Segal Rogerscasey Canada

INVESTMENT BRIEF

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Does "Smart" Beta Make Good Sense?

After a period in which many active investment managers have struggled to exceed capitalization (cap)-weighted benchmarks, several quasi-passive strategies are garnering attention and assets. Instead of weighting holdings according to market capitalization like traditional index funds, these so-called "Smart" Beta[1] strategies use computer-based models to tilt a portfolio toward one or more risk factors, such as Momentum, Size and Value, to capitalize on inefficiencies in asset prices without active securities selection. This issue of *Investment Brief* presents an overview of the concepts behind "Smart" Beta, describes the popular forms today, and considers their pros and cons for investors.

What Is "Smart" Beta Supposed to Be?

"Smart" Beta is not so much an investment mechanism or a style or a process as it is a catchy marketing line (hence our putting "Smart" in quotes throughout this publication). It is quite simply defined as building a portfolio from a universe of securities applying a decision rule other than capitalization weighting. First, a universe, such as the S&P 500® Index or the Russell 2000 Index, is selected. As a starting point, the universe has to be organized based on capitalization, with the holdings mirroring the percentage of each individual security's value in terms of number of outstanding shares multiplied by price. "Smart" Beta is building a market-based portfolio through a weighting scheme that applies a factor that is *not* capitalization-based.

Popular forms of "Smart" Beta include:

- ***Equal Weighted S&P 500®*** Stocks are held in approximately equal weights or 0.2 percent in each stock.
- ***Low Volatility S&P 500®*** The portfolio consists of the stocks that have exhibited the least volatility in terms of price movement over some historic period.
- ***Momentum Morningstar U.S. Target*** This form owns those stocks that have demonstrated the most positive price movement over a trailing time frame.
- ***Value S&P 500®*** The portfolio tilts toward those stocks with either the lowest price-to-book (P/B) or price-to-earnings (P/E) ratio.
- ***S&P Small Cap 600®*** The portfolio tilts toward the small market-cap segment of the U.S. equity market.

It is important to note that the concepts of Equal Weighting, Value Bias and Momentum (exhibited in some of the approaches described above) are not new; there is a substantial amount of academic and real-time analysis dating back more than 25 years.

Why Is the Industry Talking about "Smart" Beta Now?

Capitalization-weighted indexation has gained quite a bit of asset-gathering momentum in the last several years as more active managers than usual have struggled to exceed this very inexpensive approach to owning stocks. Yet the pressures to create attractive returns are potent, and the opportunity for an approach that generally costs less than active management and still provides the potential for improved results has powerful allure. "Smart" Beta purports to provide an efficient solution.

Why Are Some Investors Interested in "Smart" Beta?

The characteristics of "Smart" Beta that may fit the circumstances or needs of an asset owner include the following:

- ***Ease of Manager Selection*** Although there are elements of picking the right provider to consider, the due diligence process is less intense than would be necessary for selecting active managers.
- ***Fees*** In some cases, single-variable "Smart" Beta tilts can be purchased for between 10 basis points and 15 basis points — more expensive than cap-weighted passive approaches, but quite a bit less than active.
- ***Logic*** Many factors for the tilted portfolios have embedded strong logic for their likelihood of producing above-cap-weighted returns.
- ***Rebalancing*** Cap-weighted strategies by their nature infrequently rebalance. Many "Smart" Beta approaches rebalance frequently to continually tilt the portfolio toward the desired factor.

[1] Beta is the measure of an asset's risk in relation to the market.

- ***Total Portfolio Diversification*** Since these strategies differ from a market-cap-weighted strategy, they will not be perfectly correlated and can offer diversification benefits.

Why Should Investors Be Wary of "Smart" Beta?

For "Smart" Beta, there are several potential issues that investors should be aware of:

- ***Turnover*** Given the nature of most strategies, there will certainly be more turnover of securities than in a pure cap-weighted approach. While additional trading is viewed as having a modest cost, and may be less than traditional active management, the cost of trading is variable and can be higher than projected during times of market stress.
- ***Taxes*** For the taxable investor, turnover can create a more relevant tax consequence than a cap-weighted portfolio that will have little in the way of gains or losses.
- ***Modeling Error*** While the spread between bad and good modeling should be much less than for active management, there is some degree of manager-selection risk inherent in "Smart" Beta requiring appropriate due diligence and analysis.
- ***Regime Change*** The past is not always prologue, and historically-persistent attractive factors can reverse and detract from, rather than add to, results.
- ***Risk Factors*** The tilts these approaches create reflect a set of risk factors. Naturally, there may be long periods of time when any risk factor may be out of favor and underperform the pure cap-weighted baseline portfolio.
- ***Active Decision*** Strategy allocations are active decisions even though they are "beta exposures" because they are not market-cap-weighted (passive).

In addition, some products do not capture the risk premium they intend to harvest.

Conclusion

Tilting a portfolio toward, or away from, certain risk factors can provide benefits versus both cap weighting and active management. Lower costs, rebalancing advantages and better representing a rational view of the potential for rewards from taking certain risks are important and substantial reasons for doing so. However, buying into a factor tilt is in no way a guarantee of success in terms of levels of either risk or expected return. This action should be regarded as a conscious acceptance of a bet against the broad standard by which most asset owners are judged.

In our view, based upon our experience in performing due diligence on asset strategies over many years, we would prefer active tilts that include multiple factors with some systematic and proven approach to shifting exposures to those factors over time versus a mechanized approach subject to the sometimes-long and dramatic cycles of capital markets. While this approach may not be "genius," we believe it may be better than just trying to be smart. ■

For a more detailed discussion of "Smart" Beta that includes analysis of data, see Segal Rogerscasey Canada's June 2015 *Investment Focus*, "Genius Beta: Why Settle for Just 'Smart' Beta?"

Questions? Contact Us.

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