The good news that smart beta brings is that even when you cannot forecast, you still can build a portfolio that makes plenty of sense.

The investment management industry relies on foundations and pillars that strongly influence beliefs and decision making. Whilst some are robust and strongly defined, others are either flawed or not well defined, which leads to misunderstandings. This is particularly important at a time where the industry is flooded with buzzwords and unreliable terminology.

Misunderstandings around these are often triggered by a lack of clear definitions, and can directly lead to material consequences in portfolio allocations. We discuss here some of these myths and their consequences.

There is a commonly held view that passive management – the tracking of market capitalisation-weighted indices – is ‘neutral’, providing well diversified access to the risk premium.

It is not the case. Investing in a capitalisation-weighted benchmark means buying a portfolio that is hugely biased and speculative. Such benchmarks attribute greater index representation to stocks or factors as they have appreciated and less after they became cheaper. These benchmarks inherently forecast that the successes of the past will be successes of the future.

This takes us to a second confusion, the ‘cheapness’ of passive as opposed to active investment. Investing through market capitalisation-weighted benchmarks ultimately destroys value for investors. While ‘cheap’ in relation to fees, perhaps, passive investing is quite ‘expensive’ in terms of portfolio efficiency. ‘Passive’ is a cheap way to buy expensive stocks...

A second myth has it that tracking error is an accurate measure of risk, thus a low tracking error equals low risk and a high tracking error signals higher risk.

This is wrong. Tracking error does not measure anything in absolute terms. It is exclusively a relative measure. Its interpretation depends necessarily on the basis of comparison. Tracking error cannot be viewed as a proxy measure of risk. It does not even correlate to absolute risk.

ACWI Equity strategy and the funds invested in the same universe as presented by eVestment. Figure 1 plots the tracking error compared to the reference index, and the risk of the funds (measured by the standard deviation). It shows that there is no correlation between the two measures.

One additional myth suggests that a portfolio’s exposure to a risk driver can be judged simply by its allocation in terms of weights to a stock or sector. To mitigate stock-specific risk, many investors choose to allocate portfolio holdings over as large a selection of stocks as possible and/or simply keep portfolio allocations close to those of the market capitalisation benchmark. However, both practices may lead to overexposure to stock-specific risk factors.
We believe:

• That the investment industry is prone to misunderstandings of various concepts and that this leads, in turn, to the creation of myths that can have damaging consequences.

• Much of this mythology is centered on misunderstandings about the relative nature of passive and active investment management.

• Contrary to mythology, there is nothing ‘neutral’ about passive investment. In fact, passive investment involves buying into all the previous speculations, betting that yesterday’s winning stocks will also be those of tomorrow.

• Smart beta investing is about collecting the pure risk premium in a much more efficient way than the market cap-weighted passive investments.

Hence why we question its belonging to the ‘smart beta’ movement. In fact, it is not about beta at all. It is about being insightful. It is about alpha. It provides a very good complement to smart beta, but cannot be assimilated to smart beta.

Last, there is a commonly held, but deeply misguided perception that the average active manager does not represent value for money because they cannot beat a market cap-weighted benchmark.

By definition the average active manager cannot outperform the benchmark because the benchmark is determined by the sum of activity carried out by both active and passive managers. And because passive managers have no impact on the benchmark - they merely follow it - it is, in fact, the sum of all the bets taken by active managers that determines the benchmark.

In conclusion, myths and misunderstandings persist in the asset management industry, and more education is needed to help investors understand the real meaning of various investment terms that continue to confuse and potentially lead to negative consequences for their investments. «