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Smart beta might not live up to its promises

Experts question diversification benefit and sustainability of the strategies' performance

By BARRY B. BURR

Smart beta strategies can fail to live up to their promised outcomes in performance, diversification and stability, according to some in the investment management industry, challenging perceptions to an increasingly popular alternative to passive market-capitalization-weighted indexes.

"Smart beta strategies exhibit all the characteristics of a great fad as measured by the growth of media attention, proliferation of products and the surge of assets," said Bruce I. Jacobs, principal, Jacobs Levy Equity Management, Florham Park, N.J. "Fads can lead to unwelcome outcomes."

In addition, smart beta strategies deepen asset owner involvement in portfolio management decision-making, having them take on more responsibility than setting asset allocation and selecting investment managers, he said.

"Smart beta strategies require the plan sponsor to make active decisions as to which factors to bet on," Mr. Jacobs said. "The plan sponsor is taking responsibility for that decision as opposed to hiring an investment manager who would have that responsibility."

Eugene L. Podkaminer, senior vice president, capital markets research, Callan Associates Inc., San Francisco, said: "My complaint, if you will, is that the marketing and the naming (of smart beta) have really obscured what's going on under the hood. As an economist and a practitioner and an adviser, that really irritates me."

"My clients and my investors demand to understand what these strategies are really all about, how are they different than what's in their portfolio already and how are they accretive or additive to either enhanced return or enhanced diversification," Mr. Podkaminer said. "And it is not intuitive how that is the case with smart betas unless you really start to dig."

In a research paper on the issue, Mr. Podkaminer said, "One of the really important takeaways for investors is that because the way smart beta indexes are constructed, they pull from the same universe of stocks as traditional cap-weighted indexes and you don't see a lot of diversification benefits."


Shelley Kusnetz

"Smart beta strategies exhibit all the characteristics of a great fad," says Bruce I. Jacobs, principal, Jacobs Levy Equity Management.

"So there is a lot of hype around smart beta," Mr. Podkaminer said. "It promises to do all these wonderful things but when you dig deeper into the construction methodology and the empirical results, you find there is a lot of overpromising."

Mr. Podkaminer doesn't reject smart beta strategies. But, he said, "I want my clients … to go in with both eyes open."

"Many of these products are little more than a repackaging of small-cap and value effects," said Mr. Jacobs, whose firm manages $9.1 billion in U.S. strategies, including long equity, defensive equity, 130/30 long/short and market-neutral long/short. "Once you account for small cap and value, you account for most of the (performance) value" in smart beta strategies, he said.

In addition, active strategy managers "can close their strategies when they reach capacity limits for assets under management. Smart beta managers know no asset bounds," Mr. Jacobs said. "Even if a manager chose to limit the amount it would manage, because these are public factors other managers would use that capacity … there is no way to control the volume of investment in smart beta strategies."

Assets owners' responsibility

Agreeing that asset owners have to take responsibility with smart beta, Lynn Blake, chief investment officer of global equity beta solutions, State Street Global Advisors, Boston, said: "They own that investment decision and that investment decision is typically around specific factor exposures."

Whenever factors "underperform the broad market, it is ultimately the investor or asset owner that determines that investment decision and has that responsibility of underperformance as opposed to the manager that is implementing the smart beta strategy," Ms. Blake said. "That's different than the typical investor-active manager relationship.

"And that's absolutely one of the challenges of smart beta strategies," Ms. Blake said. "The investor or asset owner needs to be comfortable with the decision and the accountability of that decision."

"More frequently now, what we are seeing because of that challenge is investors moving away from … just using single factor types of exposures because of the active risk and the potential for underexposure over certain periods of time. So a lot of our discussions now are about combining certain factors that achieve very broad and good diversification benefits and take out some of these periods of significant underperformance potentially."

SSgA managed $72 billion in what it calls advanced beta strategies, including commodities and real estate investment trusts, as of Dec. 31, according to its latest data.

In his research paper "The Education of Beta: Can Alternative Indices Make Your Portfolio Smarter," released by Callan in June and triggered by the growing popularity of factor-based investing, Mr. Podkaminer points out:

- because smart beta index strategies reweight stocks from the same universe, diversification with standard benchmarks has been very weak;
- even smart beta strategies marketed for low volatility and lower risk give no reason to expect a different weighting construction will "magically result in an overall public equity portfolio which is appreciably less risky"; and
- while smart beta performance has been strong, there is no reason to expect the economic justification for its outperformance to necessarily persist.

In terms of diversification, Mr. Podkaminer said: "A market-cap (weighted) index like, say, the S&P 500 covers large, economically important U.S. companies. You might have a smart beta product (being sold to you) that uses a subset of that universe. But you are just sort of rearranging the stocks and probably have less of them or some (weighting) in a benchmark. Ultimately you are still going to have really high correlation to the cap-weighted index."

Under smart beta construction methodology, "it's a given kind of by design that there is high correlation there," Mr. Podkaminer said. "The point … is that if you are interested in the underlying factors … smart beta products target — things like low volatility, (small) size or value or momentum — there are better ways to access those factors, better investment vehicles than a smart beta strategy."

No matter how equities are allocated, diversification benefits are limited.

"Since all equities are correlated, the best diversification comes from other asset classes, not from alternatively weighted equities, non-market-capitalization weighting," Mr. Jacobs said.

Because "smart beta portfolios concentrate on certain factors, this leaves them susceptible to episodes of poor returns," he said.

Ms. Blake said: "There certainly are periods of time when some of these factors will underperform the broad market. So when we talk to investors about advanced (or smart) beta, we absolutely encourage them to invest over long time horizons in order to be able to harvest the premiums that have existed historically."

"Some of the factors are based on the belief that they truly are risk premiums and other factors are more behavioral based," Ms. Blake said. "And in the case where they are behavioral based then absolutely an investor needs to ask the question: Will these factors persist over time? And an investor does need to get comfortable with the rationale … around those factors. We don't disagree with that whatsoever."

"But it's those same beliefs that drive active management as well," Ms. Blake said.

Whether factors can persist in producing return and risk objectives, Mr. Podkaminer asked, "What is the economic rationale for a particular investment? Looking at low volatility, if markets are even somewhat efficient, why doesn't that go away? If I as a client as an investor can't articulate an economic rationale for that to continue, then I shouldn't hold that strategy."

"Not everybody can invest in low-volatility stock," otherwise the factor won't pay off, Mr. Podkaminer said. "Some (investors) need to invest in high-volatility stocks, or there is an arbitrage opportunity there."