

SMART BETA

Smart beta describes indices designed to capture an alternative construction of a stock market index.

The premise of smart beta indices is the market capitalization approach currently used by most indices, is inefficient, as it emphasizes “overpriced” stocks over “underpriced” stocks. In reviewing smart beta offerings, it’s important to be smart and understand their merits and limitations.

Expected to outperform over the long term, smart beta indices aim to capture style factors, or return premium, which can include the following hypotheses:

- **Value factor:** low price earnings multiples will produce higher returns than stocks with high multiples.
- **Small cap factor:** smaller capitalization stocks will produce higher returns than larger capitalization stocks.
- **Low volatility factor:** less volatile stocks will produce better returns than high volatile stocks.

A number of smart beta solutions combine the various style factors.

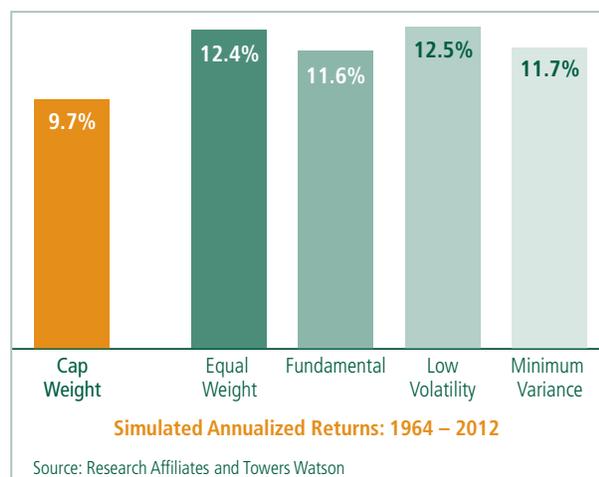
REBALANCING PREMIUM

In a research paper from Research Affiliates and Towers Watson¹, an additional return premium was identified for smart beta indices – a rebalancing premium.

The research considered a number of different smart beta factors for the US equity market between 1964 to 2012. The simulated returns for the smart beta factors were compared to the performance of the market capitalization index return.

Chart 1 shows the results for the factors analyzed, all of which outperformed the market capitalization index return over the period.

Chart 1– Smart Beta Approaches



Not only did the various smart beta factors outperform, but they did so with a lower level of risk as measured by the Sharpe ratio².

The analysis concluded rebalancing associated with the construction of smart beta indices provided a “buy low” and “sell high” discipline, which contributed to higher returns achieved by the various smart beta factors.

Research supporting outperformance of smart beta factors has given rise to a belief that smart beta provides a cheaper alternative to active management. It is therefore important to appreciate differences between beta (market returns) and alpha (active management).

IMPORTANT CONCEPTS

Beta is the return achieved by investing in an index and available to all investors who invest in an index fund.

Alpha is the return attained through investment skill, or active management. Alpha is achieved by making overweight and underweight decisions relative to an index construction and can involve combining long and short positions. It is a zero sum game where the average investor gets no alpha.

Delivering alpha requires significant insights by an investment manager and can be expensive for the investor. For example, it can cost 15-25% of the alpha in investment management fees. Smart beta needs to be evaluated as an active alpha strategy.

SMART BUT COSTLY

A common shortfall of research supporting the outperformance by smart beta factors of a market capitalization construction approach is the exclusion of the impact of trading costs. Such costs can be significant depending on the smart beta factor and rebalancing implications. This is key because smart beta strategies have higher turnover than indexed portfolios.

Moreover, many investors do not have an appreciation of the level of trading costs associated with active management and portfolio trading in general.

Trading costs include: bid/offer spreads, market impact of trades, stamp duty, custodial and agency fees. Such costs are often much higher than active management fees, particularly for quantitative driven investment strategies or high-turnover strategies. In such cases, the trading costs can amount to 50 to 75 basis points per annum. And unlike investment management fees, trading costs are not as transparent as they are simply rolled up into the return calculation.

Proponents of smart beta who suggest it provides a cheaper alternative to active management are concentrating on only one half of the story and are overlooking the potential higher costs associated with trading.

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To illustrate the impact of trading costs, the quantitative team at Connor, Clark & Lunn Investment Management researched a commonly used multi-factor approach for the global equity universe (developed and emerging markets) and simulated returns over the period 2003 to 2013³.

The analysis supported alpha factors outperforming the market before consideration of trading costs. However, when taking into account trading costs, assuming an investment of \$500 million, much of the alpha was eroded away. For a \$5 billion investment, the alpha factors actually underperformed the market return due to the impact of rebalancing and associated trading costs.

BE SMART

When reviewing smart beta offerings, be smart and understand their merits and limitations.

While past results may have been good for some smart beta indices, it's important to remember:

- Fixed embedded style factor tilts are not guaranteed to always outperform;
- Trading costs are not as transparent as investment management fees, but are typically higher than investment management fees;
- The relationship and implications of trading costs associated with rebalancing rules and growth in assets invested for smart beta approaches; and
- Adopting a smart beta approach is an active decision by an investor to incorporate a style factor tilt.

Capturing alpha requires significant insights and skill by an investment manager. It is a zero sum game where the average investor sees no added value.

Therefore, be cautious when alpha is portrayed as being easy and cheap to access such as the case being made for smart beta strategies. A saving in active management fees can easily be eroded by greater and more expensive trading costs.

¹ The Surprising Alpha From Malkiel's Monkey and Upside-Down Strategies – R. Arnott, J. Hsu & V. Kalesnik, Research Affiliates and P. Tindall, Towers Watson

² Sharpe ratio measures the excess return over the risk-free return divided by the standard deviation of the excess return.

³ The investible universe used in the analysis covered 44 countries. For the purposes of simulation shorting was allowed for some markets. The naive simulations used monthly trading, in some cases optimized in context of CC&L trading cost and risk models. Assumptions for commissions and ticket costs and market impact all reflect actual true modeled costs. For more information contact the author.

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