Investment

Are Alphas Becoming Smart Betas?

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Smart beta has become one of the most popular investment terms in the industry as a Google search for the term pops up 43.5 million results. However, what is smart beta?

To begin, we need to define what alpha is. Generally, investors casually refer to alpha, or value add/excess returns, as the return generated from active investment management. Alpha is defined as the difference in return between an actively managed portfolio and a passively managed portfolio or benchmark such as the S&P/TSX Composite Index.

However, beta is harder to define. Some managers will suggest that beta is a risk concept that measures the sensitivity of the manager's portfolio relative to a specific index and is calculated using regression analysis. Agreement on this definition will then raise a whole list of questions such as which index, over what time period should beta be calculated, and what frequency should the data be (daily, weekly, monthly, quarterly, or yearly)? Different time periods, indices, and frequencies will yield dissimilar statistics. Some managers use fundamentals to estimate beta while still others calculate beta employing style or factor risk characteristics.

Frankly, beta really is a nebulous notion, for unlike alpha, there are multiple methodologies and types of calculations that can be employed for estimation purposes.

Not surprisingly then, the term 'smart beta' has been defined in quite contradictory fashions. Some highly respected practitioners have suggested that smart beta is a passive investment strategy: "passively following an index in which stock weights are not proportional to their market capitalizations, but based on some alternative weighting scheme."[1] Other equally bright investment professionals define smart beta as "active strategies with some of the characteristics of passive strategies ... that deliver fairly static exposures to characteristics historically associated with excess risk adjusted returns."[2]

Are Alphas Becoming Smart Betas?

Either definition of smart beta supports the marketing efforts of those who have defined smart beta solutions as strategies that harvest known 'risk premia' factors such as value, momentum, cap, income, low volatility, and quality. These risk premia factors are being packaged and marketed to the masses in the form of smart beta ETFs (see *Figure 1*).

Is it really this simple to package quantitative investment strategies that can successfully compete against active investment strategies?

A classic value risk premia factor is the price-to-book ratio where investors consider buying stocks with relatively low price-to-book ratios and shorting stocks with high price-to-book ratios. As illustrated in *Figure 2*, while such a simplistic strategy should do well in the long term, there will be times where high price-to-book stocks outperform low price-to-book stocks. This raises the question of what will the masses do when a naïve value risk premia based ETF underperforms for a persistent period of time?

Another example of the dangers of unsophisticated smart beta strategies are those designed to capture the low volatility effect. One would hypothesize that all managers offering a one-dimensional low volatility strategy should have very similar results. The analog to this idea is that all passive index fund managers have very low tracking errors relative to the index they are replicating. Unfortunately, an examination of the results of low volatility managers reveals the exact opposite to our hypothesis. There are

Figure 1

THESE RISK PREMIA 'FACTORS' ARE BEING PACKAGED AND BOUGHT BY THE MASSES IN THE FORM OF SMART BETA ETFs

Largest Smart Beta ETFs

ETF Name	MER	AUM ($US B)
iShares Russell 1000 Value ETF	0.20%	$33
iShares Russell 1000 Growth ETF	0.20%	$31
Vanguard Value ETF	0.08%	$25
Vanguard Growth ETF	0.09%	$22
Vanguard Dividend Appreciation ETF	0.08%	$22
iShares Select Dividend ETF	0.39%	$16
Vanguard High Divided Yield ETF	0.09%	$16
SPDR Dividend ETF	0.35%	$15
iShares S&P500 Growth ETF	0.18%	$15
iShares Edge MSCI Min Vol USA ETF	0.15%	$13

Source: See EFT.com. As of November 23, 2016.

huge differences in both risk and return for low volatility managers (see *Figure 3*).

Decay Over Time

Simple smart beta strategies can decay over time because the factors they are based on can decay, evolve, or change over time. This occurs for a variety of reasons including:

- Everyone is using them
- Data mining
- Process failures or inadequacies in the methodology employed to derive these factors
- Changes in regulatory environment
- The structure of the market evolves over time resulting in new market drivers
- New agents or investors impact stock pricing
- Technology
- Naïve extrapolation

Alphas Are Not Smart Beta Strategies

Successful, active, quantitative firms and investment strategies significantly differ from currently marketed smart beta strategies because they possess the following characteristics:

- Experience and long-term memory
- Aligned with investor expectations
- Independent thinkers
- Focus
- Adaptive
- Shared knowledge driven
- Proprietary factor work
- Multi-factor based
- Unique factor blends
- Ongoing research to 'sharpen the saw'
- Live risk and stress testing
- Best execution
- Strategy quality and consistency

Good Thing

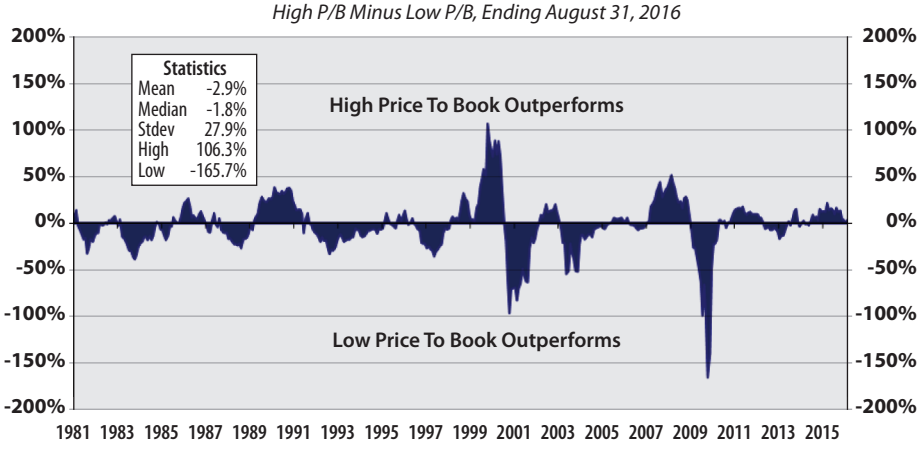
Contrary to the theme of this article, smart beta strategies are actually a good thing to the extent that they 'popularize' quantitative investing. Like any other investment innovation, smart beta ETFs are 'flattening' the pricing in the investment business; empowering investors to run their own money; leading to the rise of 'robo advisors;' minimizing the differentials between fundamental and quantitative managers; and shining the light on successful quantitative processes. Skillful money management, either in the form of smart beta or smart alpha, will always be elusive. **BPM**

Figure 2

SMART BETA VALUE FACTORS WILL UNDERPERFORM

Russell 1000 12 Months Rolling Factor Return Spread

High P/B Minus Low P/B, Ending August 31, 2016



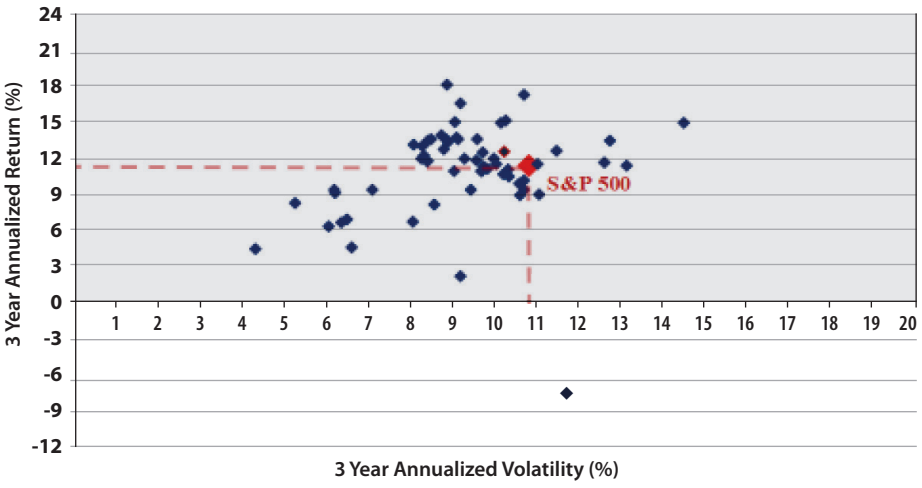
Source: Hillsdale Investment Management Inc.

Figure 3

HUGE DIFFERENCES IN LOW VOLATILITY MANAGER RESULTS

Low Volatility U.S. Equity Funds

3 Year Return And Risk, Ending September 30, 2016, U.S. Dollars



Source: eVestment Alliance.

1. Blitz, D. 'How Smart Is 'Smart Beta' Investing?' Robeco White Paper, December 2012. Pg 1.
2. Kahn, R. N., & M. Lemmon. (2016). 'The Asset Manager's Dilemma: How Smart Beta Is Disrupting the Investment Management Industry.' *Financial Analysts Journal*, Vol. 72, No. 1 (Jan/Feb), 15-20: Pg 16.