MONETA INVESTMENT MONTHLY

Is Investing in Smart Beta a Wise Move?

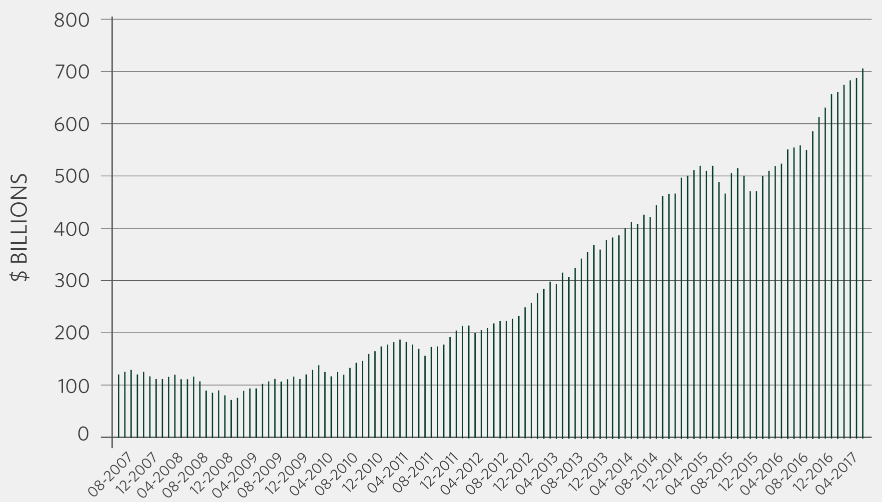
The market has been buzzing about "smart beta" for some time now. It's attracting more attention than ever as hundreds of ETFs have emerged, amassing nearly $700 billion in assets (Display). But what exactly is smart beta? And what's the allure for investors?

Known by many different names (strategic beta, advanced beta, factor-based investing and many more), smart beta is an all-encompassing term used for rules-based strategies that veer away from traditional market-cap weighted indices in an attempt to generate better risk-adjusted returns.

Although it's a hot topic, smart beta has been around for much longer than many investors may realize—they just called it something else: a value-focused, dividend-weighted or momentum strategy, for instance. These previous versions, as well as the current slew of products, all stem from research that shows that stocks with certain criteria typically outperform the market overall.

Display

Smart Beta Assets Have Grown Significantly in Recent Years



As of July 31, 2017
Source: Morningstar

If this beta is smart, the other is...

In order to understand a smart beta index, the best place to start is to understand what it is not, which is a traditional market-cap weighted index (such as the S&P 500). With this type of index, the weighting is allocated based on the market value (market capitalization) of the company, where the larger companies make up a bigger percentage of the index, and therefore a larger portion of an investor's assets. Additionally, as the company becomes more expensive, it will achieve a higher weight in the index. Therefore, by investing in traditional market-cap weighted indices, investors will be provided the return of the market at a lower cost than any other strategy.

While also taking a passive approach, smart beta indices were created to do better than the market under the belief that outperformance was possible by breaking the link between the value of a company's stock and its weighting in the index. This is accomplished by ranking stocks based upon one or a collection of factors such as valuation, dividend yields, fundamental characteristics (e.g., revenue), return on equity and momentum. For example, if you were to evenly rank stocks in the S&P 500 by their price-to-earnings ratio, and then invest the most money in the cheapest stocks and the least money in the most expensive stocks, you will have created a smart beta product.

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Wait, this sounds like active management. What makes smart beta different?

Smart beta borrows from both active and passive investment styles to boost returns while mitigating risk. However, there are key differences from active management. Although most active managers may use some of the same or similar factors as smart beta indices, they do not simply use the high-level quantitative screens to construct the final portfolio. Part of their added value is the interpretation of the data (e.g., reviewing trends in the fundamentals and valuations), using proprietary models to build custom valuations, evaluating industry conditions unique to companies and communicating with company management. These due-diligence components cannot be replicated in a quantitative rules-based model used by a smart beta index.

These added layers of due diligence for active managers only increase the costs to investors. Therefore, one benefit of smart beta is that by using a rules-based approach to many of the factors used by active managers, smart beta products are considerably cheaper than traditional active management. Multiple studies have shown that higher fees are a major reason that many active managers end up underperforming the indices that they're attempting to beat. Not surprisingly, investors find the lower fees to be particularly attractive components of smart beta ETFs.

Where We Stand

Moneta continues to evaluate smart beta. We've witnessed the smart beta strategy explosion over the past few years and the various products that have hit the market, including:

- **Products that are weighted according to a valuation metric (basic extensions of Fama/French research)**
- **Factor-based varieties, using quality and momentum metrics**
- **Fundamentally weighted products; for example, weighting companies based on their sales or earnings**
- **"Multi-factor" models, which incorporate various parts of the other approaches**

Factors are a key component to smart beta, but it's important to remember that they go in and out of style. The more factors these products incorporate into their process, the more the products begin to look like traditional active management. Another consideration: smart beta products hold multiple stocks and tend to be dogmatic in their inability to make changes, while true active managers typically make more active bets and override decisions when necessary. Regardless of the outcome of future smart beta development, we think that competition in the smart beta world will eventually force active managers to drive their fund fees lower—similar to the impact of passive investing in general.

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Bottom line, although many funds may be classified as smart beta, they may each utilize different factors or use different definitions of the individual factors. Even if they use similar factors, the processes by which they are applied may differ. There's a very good chance that these products are going to behave differently at different times and therefore must be evaluated like traditional active managers—potentially a large risk for these types of strategies. They will outperform and underperform traditional indices much the same way that active management out/underperforms. The evaluation process takes time as we need to see a track record with live results—not back-tested data.

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