Smart Beta Series Part 1:

Shiny New Name or Genuinely New Idea?

UNCORRELATED ANSWERS®

David Schofield
President,
International Division

Key Ideas

The term ‘Smart Beta’ has recently established itself as the clear winner in the battle to become the investment industry’s preferred label for an eclectic mix of diverse investment strategies. The common thread linking these various ‘Smart Beta’ approaches is the objective of providing investors with a ‘different’ – but still systematic – equity exposure to that offered by traditional cap-weighted indices.

It is a new, modern-sounding name, and carries with it the positive connotations of ‘smart’ technology currently popular in consumer electronics. Who would admit to not having a smartphone or aspiring to a smart TV? The marketing implication of the term is that products labeled ‘smart’ seem to do what the users require of them almost intuitively, and without the requirement for skilled operation.

So it is certainly a new, 21st century name – but is it really a new idea?

In short, the answer is clearly ‘no’ – systematic alternatives to weighting schemes based on market capitalisation have, in fact, been around for more than thirty years.

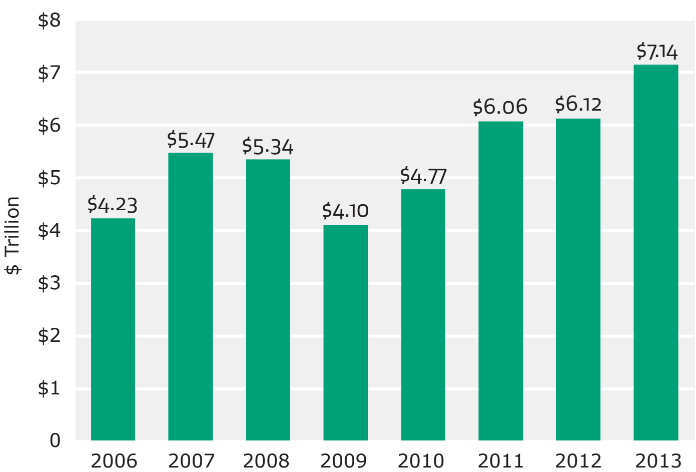
Intech®

Dumb Beta?

Of course, the unspoken implication of the term 'Smart Beta' is that good old-fashioned traditional beta is not so smart. The original idea of a market's 'beta' has been around since the 1960s. Over the years, it has become industry shorthand for exposure to the market as measured by a capitalisation-weighted portfolio. Such portfolios, despite the fact that they represent just one of many possible systematic ways of weighting stocks in a portfolio, have themselves become the accepted proxy for the return of the market as a whole. They have the advantage of low cost, utter simplicity and limitless capacity. As a cheap, quick and easy way of investing vast sums in the stock market, cap-weighted index portfolios have attracted trillions of dollars from investors all over the world. Academic fuel to the cap-weighting fire was provided from the very beginning by the Capital Asset Pricing Model, which argues that (as long as you accept a whole range of oversimplifying and unrealistic assumptions) the cap-weighted index is, in fact, an efficient portfolio. This cornerstone of Modern Portfolio Theory spawned the belief, still widely held by many, that the cap-weighted index portfolio offers the highest achievable return for the level of risk associated with it. Cap-weighted index funds continue to attract large volumes of asset flows from all types of investors, all over the world, who still cling to this long-discredited notion.

EXHIBIT 1

CAP-WEIGHTED INDEX ASSETS



Source: P&I. Cap-weighted index assets may include amounts of assets benchmarked to non-cap-weighted indices due to past data reporting limitations.

When did the first 'Smart Beta' ideas emerge?

Although the term 'Smart Beta' was 30 years from being coined, systematic investment strategies designed to improve upon the inherent flaws of cap-weighted index portfolios began to emerge already in the 1980s. For example, Dr. E. Robert Fernholz, founder of Intech® and a creator of enhanced equity portfolio construction methods, published a seminal paper as early as 1982 in which he demonstrated that not only is the cap-weighted index NOT an efficient portfolio, but that a higher return can be generated with similar risk by simply better diversifying the holdings and rebalancing. At Intech®, we have been pursuing such an investment strategy for over 30 years, and today manage in excess of $40 billion according to such principles.

Subsequent further attempts by practitioners and academics in the investment management industry to identify their own persistently successful portfolio 'tilts' are well-documented. There has been a plethora of various alternative weighting schemes proposed over the years: equal-weighted, revenue-weighted, dividend-weighted, earnings-weighted, liquidity-weighted, beta-weighted, wealth-weighted and GDP-weighted, to name but a few. Various blends of these 'factors' and others formed the basis for a succession of competing 'Enhanced Indexation' products offered by quantitative managers throughout the 1990s and beyond. They, too, may have been thrown into the 'Smart Beta' bucket at the time had the term been available.

However, a small number of these individual 'factors' stand out from the crowd; they are 'Size' (1981), 'Value' (1992) and 'Momentum' (1997). They have attracted such a following over the last three decades that they have achieved celebrity status and become named 'effects.' Some might add to this list 'Volatility,' with the 'Low Volatility Anomaly' currently knocking on the door of the "Risk Factor Hall of Fame." Portfolios constructed according to these measures have become immortalised as winning investment strategies that just 'work.' Whether or not this is true is open to doubt and the subject of a later paper. However, suffice it to say, that investment management firms have built entire businesses and manage hundreds of billions of dollars based upon offering products designed to exploit these effects. And furthermore, along with beta, they have become enshrined in both the literature, practice and faith system of our industry as the basic components of portfolio performance: risk factors that can be used to explain the performance of other portfolios.

Smart Beta – a name in search of a category?

So why the sudden emergence of 'Smart Beta' as a category, if the constituents of that category have been around for over 30 years? The answer lies most likely in some investment industry themes that have risen to heightened prominence in the last five years: how to achieve better returns, how to reduce risk and how to control costs.

Two major stock market crashes since the turn of the century have left investors bruised, pension funds in deficit and everyone in need of more return. At the same time, there has been a heightened focus by plan sponsors, regulators and investment committees on risk – how to diversify exposure, and thereby reduce it. And achieving both of these things in a highly cost-effective way is at the forefront of investors' minds at a time of global economic austerity and modest expected future returns from the capital markets as a whole. The concept of 'Smart Beta' has been pushed forward to meet these challenges.

As previously noted, the term 'beta' is synonymous with passive management, of which a key benefit is its very low cost. However, for about 50 years, the only passive option on the menu was cap-weighted indexation, which, though inexpensive, has a number of shortcomings. Chief amongst these are: overexposure to overvalued stocks, overexposure to large stocks and lack of downside protection. Even in an index fund there's a reasonable chance you might lose half your money in a 12-month period.

'Smart Beta' approaches purport to offer the same low-cost, passive approach enjoyed by cap-weighted index portfolios, but designed to exploit many of the favourite risk factors highlighted above, to generate a higher return at the same or less risk. They are sometimes called 'alternative' index portfolios, as they employ weighting schemes based on measures other than market capitalisation, such as fundamental valuation metrics or stock volatility. So accepted and mainstream have these 'effects' now become that they are considered commoditised exposures that can be accessed mechanistically and passively through rules-based processes as part of one's 'Smart Beta' allocation – a diversifying alternative to traditional cap-weighted portfolios. Although such factor-based strategies have been around for over 30 years, 'Smart Beta' index portfolios aim to remove the need to employ skilled active managers to access them. What was previously sold as alpha has been re-packaged as beta and offered to investors in generic 'index' form.

But are these strategies really indices? And are they truly passive? Is 'Smart Beta' genuinely smart, and is it really beta? The answers to these questions and others are the topic of the second article in this series.

Intech is a global quantitative asset manager investing on behalf of pension funds, governments, endowments, foundations, and other institutional investors worldwide. Having pioneered the application of Stochastic Portfolio Theory in 1987, Intech continues to seek distinctive alpha sources for clients in five continents. Today, Intech provides investment solutions encompassing ESG, absolute return, defensive equity, and traditional long-only strategies.

Locations

HEADQUARTERS
WEST PALM BEACH
250 South Australian Avenue
Suite 1800
West Palm Beach, FL, 33401
United States of America
+1-561-775-1100

RESEARCH & DEVELOPMENT
PRINCETON
One Palmer Square
Suite 441
Princeton, NJ, 08542
United States of America
+1-609-497-0443

INTERNATIONAL DIVISION
LONDON
201 Bishopsgate
London
EC2M 3AE
United Kingdom
+44 (0)20 7818 5600

Contacts

NORTH AMERICA
CONSULTANT RELATIONS
Adam Craig, CFA, Sr. Managing Director
acraig@intechinvestments.com
+1-508-250-9430

CLIENT RELATIONS
Nancy Holden, Sr. Managing Director
nholden@intechinvestments.com
+1-720-273-8225

BUSINESS DEVELOPMENT CANADA
Jim McHugh, Sr. Managing Director
jmchugh@intechinvestments.com
+1-561-714-0256

BUSINESS DEVELOPMENT US-EAST
John A. Cardinali, CFA, Sr. Managing Director
jcardinali@intechinvestments.com
+1-203-623-8799

BUSINESS DEVELOPMENT US-WEST
Jim McHugh, Sr. Managing Director
jmchugh@intechinvestments.com
+1-561-714-0256

INTERNATIONAL
INTERNATIONAL DIVISION
David Schofield, President, International
dschofield@intechinvestments.com
+44 (0)20 7818 5600

Iheshan Faasee, Managing Director
ifaasee@intechinvestments.com
+44 (0)20 7818 2717

intechinvestments.com

January 2014 / For institutional investor use only / C-0418-1961

Intech®