Smart Beta: New generation of choices

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The 'smart beta' revolution is taking investors from one 'passive' solution – the cap-weighted index – to many. Rachel Fixsen looks at the questions this raises

The vast majority of passive equity investment assets may still be linked to indices based on market capitalisation, but many pension funds in the Netherlands, Scandinavia and elsewhere in Europe are shifting the beta portion of their equities portfolios towards alternative indexing methods. These so-called 'smart beta' strategies promise to lower risk while maintaining, or even enhancing, long-term returns.

Critics of the practice of market cap-weighting say the method leaves investors more exposed to stocks whose prices have risen strongly, and overweight stocks that are fundamentally over-valued.

Over the decades, such arguments have been used more to promote active management than value or growth strategies specifically. More recently the arguments have focused on alternatively-weighted indices. But whereas a good deal of scepticism continues to greet the claims of traditional stockpickers, the new generation of index providers now seem to be winning these arguments in convincing fashion – at least in the eyes of pension fund investment chiefs.

The strategies they offer include several different approaches. Ramon Tol, equities fund manager at Blue Sky Group, which runs the KLM pension funds, sees smart beta defined in two groups – alternative strategies, including risk parity, minimum variance and maximum diversification; and risk-factor indices – momentum, value and growth.
Ksenya Rulik, head of quantitative research at ETF provider Ossiam, takes another view, categorising alternative betas by their objective.

Some strategies integrate risk management tools or processes, such as weighting to achieve equal risk contribution from each stock, or minimum variance, which is designed to overweight low-volatility stocks or minimise the volatility of a set of stocks.

A second group produces alternative valuations or return forecasts. Included in this category are GDP-weighted (used for multinational indices) and the fundamentally-weighted and other accounting-based indices, pioneered by Research Affiliates, which rate stocks according to metrics such as book value and sales.

A third group, which includes simple equal-weighting, aims to increase diversification. Paris-based asset manager TOBAM believes that diversification can go even further than equal-weighting. It offers an alternative strategy to market cap, which it calls maximum diversification or anti-benchmark, and creates passive-like equity products using a formula that divides the average weighted volatilities of single stocks in a portfolio by the volatility of the portfolio itself.

While other alternatively-weighted benchmarks such as fundamental-based and minimum variance have offered different biases, which allow for outperformance, TOBAM holds that diversification is the only approach that is truly weatherproof in the long-term.

"We are only taking advantage of the markets' efficiency – that is, their lack of predictability," says TOBAM's founder, Yves Choueifaty. "Because of this, the only option you have to outperform is to diversify."

As Rulik observes, there is a broad family of strategies. "They are not a perfect substitute one for another, but they can be thought of as substitutes for traditional beta," she notes.

"As institutional investors review their choices for investing in index products, they should bear in mind that the range of available strategies has evolved and expanded, from traditional, widely used cap-weighted indices at one end of the spectrum to engineered beta – actively targeted exposure with specific diversification and volatility goals – at the other," advises John Krieg, managing director, asset management, EMEA at Northern Trust. "This evolution has produced myriad new approaches ranging from alternatively-weighted indices to customised beta approaches that allow investors to choose the type of index exposure that best meets their specific needs."

These strategies can, of course, be used separately or combined. Investment managers offer funds run according to the index rules and segregated accounts that allow for tailoring to the individual institution. Index providers license their methodologies, allowing pension funds to run portfolios in-house if they have the infrastructure to do so. According to a survey conducted earlier this year by bfinance on pension fund allocation, 37% of investors were considering moving more traditional core investments to smart-beta index strategies, and a third expect more than a tenth of assets to be invested in this type of strategy by 2015.

"A lot of pension funds are talking about smart beta, and some are already investing in it – mainly the big funds who've got the ability to have an investment team in-house," observes Des Morris, director of institutional clients at Switzerland-based quantitative investment specialist 1741 Asset Management.

Lars Jaeger, chief executive at its compatriot, Alternative Beta Partners, suggests that, since pension funds are long-term investors, their passive equity investments are likely to do well if they impose even a simple value tilt onto them – because value tends to

outperform the broad market over time. But how they construct a portfolio depends on the individual fund's aim. "There's no one-size-fits-all solution," he says.

So far, what have pension funds actually done at the cutting-edge?

In the UK, the pension fund committee at Wiltshire County Council decided last July to put 5% of the fund's total assets of £1.3bn (€1.6bn) into a global equities fundamental index – Research Affiliates' RAFI All World 3000 Equity – which complements market-cap indices, rather than being a first step away from them.

The aim of the fundamentally indexed investment is to strip out the volatile impact of investor sentiment, explains Catherine Dix, Wiltshire's fund investment and accounting manager.

The decision to go with a fundamental index was partly driven by an investment belief in the validity of this selection method, but also about diversifying sources of beta, as reflected in the fund's intention of maintaining an 11.5% allocation to cap-weighted mandates. It is not looking at any other alternative betas besides fundamentally-weighted, Dix says.

In the Netherlands, the €3.4bn pension fund PNO Media opted to equally weight its equity portfolios last year, in place of passively managed cap-weighted investments in EU and US equities. Because it constructed its own portfolios, the fund was able to implement its ESG exclusion list cheaply and easily, and bring the portfolio much closer to its value drivers, according to fund director Jeroen van der Put.

The EU portfolio is based on the MSCI Pan-Euro index, and US portfolio on the Russell Top 200 index. "For both portfolios we have selected the 200 largest companies and have them weighted equally – 0.5% per company," Van der Put says. "We rebalance once a year."

Last November, it started an emerging equities portfolio, which is also equally weighted.
"In our philosophy we believe that a passive portfolio should have a character of buy-and-hold, incorporate the most important equities in the market, and be simple and easy to manage at low cost," he says.

Elsewhere, the UK pension fund of AkzoNobel made a first step in switching its beta into alternatively indexed strategies, buying into a fund tracking a global fundamental index (see panel). Back in 2006, Swedish state buffer fund AP2 opted to benchmark its North American equities against a RAFI index, and extended this to the global level two years later. And in 2011, the French state pensions reserve fund FRR said it would begin mixing traditional cap-weighted passive strategies with some tracking alternatively-weighted indices – aiming to test different methodologies, starting with fundamentally-weighted indices, minimum variance and a maximum Sharpe ratio index.

While some have chosen to adopt a single methodology, such as equal-weighted, investors adding alternative beta strategies to their portfolio should not put all their eggs in one basket but combine different strategies, according to Dimitris Melas, MSCI executive director and global head of new product research.

The combination of value-based and risk-based strategies, in particular, looks attractive, he says. Both strategies have historically outperformed the market over long periods but they also have low correlation with each other. But it is also important to think through carefully which strategies to combine, he says.

"We're not saying, look at everything out there – that would be excessive diversification which in the end would be the same as the market," he observes.

Mamadou-Abou Sarr, senior equity index specialist, EMEA, for Northern Trust, agrees. "Some alternative indices add value, but not necessarily under the same market conditions," he says. "Investors need to understand the underlying biases and the overall fit in their portfolio before selecting the right benchmark."

So, on what basis should investors pick and choose? Investment beliefs are paramount in deciding which strategies to use, says Jan Bertus Molenkamp, director of fiduciary management at Kempen Capital Management. "For example, low-volatility optimisation strategies could fit a defensive portfolio that would like to benefit from equity beta with a lower risk profile," he says. "While investors believing in efficient markets and preference for low cost should prefer market cap-weighted."

That fits with the approach Blue Sky Group took, using a low-volatility strategy. Equity strategist Imke Hollander describes it as a no-brainer for the KLM pension funds. "If you reduce your risk, your solvency ratio becomes less volatile," he says.

But Rulik is doubtful about the wisdom of using investment beliefs as a basis for picking beta for strategic allocation, because those beliefs can change and may be based on prevailing market conditions. "What alternative beta strategies give is broad equity exposure plus sources of additional systematic return, and the approaches used don't change over time," she says.

Xiaowei Kang, director of index research at Standard & Poor's, says the quantitative asset management industry is moving towards a model that tends to combine strategies based on simple parameters rather than one strategy with a combination of various parameters – because having too many can make things confusing.

"You don't really know which factors are contributing to the construction of the index, so we really prefer simplicity, and typically we just pick three factors, maximum," he says.
Simpler products allow users to set about the task of constructing their own portfolios with confidence.

Danish pension fund PKA, for example, recently decided to overhaul its equity strategy by replacing traditional asset classes with a wide range of risk factors, or risk premia. These are grouped into traditional beta – developed markets risk premium and frontier markets risk premium, for example – and alternative beta, including index strategies such as low volatility, value, momentum and quality, but also several hedge fund-like risk premia – such as merger arbitrage and liquidity events.

Is there a danger, as Melas warns, that by diversifying too broadly an investor could end up replicating exactly what they were trying to avoid in the first place – the market portfolio?

Morris at 1741 AM doesn't think so. Combining them does not cancel out the factor tilts or specific characteristics of individual strategies to the extent that the overall portfolio would resemble a market capitalisation-weighted index, but instead results in a watered-down version of each index strategy and its characteristics, he says.

"These are highly diversified index products which target exposure to specific factors and characteristics," says Morris. "If you combine them, you are expected to get a more reliable and stable return generation."

Similarly, Molenkamp points out the cap-weighted index is not the sum of the alternative indices, as these are only a small part of the universe underlying the cap-weighted index. "The market value of a stock can be subject to all kinds of biases like home bias, large cap bias, liquidity constraints, preference for high beta stocks, et cetera," he says.
So a combination of investment beliefs, specific investor requirements (do you have a high risk appetite, or are you risk-averse?), and diversification among several options seems like a sound approach to this new world of smart beta.

But does that include hanging onto the apparently inefficient and heavily-biased cap-weighted index as part of this diversified solution? Should investors go for a core of cap-weighted, and satellites consisting of smart beta? Put together a fully-diversified portfolio of betas – smart and traditional? Or simply ditch cap-weighted for a diversified portfolio of smart beta alone?

"Smart beta is an alternative for traditional beta, so it is perfectly suitable to use for the core, and the choice of strategy should be aligned within the objectives and constraints of the investor," says Rulik. "What is important for the investor [to consider] is [that] if he wants to analyse the performance afterwards, a mix of strategies might be a bit non-transparent, as it will have no clear common objective. "If he uses a strategy like minimum variance for the core, then the core has a clear objective to access equity return with reduced risk. Then some alternative hedge fund strategies uncorrelated to the broad equity could be more suitable [around] the core."

In reality, many investors may maintain market-cap as the core, using some of the alternative index strategies as satellites. Kang believes investors are cautious about moving away from market cap, because fundamentally they feel it creates a very elegant portfolio, taking in all the information available in the market.

"Of course there might be some more aggressive pension funds who make the claim that they will do away with the cap-weighted because they think it is so flawed," he says.
And, of course, there are others who question the whole concept of smart beta.

"Using the name 'smart beta' implies it's something like a smart phone that's dramatically better," says Jeff Molitor, CIO Europe at index fund manager Vanguard – a stout defender of the cap-weighting concept. In fact these strategies simply reflect active decisions to deviate from the broad market, he argues, and should therefore be regarded as active and not passive strategies.

"Fundamental indexing – that's an active strategy, and it shouldn't be viewed as an index," he says. "Any time you pick just part of the market, you the investor are making a decision."

Passive, active, index or not, whatever advantages investment professionals see in these alternative strategies, for pension funds at least, investment committees must be able to understand them before they will be happy to agree. "It is vital the boards do understand what you are doing," says Blue Sky's Hollander.

So how should this process of education be approached? "I think in some ways, it's easier to identify conditions when a market-cap index might deliver poorly, for example in a collapsing TMT situation," says John Hastings, a partner at Hymans Robertson.
Some of the smart beta strategies are more readily understood than others, he adds. "With fundamental, you can identify a value bias, and if a trustee believes in value, they can use that investment belief to approve of the strategy. But if you go for the risk-efficient index, I think the complexity might be a struggle for many trustees to get their heads around."

Educating trustees on this type of smart beta strategy may not be realistic – and of course the acid test for any of these strategies is how the investment team is able to explain away any underperformance. The AkzoNobel scheme is already grappling with this situation. "They'll want answers," Hastings warns.

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