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HOW SMART IS FACTOR INVESTING AND SMART BETA?

Why Factors and Factor Investing?

A number of studies by leading finance academics have demonstrated that most of the returns of active managers over and above passive market weighted benchmarks can be explained by their exposure to a small number of systematic factors and return premia that are associated with these factors. Such factors include beta, value, size, price momentum and low risk among others.[1] Above and beyond these factor premia no return premium can be earned from these strategies on average.

According to these studies it therefore matters less which assets or asset classes an investor holds and in which proportions than which factor exposures result from an investor's asset (class) mix.

As Andrew Ang, a pioneering academic advocate of factor investing from Columbia University, put it: "Just like 'eating right' requires you to look through food labels to understand the nutrient content, 'investing right' means looking through asset class labels for the underlying factor risks. It's the nutrients in the food that matter. And similarly, the factors matter, not the asset labels."

In order to ensure that factor return premia are robust and continue to exist in the future, the factors considered should always be supported by a strong underlying economic rationale as well as robust empirical evidence. Given this, some factors are more compelling than others.

Smart Beta

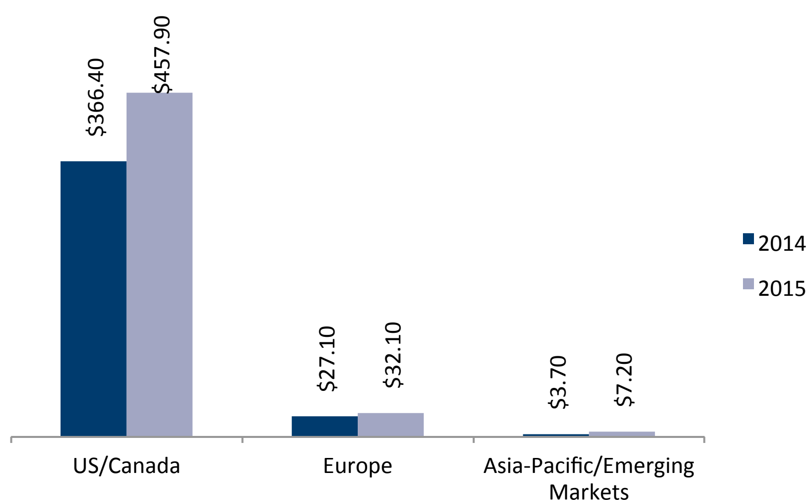
While there are various ways to harvest factor premia, a variety of approaches, commonly labelled as "Smart Beta", have gained considerable traction in recent years.

Smart Beta is a general term for a multitude of investment strategies, which tend to have the following in common: They use mechanical index construction rules that differ from traditional market capitalization based indices. They attempt to capture systematic factors or market inefficiencies in a straightforward and transparent manner and involve no human judgment or subjectivity once they have been put in place. The exact portfolio construction rules are generally publicly available.

Smart Beta has become extremely popular in recent years, both as an alternative to passive market weighted indexing and traditional active investing. According to research firm Morningstar, 844 Smart Beta ETFs with about $500 billion in assets existed as of June 30, 2015, up from 673 products with about $400 billion in assets a year earlier.

[1] Factors can be thought of as company characteristics that are related to future asset returns. For example, high-value companies (i.e. those with strong fundamentals) tend to have higher subsequent asset returns than low-value companies or companies with weaker fundamentals captured by some accounting metric.

Global Smart Beta Assets (in billion $)



Source: Morningstar, as of June 30, 2015.

The growth of Smart Beta stems from two main sources: (1) Dissatisfaction with traditional active strategies and (2) evidence that simple rule based approaches can do better than market capitalisation weighted indices.

While most traditional active strategies charge high fees and have underperformed their passive benchmarks, those passive benchmarks have also been criticised for delivering sub-optimal returns. Market weighted approaches overweight stocks with high prices and underweight those with low prices, which appears counterintuitive to many investors. They have also been shown to be rather concentrated in a small number of mega-cap stocks, sectors and certain market segments and hence lack diversification, which may lower their returns and increase risk. A recent study by Clare, Motson & Thomas (2013) shows that almost all common rule based approaches have beaten market weighted indices.[2]

Smart Beta attempts to deliver a better return/risk trade-off than conventional market cap weighted indices by using alternative weighting schemes based on company characteristics which have been shown to be related to future asset returns such as accounting metrics, price momentum or volatility. They mechanically follow an index designed to take advantage of perceived systematic biases or inefficiencies in the market. Smart Beta strategies therefore generally cost less than active management for an investor, since there is less day-to-day decision-making for the manager. However Smart Beta strategies are still more expensive – both in terms of trading costs and management fees – than passive market weighted approaches.

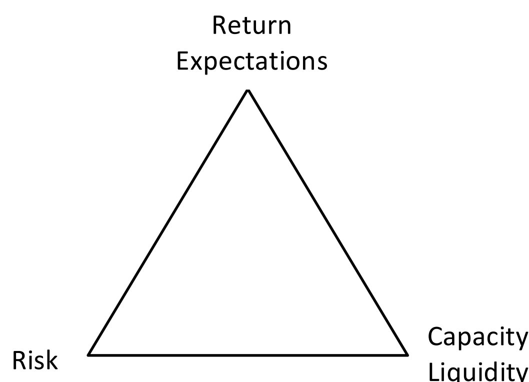
Pros and Cons of Smart Beta

Smart Beta offers active returns to investors at reasonable cost. Moreover, most Smart Beta strategies are simple and straightforward to understand as well as

[2] Clare, Motson and Thomas, 2013, An evaluation of alternative equity indices Part 1: Heuristic and optimised weighting schemes, Working paper, Cass Business School / Aon Hewitt.

transparent, which is often considered as a major advantage.

However, their simplicity is likely to be a weakness. Often these strategies sacrifice portfolio efficiency for simplicity (or overly rigid rule sets). They generally focus on only one or two of the three main investment dimensions shown in the triangle below, namely return expectations, risk and capacity / liquidity. The last dimension is related to how much money can be invested in a strategy and how easily the strategy can be implemented in a live portfolio.



For example, some Smart Beta strategies, such as Fundamental Indexing™ which weights companies by accounting metrics instead of market weights, mainly focus on return expectations and capacity and not risk. Conversely, other strategies, such as minimum variance or low risk, mainly focus on risk rather than return expectations and capacity.

These types of strategies can also be very concentrated in individual assets, sectors or particular market segments. For example, the S&P 500 low volatility index, which invests in the 100 constituents of the S&P 500 index that have the lowest estimated volatility, has at times invested 60% of the index weight in only two sectors, namely Utilities and Consumer Staples. Most investors would consider this sector allocation overly concentrated.

In addition to these portfolio construction issues, there is growing evidence that some Smart Beta strategies have now become a victim of their own success as they have become rather “expensive”. Assets with desirable characteristics, according to these strategies, have often been pushed up in price and hence future returns are likely to be lower for some of these strategies.

Conclusion

Factor investing enables investors to capture systematic return drivers directly in a cost effective manner. There is a strong rationale for this approach, as systematic factors explain most of the active returns of funds. To avoid disappointment, however, only factors with strong underlying economic rationale as well as robust empirical support should be considered.

Smart Beta is a simple and transparent form of factor investing, which is generally available to investors at low cost. However, in our view, most Smart Beta strategies that are currently offered in the marketplace should be viewed as a good starting point only. Most likely investor can do better.

While the simplicity of most Smart Beta strategies is a virtue because it makes them intuitive, transparent, and easy to understand for investors, the risk is that sensible portfolio construction is ignored. Managers need to ensure that the appropriate factors are implemented using sensible, risk-aware portfolio construction.