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Low or no returns send investors chasing 'smart beta'

Index investing

Whether it is active or passive, it could just be another fad, writes **Brendan Maton**

Investing for market returns via index tracking strategies is standard for many investors. But given the current low level of market returns, or beta, interest is increasingly turning to more sophisticated index-style approaches often labelled "smart beta" by the investment industry.

According to Northern Trust, 51 per cent of investors globally are interested in exploring these strategies to meet their objectives.

Smart beta offers the opportunity to profit from alleged systemic anomalies, such as the superior efficiency of low-volatility stocks. It often takes the form of alternatively weighted indices, using factors like sales, earnings, book value, cashflow or dividends rather than market capitalisation.

Smart beta is a kind of index, but because the anomalies can be exploited in various ways, it can also be categorised as an active strategy.

So, for example, prospective clients of Paris-based Tobam can access its capabilities via segregated mandates, commingled funds or a series of indices devised in partnership with FTSE.

Yves Choueifaty, Tobam's founder, says there are only a few differences between the indices and funds, such as the frequency of rebalancing and an input of responsible investing in some of the funds.

If the formula is little different between Tobam funds and FTSE/Tobam indices, this begs several questions: when is an index an index and when is it a strategy, and how do investors choose between FTSE's smart betas licensed from quant houses and those it has developed itself?

The conundrum is evident in the oxymoron "strategy indices", used by many practitioners and agents as synonym for smart betas.

"The key benefits of index investing are simplicity, transparency, low cost," says Dimitris Melas, head of new product research at MSCI, an index provider. "Therefore, strategy indices should have a clear objective, a transparent methodology, simple portfolio construction rules, and relatively low turnover.

"Any strategy that does not have a clear objective or changes its objective over time, that has an opaque methodology, that relies on complicated portfolio construction rules, or that has high portfolio turnover making it difficult to replicate at a low cost, should be viewed as an active strategy."

Unfortunately, there are no universally agreed definitions of "simple", "transparent" or "opaque". Mr Choueifaty, for example, claims his group's methodology is there for all to see in applications for the intellectual patents that protect the business. Mr Melas says even with a PhD in mathematics he struggles to understand the Tobam formulae.

Meanwhile, MSCI's Minimum Volatility index had a higher turnover in several years than Robeco's minimum volatility funds, exactly the kind of strategy the MSCI index was designed to benchmark. Does this mean that MSCI Minimum Volatility, with a relatively high turnover, falls foul of Mr Melas's own definition?

Mr Melas admits that

Tobam UK

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MSCI Minimum Volatility is an attempt to represent a strategy and as such includes criteria (such as caps on size and turnover) that are variable. Richard Hannam, European head of passive equity at State Street Global Advisors, reckons that as MSCI Minimum Volatility has fewer than 300 constituents versus 1600 for MSCI World Equity, it ought to be considered a strategy.

The oldest smart beta house, London-based GWA, has 22 indices licensed via FTSE. GWA founder David Morris says: "We can index anything in the world but my bugbear is when folk claim these new indices are passive. [An index weighted by] market cap represents the full opportunity set and anything else is active."

Indicative pricing confirms that smart beta sits between passive and active. Strategy indices managed under licence cost between 10 and 15 basis points for a €100m mandate. Direct from the quant house itself, the strategy would be 30-35 basis points. Providers such as Edhec-Risk Indices & Benchmarks do the former only. Businesses such as Acadian, Analytic Investors, Robeco and WisdomTree only tread the second, traditional route. GWA, Research Affiliates, Tobam and Westpeak do both. The big passive managers such as SSgA and Northern Trust will customise any smart beta a client wishes for as well as manage licensed strategies. US-based WisdomTree packages its strategies exclusively as exchange traded funds.

Pimco, the world's largest commercial bond investor, has taken a singular route, bypassing index providers altogether for a new series of indices against which it actively manages assets. The new indices cover a fraction of Pimco's total client assets but Mr Melas makes the point that if asset managers follow the same route as investment banks, which create proprietorial indices for every new business opportunity, the fear of conflicts of interests arise.

Clients – at least those with billions to manage themselves – do not seem bothered for the moment. Mr Choueifaty recalls that the origin of his group's series with FTSE was the desire of a huge institutional investor to access Tobam's intellectual property but in a customised manner and run by the client's inhouse team. Historically, the largest clients got segregated mandates with a direct line to the portfolio manager and the most attentive client liaison. The nature of smart beta means sovereign wealth funds can devise their own bespoke index without any expectation of sharing it.

> 'My bugbear is when folk claim these new indices are passive'
>
> **David Morris, founder GWA**

Few, however, predict the end of market-cap weighted indices. Smart beta specialists such as Pim van Vliet, portfolio manager of Robeco's Conservative Equity declare them the only representative benchmarks based on sound financial theory.

Licensing strategies via index providers might be the evolution of the business of asset management (equivalent to the move by IBM out of manufacturing computers into consultancy) but it does not follow that smart beta will persist.

The history of active asset management suggests that bright ideas, from the Nifty Fifty to tactical asset allocation to 130/30 funds, dim in time.

Dimitris Melas: strategy indices should be simple

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Press Index

The main indices on a good day: tracking indices is no longer attractive for some investors PA