THE WALL STREET JOURNAL.

Trump Bump Boosts ‘Smart Beta’ Funds

Interest increasing in funds known as smart beta that pick stocks based on traits like growth or volatility

BlackRock offers funds marketed under the term smart beta, which has become one of the hottest trends in exchange-traded funds. *PHOTO: GETTY IMAGES*

By
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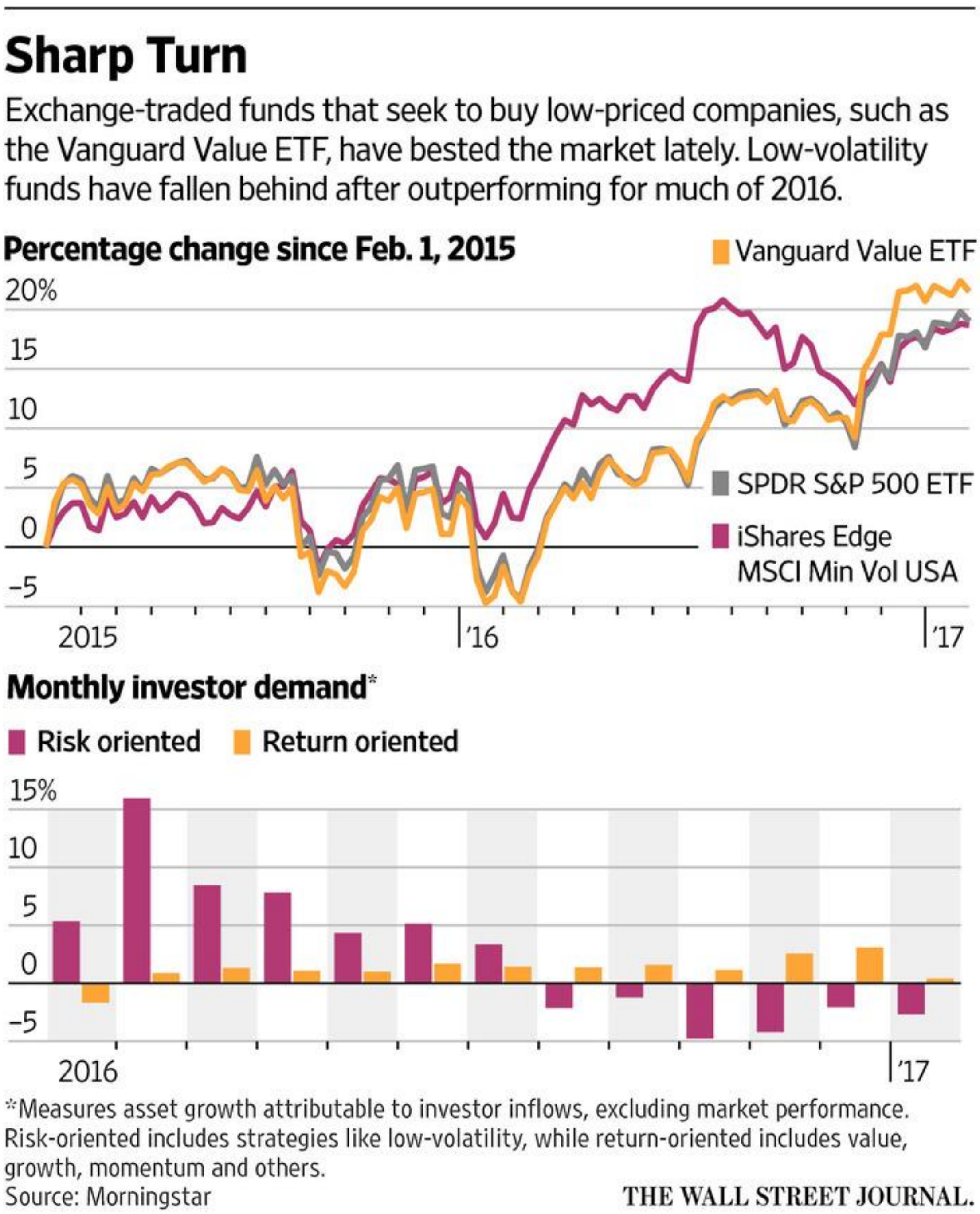
Feb. 5, 2017 7:00 a.m. ET

The Trump Trade has been a boon for so-called smart beta, the hottest trend in exchange-traded funds.

ETFs that pick undervalued U.S. stocks have swelled to record size since the election, buoyed by the gains in financial and technology stocks that followed President Donald Trump’s victory. Value ETFs that invest in big U.S. companies have taken in $15 billion since the start of November, though inflows slowed in January, according to Morningstar Inc.
Smart beta, a term popularized by a consulting firm, has become a catchall for funds that pick stocks based on traits like value, growth or volatility, as opposed to traditional index products that invest in proportion to company size.

Issuers are looking to smart beta to help bolster profits, charging fees that can be as much as five times the cost of traditional index ETFs. The smart-beta category has added 208 new U.S. ETFs since the start of 2015, according to Morningstar. Despite its rising popularity, there is still considerable confusion about how smart beta works, how best to harness it and even what it means.

“There’s a huge range of possibilities in the smart-beta world, and they can’t all be that smart,” said Yves Choueifaty, chief executive of Tobam, an asset manager based in Paris.



Money managers and quant traders have used the strategies for decades, and value and growth "style" ETFs have been around for years. It is only recently that asset managers like BlackRock Inc. and Invesco Ltd. began marketing ETFs under the smart-beta moniker. Smart beta's purported benefit is that it avoids the built-in hazards of traditional funds that apportion their investments based on company size, where bigger companies and industries are larger shares of the pie. Smart-beta adherents say that weighting based on company size forces investors to pay inflated prices.

“Market-cap weighted benchmarks are simply very dumb,” Mr. Choueifaty said. “The benchmark only buys what is fashionable, and there’s a price for that.” For example, the S&P 500’s exposure to information technology stocks peaked in 2000 at almost 35%, right before the tech bubble burst. It is now 21.3%.

Smart beta does it differently. Instead of weighting investments based on the size of the company, a smart-beta index might give equal weight to stocks; focus on companies with share prices considered cheap relative to profits; or try to build portfolios that aim to muffle market swings.

But the industry’s popularity, along with the proliferation of new funds, has sparked concern that smart beta will lead investors into new mistakes. The recent surge into value ETFs at the expense of last year’s vogue for low-volatility funds, in the view of some analysts, is a sign that investors are using smart beta to chase the latest fad.

“People are making classic mistakes with a shiny new set of toys,” said Ben Johnson, head of ETF research for Morningstar.

One of the most outspoken critics of the explosive growth of smart beta is Rob Arnott, the founder and chairman of Research Affiliates and widely considered the godfather of the smart-beta movement. In a paper published last year, he said the surge into smart beta may inflate company stock prices.

“We think it’s reasonably likely a smart-beta crash will be a consequence of the soaring popularity,” Mr. Arnott and his colleagues wrote.

BlackRock, Goldman Sachs Group Inc. and Invesco, among others, have published research disputing Mr. Arnott’s theory, pointing out that ETFs are just a fraction of the money following these strategies, which have been used by mutual funds and other active managers for decades.

Adding to the confusion, not everyone agrees about what counts as smart beta. Morningstar includes value and growth “style” ETFs that have been around for more than 20 years. BlackRock doesn't. And value funds that sound similar can perform very differently.

“Many investors in these funds probably are not aware of the differences between funds that sound the same,” said Melissa Brown, senior director of applied research for Axioma Inc.

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