Brinker Capital

Innovative Solutions Series

the search for smart beta

A discussion of smart beta strategies and the industry's ongoing challenge to define them.

In this paper, we will discuss:

- Where smart beta strategies fall on the active vs. passive spectrum
- The elusive definition of smart beta
- Risks to consider when utilizing these strategies within a portfolio

Authored by:

William H. Miller, *Chief Investment Officer*
Dan Williams, CFA, CFP®, *Investment Analyst*

Revisiting the active vs. passive discussion

In an earlier paper, Brinker Capital weighed in on the debate of active vs. passive investing, supporting the opinion that active management exists, at some level, in virtually all investments.

Active management can mean several things:

- The actual management of a mutual fund
- The active bet placed on a specific segment of the market holding a somewhat narrow index fund
- The overall asset allocation decision across broad asset classes

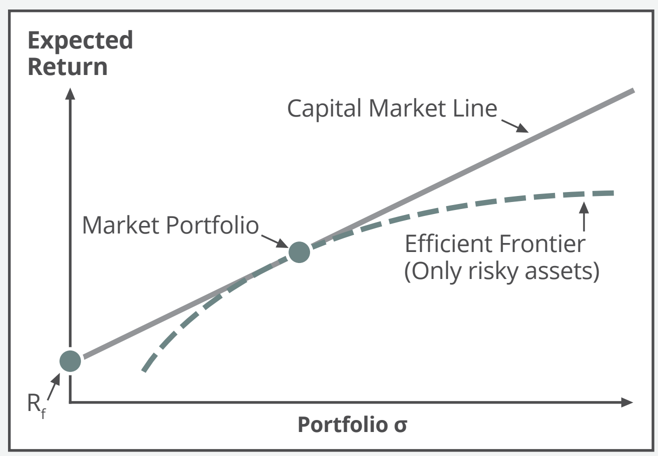
This last idea of asset allocation actually represents the biggest driver of return. With that in mind, in the past, investments tended to fall to either the active or passive side of the spectrum. Recently, however, we have seen the entrance of many new offerings to the market under the banner of "smart beta."

Let's talk passive

On the passive side exists the broad market-weighted index fund. Through merely holding the securities of the market in the appropriate weightings, the holdings rise and fall proportionally. In theory, the only buying and selling that should occur (outside of the initial purchase, reinvesting of dividends, and the final selling of the fund) should be when securities are added or removed from the index. The theoretically perfect passive investment is one that already holds all securities in all markets. More specifically, as shown in Figure 1, it would be the "market portfolio" on the theoretical capital market line that holds all assets and underlying securities in proportion to their global market percentages. By holding all assets and securities in their proportional weights, such an investment is free from making an active bet on relative asset class performance.

This "market portfolio" is impossible to construct as it would require investments in both public and private assets, including all of the art in all of the world's museums and private estates, all the wine not presently consumed, all businesses that currently exist (including your cousin's Mary Kay® cosmetic endeavor) and every other asset, including Beanie Babies. In practice, broad market index funds represent achievable representations of this portfolio and are the anchors on the extreme passive side of the spectrum. An investment in the S&P 500 Index fund represents an active bet for large cap domestic equity and is less broad than an investment in a Russell 3000 Index fund. The Russell 3000 Index fund, in turn, is less broad than an investment in the MSCI All Country World Index. All of these investments are considered fairly broad and to be on the passive side of the spectrum.[1]

Figure 1: Capital Market Line (CML)



Source: Financial Planning Body of Knowledge.

Speaking of active

On the other side of the spectrum are the actively managed funds that loosely track an index and hold a subset of market securities at different weights than the market. The most active of those make decisions both within an asset class and across asset classes. The belief is that the overall market makes mistakes and a designated manager has the ability to exploit them. The manner in which they exploit these mistakes varies and the group is only united in their belief that they can do better than the market. As a result, investing in this group requires an extra level of due diligence.

Such was the bipartite investment landscape that existed from 1975, when Vanguard created the first index fund, until approximately 2000. There were broad market-weight index funds on the passive side as "traditional passive strategies" and active managed funds providing the other investment option.

[1] Investors cannot invest directly in an index. Past performance is not a guarantee of future results.

The introduction of a smarter beta

As we entered the 21st century the question surfaced; could a better or enhanced index be built?

As shown in Figure 2, the 2000s were a period of enhanced or alternative factor index creation. These new alternative index factors included equal-weighted strategies, dividend-weighted strategies, valuation-metric weighted, low volatility or something even more unique, such as based on spin-offs or insider sentiment.

Right or wrong, these alternative factor indexes are often referred to as "smart beta" in the market place. Shown in Figure 3, the assets under management—especially in ETFs—in strategies labeled as smart beta has steadily grown since 2009.

Figure 2: Equity index creation by different weighting methods (2000-2011)

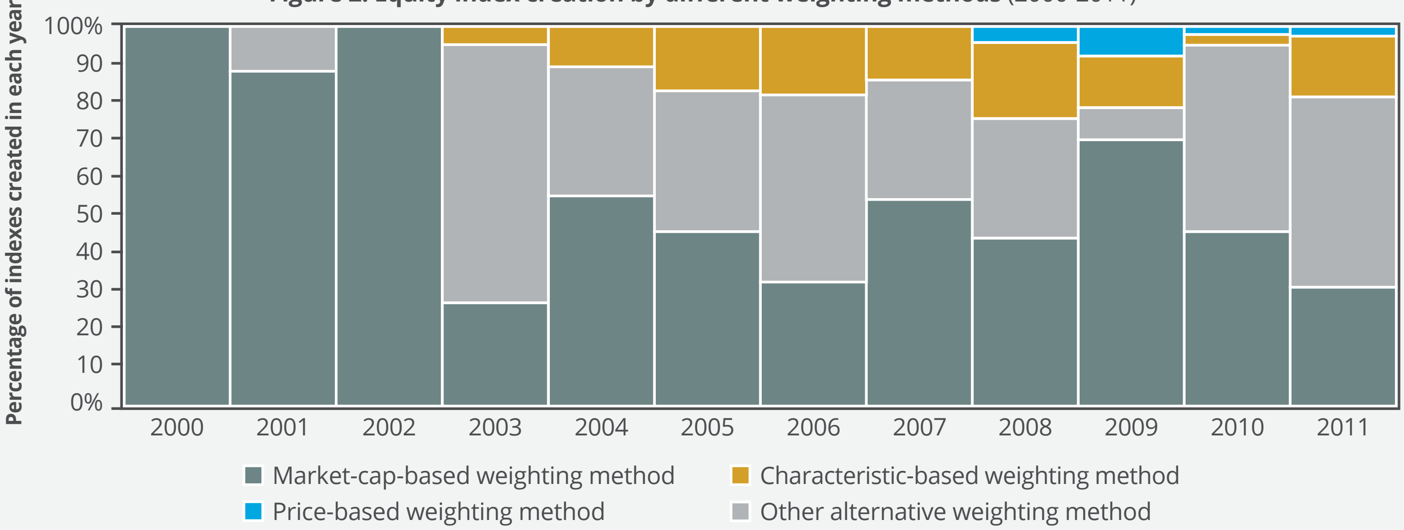


Figure 3: Smart-beta index ETFs vs. smart-beta index mutual funds (2009-2014)

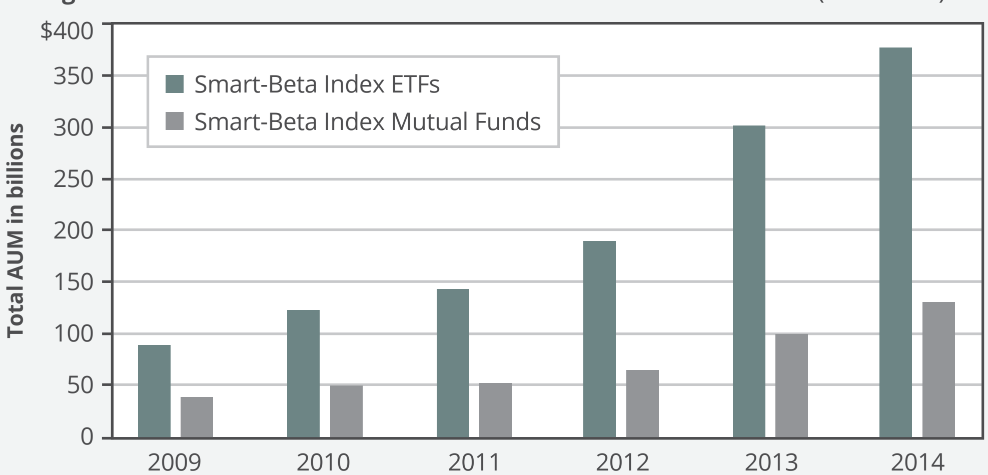


Figure 2 Source: Vanguard, data from Strategic Insight's Simfund and Index-Universe. Figure shows percentage of indexes by weighting criteria that were launched in each year (based on a total of 637 indexes that "went live" after 2000). "Price-based" weighting methods include weighting based on momentum, price, and volatility. "Characteristic-based" weighting methods include weighting based on earnings, revenue, fundamentals and dividends. "Other alternative" weighting methods include equal, tiered, proprietary, and multifactor.

Figure 3 Source: Yasenchak, R. and Whitman, P. (2015, February). "Understanding the Risks of Smart Beta, and the Need for Smart Alpha." INTECH.

The debate continues

Given our discussion of the passive-active spectrum, we should first consider whether smart beta should be labeled as active or passive. Here there is much debate. Chief Investment Officer magazine recently addressed this topic in their January 2015 article, "The Smart Beta Debate: Is It Active or Passive?"[2] In this piece, the magazine cited a Russell Investments survey that found 39% of investors with experience of smart beta—from a pool of more than 50 asset owners—said the strategies were a replacement for passive management. However, a similar amount said the strategies could replace either active or passive. Only 20% said they stood in for active management alone." Clearly people are still struggling to understand smart beta and assign the active or passive label with consistency. Given the combined active and passive characteristics of smart beta, the best answer is likely that it lies somewhere in the middle of this spectrum.

The secret sauce

In order to gain a better understanding, let's take a look at how various sources define smart beta. Towers Watson, the firm who originally coined the smart beta term, refined their definition in 2013 as follows:

> *"Smart beta is simply about trying to identify good investment ideas that can be structured better… smart beta strategies should be simple low cost, transparent and systematic."* [3]

Rob Arnott and Engin Kose (2014) note that "the term smart beta grew out of attempts by people in the industry to explain the Fundamental Index approach vis-à-vis existing passive and active strategies."[4] Similar to Towers Watson, for Arnott and Kose, the secret sauce of smart beta lies in capturing the best attributes of passive investing—transparency, rules-based, low-cost, large capacity, and well-diversified—while avoiding a major pitfall of traditional market-weighted indexes. According to Arnott and Kose (2014), "if the market is not efficient and some companies are priced too high and some too low, then cap-weighted indices naturally have disproportionately large concentrations in companies that are likely to be overvalued and light allocations in companies that are disproportionately undervalued…breaking the link with price is, in our view, the most important component to any useful definition of smart beta." To this end, Patrick O'Shaughnessy defines smart beta as "a strategy that chooses stocks based on some proven criteria other than size or market capitalization."[5]

Creating new definitions

The inability to agree on a definitive explanation of what smart beta is has prompted some providers to develop their own term and criteria. Research provider Morningstar recently coined the term *strategic beta* as "a group of index-linked investments, all of which have the goal of achieving a beta equal to one, as measured against their benchmark indexes" and whose "objectives primarily include attempting to improve performance relative to a traditional market-capitalization-weighted index of altering the level of risk relative to a standard benchmark."[6]

ETF research and advisory firm XTF categorizes the investment philosophy of ETFs as either passively managed, actively managed, socially responsible, or *enhanced strategy*. According to Richard Radnay, Chief Investment Officer of XTF, *enhanced strategy* is defined as "a rules-based investment methodology which attempts to outperform a market segment by increasing performance or reducing risk or both. This can be achieved by either selecting securities with the intention that they will outperform the market segment or by adjusting the weightings of securities or a combination of both. [Additionally] the ETF follows an index designed to take advantage of perceived systematic biases or inefficiencies in the market. These strategies attempt to deliver a better risk-adjusted return than traditionally-weighted index compositions."[7]

Despite having very similar definitions, the two resulting lists of ETFs that fall into either the strategic beta or enhanced strategy category differ significantly. Morningstar's strategic beta definition includes ETFs that follow traditional style factors of value and growth but exclude factors such as spin-offs or insider-buying that are more qualitative in nature. XTF's list of enhanced strategies includes these qualitative factors but excludes traditional value and growth factors. As well, enhanced strategies does not include simply equal-weighted index tracking ETFs. Instead, XTF considers equal-weighted as an example of a traditionally weighted index.

A rules-based approach

A universal definition for smart beta proves to be elusive. Regardless, the hallmark of ETFs in this space is the possession of an idea of merit that can be simply executed with a rules-based approach. Also, similar to active funds, there is a belief that the market, as a whole, has gotten something wrong and is systematically undervaluing a group of securities. To that end, smart beta ETFs often feature adjusted asset weightings or allocations.

[2] Um, S. (2015, January). "The Smart Beta Debate: Is It Active or Passive?" Chief Investment Officer. [3] Towers Watson. (2013). Understanding Smart Beta.
[4] Arnott, R. and Kose, E. (2014, August). "What 'Smart Beta' Means to Us." Research Affiliates. [5] O'Shaughnessy, P. (2014, March 17). "A Primer on Smart Beta." Millennial Invest.Affiliates. [6] Johnson, B. (2014, April 10). "The Strategic Factor of Smart Beta." Morningstar. [7] Radnay, R. (2015). XTF.

Joel Dickson, senior strategist at Vanguard Investment Strategy Group, noted that "...what most investors expect when they buy an index is that they'll own the market. However, a rules-based, non-market-cap-weighted strategy doesn't give you the kind of exposure to broad market segments that investors expect. With these strategies, you're in fact making a bet against the market or some segment of the market."[8]

For example, fundamental weighted indexes weight on current business factors such as revenues, profits, and dividends. The market overall, however, sets prices based on the current business as well as future business prospects. Those that have their market prices more driven by their current business operations are considered to be value stocks whereas growth stocks tend to have more relative valuation attributed to future business prospects.

This is a fact that Rob Arnott does not hide from and counters with "or, just to be provocative, does the cap-weighted market have a growth tilt against the broad macro-economy, providing investors with outsized exposure to companies expected to grow handily and skinny exposure to troubled companies?" Regardless of which side you're on, investing in a smart beta strategy means placing a bet on a segment of a market.

Using smart beta

Smart beta strategies have broadened the opportunity set of investments available to investors.

However, these should not be confused with traditional passive strategies; rather these are active strategies that invest in a very systematic way. One of the more exciting developments of this systematic active management is that it has enabled an increased level of active management to enter the ETF space, giving access to these strategies to a significantly broader investment group with increased transparency and often at reduced investment costs.

Previously, investors needed to pick a traditional market index or an active manager with an investment philosophy in line with their own. Now investors can seek a more targeted approach that could closely match their own investment philosophy. For example, an investor may favor large cap companies but still believe that the market lets some companies get overvalued and thereby dominate the market cap weighted index. For that investor, there now exists equal-weighted or revenue-weighted indexes. Opportunities exist to invest in an easy-to-access structure in specific styles unrelated to both market cap and broad style growth/value categories.

Just because an investor has access to a particular vehicle does not mean that they fully understand it or should invest in it. With this enhanced ability to customize investment portfolios comes the responsibility to gain a solid understanding of the components. Similar to the idea that not all active strategies are the same, this holds true for smart beta strategies. Additional due diligence is necessary with the use of these strategies.

Defining new parameters

The first challenge of using smart beta strategies is the industry's lack of familiarity of the new factors used to frame the strategies in terms of asset classes, market capitalization, and growth/value style. Harindra de Silva, of Analytic Investors, notes that "from a theoretical standpoint it's hard not to be a fan of factor-based investing until one realizes the complexity surrounding this type of strategy."[9] De Silva believes that eventually the existence of smart beta strategies will result in us developing a better understanding of portfolio performance drivers. However, in the meantime, we must go through the growing pains of building this understanding. Such broad matters of agreeing on the number and definition of factors, determining factor footprint of strategies, and the correlation of these factors with each other, need to be decided.

As an example, consider a smart beta strategy that invests in newly spun-off companies. The data has shown that these companies, at least in the past, tend to outperform the market as a whole.[10] The ETF that has followed this strategy since 2007 over its life has shown to have mid-cap and growth factors in addition to its spin-off factor. The challenge for the financial analyst is to determine which factor (mid-cap, growth or spin-off) is the dominate driver of outperformance.

[8] Ameriks, J. and Dickson, J. (2014, March 19) "Smart beta: Not beta, but a bet." The Vanguard Group, Inc.
[9] De Silva, H. (2014, October 16) "Can Smart Beta Really Outsmart the Market?" Institutional Investor.
[10] GuruFocus (2014, June 4) "Can Spin-Offs Beat the Market?" Nasdaq.com

Smart beta risks

Richard Yasenchak and Phillip Whitman of INTECH note that the risks of smart beta strategies include:

- Exposure risk
- Relative and absolute risk
- Implementation risk[11]

Exposure risk is the concentration risk that a smart beta strategy explicitly represents by holding a subsection of the market. As previously noted regarding fundamental indexing, this could simply mean something such as overweighting value stocks. It can, however, also result in significant overweights to sectors that are well loved by a specific factor.

Similar to exposure risk is **relative and absolute return risk** which focuses on the differences in performance these portfolios will have versus their broad market indexes. Obviously holding different securities or holding securities at different weights than the market will result in performance that differs from the market. The magnitude of this difference however is hard to predict beforehand. Additionally, often the security and sector overweights cannot be anticipated ahead of time. It may not be immediately apparent what weightings will result from a strategy that focuses on spin-offs, insider buying, or low volatility. Finally, even if sector exposures seem reasonable, there can be unexpected increased correlation among the stocks held across sectors by applying the same factor for all sectors. The result is when a factor is out of favor, sector diversification may provide less risk reduction benefit than in a traditional passive portfolio, due to poor diversification within the sectors.

The final concern they noted is **implementation risk**. Often times smart beta strategies are the result of sound academic research. However even the best research can only look at past data and cannot anticipate if the strategies will be successful going forward with real invested assets. For example, alternative weighting methods typically provide more weight to smaller market cap securities, which usually have significant less liquidity and would require increased trading costs. This would mean a strategy requiring significant rebalancing could result in costs becoming a significant drag on performance. Additionally, if a smart beta strategy becomes successful and attracts additional assets, the prices of the securities targeted by the strategy will be driven up in price resulting in reduced future return potential.

The more things change, the more they stay the same

The entry of smart beta certainly blurs the active-passive divide for many investors. However passive vehicles, most noticeably indexes that represent a small section of the market, were already being used extensively in portfolios to make active bets on specific parts on the market. These new entries simply represent additional options for portfolio construction and add variety to the active management available. The fact that we can access these active strategies in ETFs is certainly a great development for investors as long as they understand what they are investing in.

Similar to traditional active funds, these new entries need to be evaluated regarding their ability to provide a sustainable improved risk and return profile. As new smart beta strategies emerge, as with other active strategies, they should be evaluated on a case by case basis. Brinker Capital finds some of the current strategies compelling and has invested in them; others we find do not warrant investment. Our due diligence process ensures that every investment decision we make is in the best interest of our investors.

The best funds will be those with a compelling and understandable investment thesis, liquid enough to allow for trading, and play an understandable role in the portfolio. Costs also matter, but a cheap strategy with a poorly constructed idea at its core is not superior to a better idea that costs a little more. As always, the evaluation and the investment decision is the result of many factors.

[11] Yasenchak, R. and Whitman, P. (2015, February) "Understanding the Risks of Smart Beta, and the Need for Smart Alpha" INTECH.

We continue to expand our knowledge base through the continued study of smart beta strategies. Similar to De Silva, we believe that the greatest contribution of smart beta is its ability to make investors smarter about the various factors that drive returns and improve the level of diversification in their portfolios. As such, we welcome the innovation, the research that resulted in these strategies, and the future research to be done on this compelling topic.

The bottom line

The bottom line is that similar to a traditional active strategy, each smart beta strategy must be examined for its investment thesis, the sustainability of its thesis, and the ability for the strategy to execute on that thesis.

Learn more about Brinker Capital's investment approach

- Visit www.BrinkerCapital.com
- Call 800-333-4573 and ask to speak with an Investment Consultant
- Connect with us at blog.brinkercapital.com

Meet The Authors

William H. Miller
Chief Investment Officer

Dan Williams, CFA, CFP®
Investment Analyst

Who we are

At Brinker Capital we implement great ideas with a disciplined investment approach to consistently offer financial advisors forward-thinking solutions intended to achieve better outcomes based on their clients' personal goals.

great **ideas** + strong **discipline** = better **outcomes**

BrinkerCapital.com

1055 Westlakes Drive, Suite 250
Berwyn, PA 19312
800.333.4573

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