effective).

For example, fundamentally weighted indexes have a value bias due to their use of accounting measures behind the ratios applied in the construction of value indexes.

Minimum-volatility strategies tend to outperform in bad times (recession, stress, crises). For instance, the outperformance of the MSCI World Minimum Volatility index versus the MSCI World (cap-weighted) clearly appears in crisis periods and is highly correlated with credit spreads, but disappears during phases of recovery.

Beyond requisite due diligence, implementing smart beta requires deep insight into the drivers of risk and return and may require re-evaluation. For example, growing interest in low-volatility strategies has led to second-generation products with valuation filters to avoid overpaying for exposure.

Increased attention to the choice of betas is, of course, a welcome development for portfolio diversification. However, investors – and more specifically private investors – should be aware of the significant risks related to introducing smart beta strategies in portfolios, also considering that the timing of factors remains an open question. ●

> WHILE SMART BETA REMAINS SUITABLE FOR INSTITUTIONAL INVESTORS WITH STRONG FINANCIAL RISK CAPABILITIES, SMART BETA CANNOT BE SEEN AS THE ULTIMATE SOLUTION FOR PRIVATE INVESTORS DUE TO A NUMBER OF ABSOLUTE AND RELATIVE RISKS
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> *Christophe Boucher and Bertrand Maillet*

YES

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While I am always cautious and cynical of new investment fads or products, as they normally hide some danger for investors, the concept of smart beta ETFs is different. They manage to incorporate many of the techniques and advantages of using active fund managers but in a systematic, higher probability manner, while achieving much more diversification.

During my 25 year plus career, I have managed active stockpicking funds for pension schemes, retail clients and institutions, including a hedge fund that produced a compound annual return of more than 17 per cent over nine and a half years.

What was it I looked for in companies? Normally unloved (preferably hated) stocks but which had a fundamentally strong and attractive business within them. I have always believed in buying growth at the right price and I now apply the same concept to indexes.

Personally, I can't see any problem with applying this approach or the many other approaches used by active managers but in a more rigorous and disciplined manner.

Over the last few years I have talked about the improved dissemination of information making life much harder for active managers. Information is now spread extremely quickly and cheaply to all, reducing substantially the previous informational edge of active managers. Today, when managers meet a company, the same information will probably have been delivered to everyone thanks to the internet and stricter rules and regulations.

To my mind, it is absurd to suggest that somehow these smart beta ETFs are not appropriate for private investors. I'm not suggesting they are the holy grail of investing or that investors do not need to be careful or that all smart beta ETFs are worth the extra cost. But some are, and these can be far more preferable than many traditional active funds.

Currently we hold two so called smart beta ETFs within our SCM Direct Portfolios – a US value based ETF which ranks stocks based on four fundamental criteria, and a European ETF that invests in smaller higher yielding companies. I cannot see that either of these are harder to understand than a traditional active fund. They are far more transparent and tend to be better diversified than most active funds. In comparison, traditional value based active funds tend to use vague generalisations in respect of their stock selection, market cap weightings, sector weightings etc. How can anyone rationally say that somehow this latter process can be better understood by private investors than the equivalent smart beta ETF?

There are however many smart beta ETFs that I would not touch with a barge pole and find incomprehensible. They seem to be based solely on illusory back testing with little reasoning as to why the historic outperformance should be repeated. However, this is no different to any other form of investment where there will always be some preferable to others but at least the ETFs endeavor to show how they manage the fund systematically and exactly where they invest the fund.

As a contrarian who tends to be cynical, I am detecting a hidden agenda in the debate about whether smart beta is better or worse, or whether is is appropriate or not for private investors. Some private banks and wealth managers are not wanting the public to invest directly in smart beta ETFs as it would allow their clients to bypass their own inflated fees and lousy performance. ●

> IT IS ABSURD TO SUGGEST THAT SOMEHOW THESE SMART BETA ETFS ARE NOT APPROPRIATE FOR PRIVATE INVESTORS
>
> *Alan Miller*