The Intelligence of Smart Beta

BY JULIE NEITZEL

Financial product innovation continues for global investors, and 2017 has been a highly successful year for the continued launch of "smart beta" investment products.

In February 2016, I discussed the explosive growth of passive investing in an article titled "The ETF Phenomena." Smart beta exchange-traded funds straddle active ("alpha" strategies) and passive ("beta" strategies) investment management and enable different risk/return factors and results.

The contemporary investor appetite is voracious as firms such as BlackRock, Franklin Templeton, Goldman Sachs and others rush to market with smart beta investment options. It is estimated that smart beta funds account for nearly $571 billion of the $4 trillion invested in the global ETF market. The first smart beta funds were launched in 2003, although institutional investors have been applying this strategy since the 1970s.

The ETF industry traditionally has been dominated by products based on market capitalization weighted indexes ("beta" products) that are designed to represent the broader market or a particular segment of the market. Smart beta indexes attempt to select stocks that might have better risk-return performance than the overall market by using various fundamental screens and factors such as sales, earnings, book value, dividends, cash flow and stock price volatility to create or improve on the traditional indices. The goal of applying these factors is to design a smart beta product that will outperform "simple beta" market cap weighted funds, such as the S&P 500 ETF.

The merits of including smart beta ETFs in a portfolio include:

• **Efficiency.** It enables investing in thousands of stocks with a particular risk/return profile in a simpler and less-costly manner than using mutual funds and other actively managed funds, which have higher costs and higher probability of underperforming the broader market.

• **Different investment outcomes.** Traditional ETFs ("beta" products) weight the inclusion of stocks based on their market value or by market capitalization. Instead of ranking stocks by market cap, smart beta ETFs construct indexes based on certain traits or factors that include volatility, quality, value, momentum and company size. By applying these factors, outcomes such as reducing risk and/or enhancing returns can result.

• **Investment costs.** Fees for smart beta products are considerably lower than actively managed strategies and mutual funds but typically slightly higher than traditional ETFs.

• **Diversification.** Smart beta ETFs are nimble investments that can provide broader exposure to various sectors but also apply certain factors such as reducing stock price volatility, enhancing stock yields in an efficient manner.

• **Pre-specified risk/return attributes.** Smart beta products create customizable risk/return for portions of a portfolio. For example, smart beta research concludes that constructing an index of lower-volatility stocks actually can outperform the higher-volatility stocks, over certain market periods. Considerable academic research has been conducted since the 1970s by firms such as Barra studying the impact of factors on long-term equity performance. This exhaustive research serves as the analytical rationale for incorporating smart beta strategies into portfolios.

Use a knowledgeable investment advisory team to explore the fit of smart beta strategies into a portfolio. Risk/return attributes need to be understood to set investor expectations, as smart beta investments can underperform during certain market conditions, and not all smart beta strategies will deliver superior investment results. There are currently more than 500 smart beta investment products with new ones being created regularly, requiring careful research and guidance in the selection process. Smart beta solutions might be quite smart for your portfolio, with proper advice and guidance. ◆

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