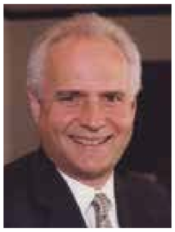

Smart Beta: Legitimate Investment or Marketing Hype?

BY JERRY BRAMLETT

A book should not be judged by its cover — or by the cover that someone else has put on it.

For plan advisors, the term "beta" is one of the most widely accepted and easily understood concepts in investing and, thus, deserves a permanent place in the lexicon of investing. Can the same be said for the newer term, "smart beta"? At least as it stands today, many industry observers take the position that smart beta is more of a marketing catchphrase than a legitimate investment term.

Background

The term "beta," which was originally coined by Nobel Laureate William Sharpe, is a means to determine the covariance of a stock or portfolio to the overall stock market. A portfolio with a 1.2 beta has more sensitivity, while a portfolio with 0.8 beta has less. A higher beta indicates that a stock or portfolio is more volatile than the stock market; a lower beta indicates that it is less volatile.

Towers Watson introduced the term "smart beta" several decades after beta had become a permanent part of the investment vocabulary. Towers defines smart beta as "strategies that move away from market-cap indexation in traditional asset classes" versus "bulk beta," which they define as "traditional market-cap passive investment in core asset classes such as equities and bonds." *(Towers Watson, 2014)*

The concept of market cap or price-weighted indexation is something that all plan advisors understand. While some argue that this type of indexing does not reflect the true value of securities (the core argument for active management), very few would argue against the view that this is the best means of determining what investors (as a whole) believe the value of securities to be worth at a given point in time.

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The term "smart beta," however, is a different story. The term implies that, rather than being able to trust that a price-weighted index reflects the most accurate price, the money manager needs to take this "bulk" beta (which presumably is "dumb") and, through some form of investment alchemy, make it "smart." This can involve such things as buying all companies in the S&P 500 on an equally weighted basis or buying companies based on their book value as opposed to their market value. Or it could mean creating a passive portfolio that, rather than representing one asset class, the portfolio is tilted to include other asset classes. This has become known as "factor" investing — a practice whereby portfolios are constructed based on certain factors such as their size (*e.g.*, small, large) or investment style (*e.g.*, value, growth).

Industry Critics

The term "smart beta" has received significant criticism from industry observers:

- A term that has been "hijacked by the industry and turned into an impressive investment branding story with a strong emotive label" *(CFA Institute, 2013)*
- An "attention-grabbing spin on beta [that] is a creation of investment firms that seek to funnel money into products that may have greater risk and higher fees than low-cost index funds that track markets" *(Forbes, 2013)*
- "Smart Beta = Dumb Beta + Smart Marketing" *(GMO, 2013)*

A Balanced View

Though there is a strong basis on which these criticisms rest, it is best to not use too broad of a stroke to paint all so-called smart beta providers as simply firms using the term as a marketing ploy. Many firms, though never having labeled their funds as smart beta funds, nonetheless have been categorized as such by industry pundits and investment firms who apply this broad definition to various investment strategies.

A closer look at some of the smart beta firms reveals they can add value over traditional commercial indices. Not necessarily by making beta smarter, but by reducing trading costs and applying asset allocation strategies as internal fund overlays of otherwise passive indices.

Commercial index managers are judged strictly on their ability to avoid tracking error and the total cost to do so. This requirement to avoid tracking error forces the index provider to trade a specific security at a particular point in time, regardless of

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whether the manager or the market is in need of liquidity.

Managers of custom indices, who are not overly concerned with being "right on the money" as it relates to the buying and selling of individual securities, can be patient and focus on timing their trades when there is a demand for liquidity. On the other hand, managers of commercial indices must trade a security at a certain point in time to avoid making a "tracking error."

The value of patient trading has been illustrated by a comprehensive study by Sunil Wahal. The study "examined all of DFA's [a so-called smart beta provider] equity trades from 2007-2009 and found its ability to be a liquidity provider when others were selling or buying generated a 60 to 80 basis point improvement in trading costs" *(Evanson Asset Management, 2014)*.

Although it is often the case that some so-called smart beta funds have higher trading costs because of the need to trade more frequently due to the changing "factors," a closer examination of some of the factor funds that focus on keeping turnover low shows that their internal trading costs are significantly lower than the industry average, even when compared to other commercial index providers. *(Evanson)*

One of the challenges posed by smart beta is that the term has created a grey area between primary portfolio management (individual security selection) and secondary portfolio management (asset allocation) when none should exist. Whether the asset allocation overlay is applied inside a portfolio or is an overlay of distinct asset classes in separate funds should not matter since it is simply a personal preference of the advisor or investor as to where the asset allocation is to occur — inside or outside the fund?

One industry observer notes that, "smart beta is simply a rebranding of the age-old concept that small caps and value stocks have tended to outperform over time. But if this is the case, why not invest directly in these factors with lower-fee, traditional passive index funds?" *(U.S. News Money, 2013)* Perhaps a better way to state this is that, since applying tilts (based on factors) is simply an asset allocation overlay, the distinction needs to be made as to whether the asset allocation overlay is an integral part of the fund's management structure or not. If so, then the advisor or investor needs to consider the efficacy of this approach based on both the cost structure as well as the value of creating tilts within a fund versus applying asset allocation strategies outside of the fund. The problem arises when one approach implies superiority over another by adopting the moniker, "smart."

Finally, there is the idea that smart beta is where passive and active meet — thus capturing the best of both worlds. This is simply not the case.

Take the case of price-weighted indices (which Towers Watson refers to as bulk beta) and book-weighted indices (often referred to as smart beta). Both strategies follow "rules" that are independent of any further analysis of the individual securities beyond these two "factors," consequently both are equally passive. There is no combining of passive and active strengths; it is just a different set of rules being applied to create different types of passive funds (one price-weighted and the other one book-weighted). Understanding active as it is widely understood would deem both to be "passive." Whether Steve Jobs runs Apple, or whether Android is a threat to iPhone's market share, are not investment "factors" — they are decisions based on subjective conclusions, not quantifiable facts derived from a company's financial statement, size or market price.

Conclusion

One conclusion is that a book should not be judged by its cover — or by the cover that someone else has put on it. Every investment fund should stand on its own as it relates to costs and risk-adjusted performance, regardless of the label that is applied to it by industry pundits and other investment firms.

As for the “smart beta” term itself, the world of investing is challenging enough as it is for plan advisors and, especially, plan sponsors. The more crisp and precise that that “investment speak” can be, the better. To that end, the term “smart beta” is not helpful in that it does not fit logically into the otherwise mostly binary terms that dominate the terminology describing investment styles today — if for no other reason than it does not have a binary partner term. “Dumb beta” must be ruled out and “bulk beta” is simply too disparaging when matched up against “smart beta.”

Finally, the fact that the author of the investment term “beta,” Bill Sharpe, has stated that the term “smart beta” makes him “definitionally sick” *(Barron’s, 2014)* speaks volumes about whether this term should be stretched beyond its use as a conceptual framework to think about indexing (as originally intended) as opposed to a means to augment selling investment strategies (as is now often the case). In short, to throw into this mix the term “smart beta” seems to create unnecessary confusion and is not helpful for those plan advisors and plan sponsors seeking to understand the salient features of the myriad investment strategies from which they must choose.

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