

Explaining smart beta

By Caspar Rock,
Chief Investment Officer

Would you invest in a fund that had, by design, larger weightings in the most expensive shares and smaller weightings in the cheapest?

If you did, you would be buying an equity tracker fund that follows, for example, the FTSE 100 Index, which is a 'capitalisation weighted index' built with the weight of each stock in the index reflecting its size or market capitalisation. This means that the weight of a particular company in an index, for instance Vodafone or BP, reflects not only the profits of that company, but also the valuation multiple given to it by the market. As a consequence, all other things being equal, more highly-valued companies will have a higher weighting in the index than lower-valued companies. ►

Define

TRACKING ERROR QUANTIFIES HOW CLOSELY A FUND'S RETURN PATTERN FOLLOWS THE BENCHMARK INDEX.

CONTANGO IS THE SITUATION WHEN THE SHORTEST MATURITY FUTURE FOR A COMMODITY IS LESS EXPENSIVE THAN THE LONGER MATURITY FUTURE FOR THAT SAME COMMODITY, BUT IF YOU OWN THE SHORTER-DATED FUTURE HOWEVER, IT COSTS YOU MONEY EACH TIME YOU DO IT.



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There is a large body of academic research that has tried to identify ways to either improve the returns of an index, or lower the volatility of returns of the index, compared to traditional capitalisation weighted indices. This research has identified attributes, ‘factors’ or ‘inefficiencies’ of shares that can at least partly explain longer-term outperformance or reduce volatility, compared to traditional capitalisation weighted indices. These factors include:

- **Accounting measures** (such as book value, revenues or cashflow), these do not have a market implied multiple in the ‘value’, but rely more on static accounting data
- **Size** ‘small cap’; there is extensive research on the demonstrable long-term outperformance of smaller companies
- **Quality**, favouring consistent earnings growth and high profit margins, efficient balance sheets and lower leverage over more cyclical and higher leverage securities with lower profit margins
- **Low volatility** to skew the selection towards less volatile stocks and to avoid the most volatile ones
- **Risk parity**, more volatile assets have a lower weighting and less volatile asset classes a higher weighting
- **Equal weighting** so as to produce the performance of the average stock in the portfolio rather than the weighted average. This is another way to remove the bias to larger capitalisation companies

For many years, market participants have been building rules-based and

systematic (hence ‘smart’) indices that use one or several of the above factors for their ‘weighting methodologies’ rather than the more traditional methodology of capitalisation weighted equity indices.

A smart beta fund is a passive fund that aims to track an index that uses one of these alternative construction methodologies.

Would you invest in a fund that has its largest exposure to the borrower with the most debt outstanding, and the smallest weight to the one who has borrowed the least?

If the answer is yes, you would be buying a fixed income tracker fund, that follows, for example, a JPMorgan Government Bond Index or a Barclays Investment Grade Credit Index.

Instead of using size of issuance as an anchor for a government bond index, smart beta funds use one, or a combination, of the following factors:

- GDP or other accounting measures of the size of the economy
- Population
- Net debt outstanding (as opposed to gross debt) – this is generated by subtracting the overseas assets of a country from the gross debt figure for that country

For corporate credit indices, similar factors to those used in equity smart beta strategies have been employed. These include:

- Sales
- Cashflow
- Book value
- Volatility
- Equal weighting

For alternative asset classes such as commodities, there is no such thing as market capitalisation; therefore, historically commodity indices have been built using one of two methodologies:

- Production weighted (sometimes capped given the over preponderance of energy in those indices)
- Equally weighted

More recently smart beta strategies have been implemented in an effort to try and reduce the effects of ‘contango’. Contango is the reason that commodity futures tend to have a lower total return than physically holding the commodity. A number of smart beta funds have been set up to try and mitigate this ‘roll’ effect through holding different maturity futures, however this may lead to returns in the shorter term that differ from the physical commodity.

In general, smart beta funds tend to be slightly more expensive than traditional passive funds but cheaper than actively managed funds. Smart beta funds have not been immune from the general fee pressure on all funds seen in recent years and the environment of low bond yields and lower expected returns.

Smart beta funds can certainly have a place in a portfolio, as they have the potential to improve absolute returns and reduce absolute volatility. It should also be noted however, that although you might improve your relative returns, you will certainly increase the relative volatility and tracking error of your portfolio, compared to more traditional indices.

When you buy a smart beta fund you are definitively taking an active bet! 