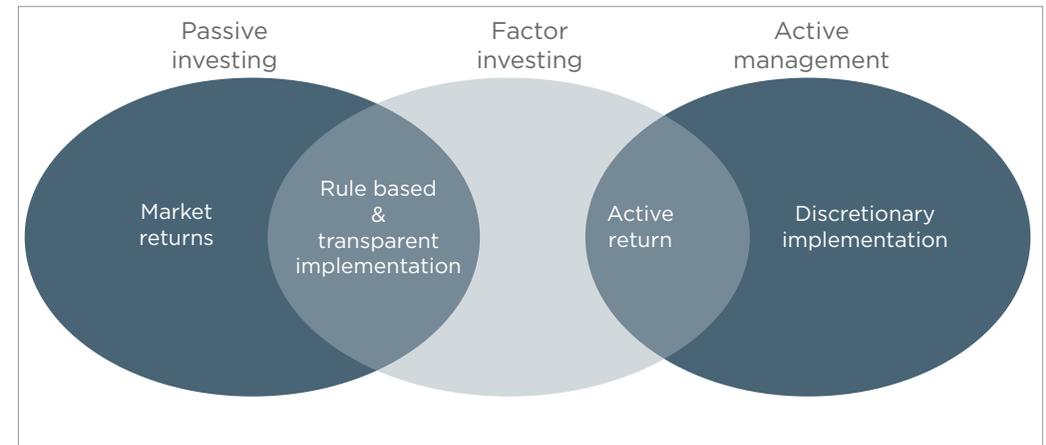


Demystifying Smart Beta

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Source: MeetInvest

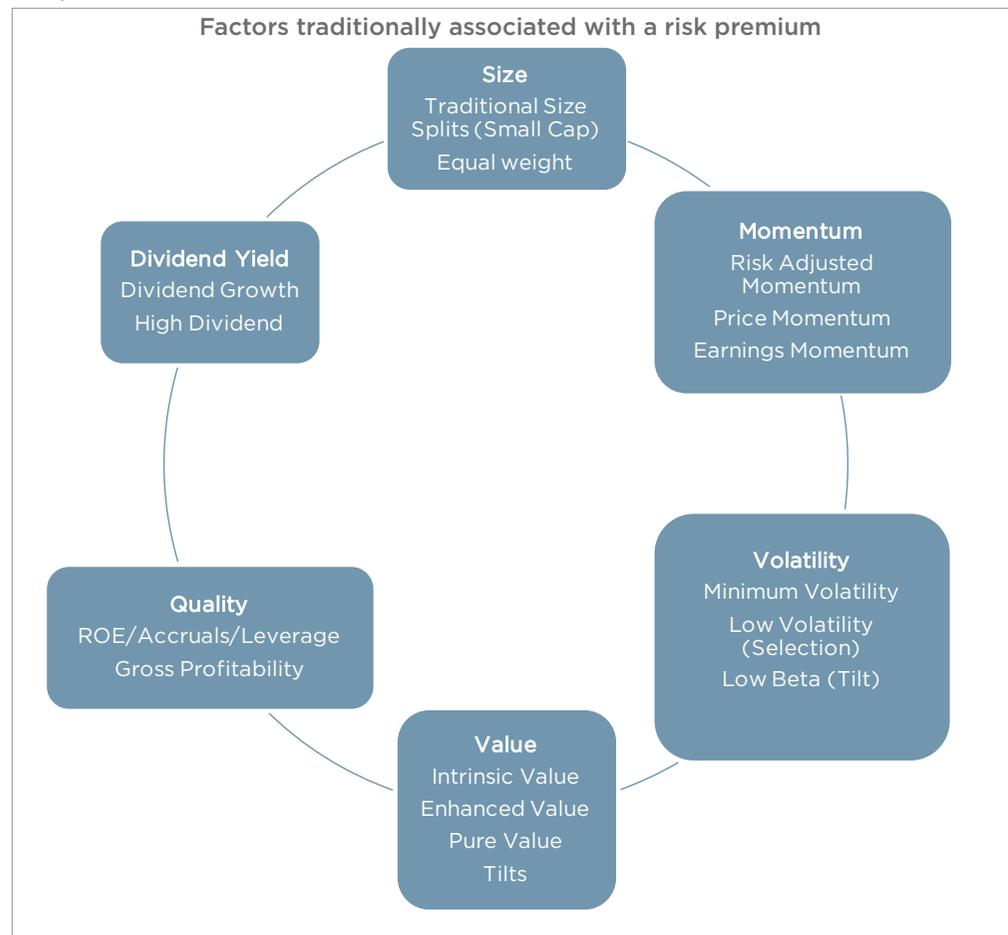
Smart beta has become one of the buzz words in the investment arena during the past 18 months. This article aims to share with investors the evolution of smart beta, the different strategies and how they are used. In addition we will examine the costs, the South African landscape and considerations for investors looking to implement a smart beta strategy into their current investment portfolios.

“SMARTER” THAN A SIMPLE INDEX TRACKER

The first index tracking portfolio was created in 1971 designed to match the NYSE index, while the first index tracking fund in South Africa was listed on the JSE in November 2000. Assets passively tracking an index have grown exponentially both globally and locally as passive portfolios and exchange traded funds (ETFs) continue to attract flows away from active asset managers. The practice, however, has evolved considerably from tracking only market cap-weighted indices, as illustrated in the diagram.

Factor investing, otherwise known as Smart Beta, Strategic Beta, Advanced Beta or Alternate Beta, is the next generation of index trackers. The indices being tracked are constructed using methods and rules other than weighting the constituents by their market capitalisations. When investing in a fund that tracks a market cap-weighted index, the investor takes on the risk of the market and is rewarded by getting the return of the market, less the fee paid to the product provider for tracking the index. Many investors believe that equity returns are driven not only by the overall market factor but by other common risk factors such as value, momentum, volatility, quality and size. These factors have associated risk premia and smart beta rewards investors for being exposed to these specific risk factors rather than total market risk. It allows investors to tilt their portfolios to benefit from the factors that they believe have the highest risk premia associated with them.

The diagram below highlights factors that have traditionally been associated with a risk premium:



Source: S&P Dow Jones Indices

Many of these factors persist because they have a behavioural element attached to them.

DIFFERENT STRATEGIES

In general the different strategies can be grouped into two categories – those that enhance returns and those that reduce risk and increase diversification. The investor choice of strategy (or strategies) depends on their investment objective. The below table classifies the various strategies into the two categories:

Strategy motivation	Strategies					Desired Outcome
Risk Driven	Low Volatility	Minimum Variance	Maximum Diversification	Equal Risk Contribution	Equal Weight	Volatility Reduction Diversification
Return Driven	Fundamental Index	Intrinsic Value Index	High Dividend Yield	Momentum Index	Quality Index	Enhanced Return Factor Exposures

Source: S&P Dow Jones Indices LLC

In this section we will examine a few of the more popular strategies in more detail. Equally weighted index

All the constituents of this index are given the same weight. Compared to a market cap-weighted index, the equal-weight methodology gives larger weights to smaller capitalisation stocks and smaller weights to larger capitalisation stocks. The equal weights are not affected by price changes, price levels, or any other measure of company size. A major benefit of equal weighting is that it avoids the top-heavy concentration that is a common problem with many cap-weighted indices, where the largest few stocks can at times dominate the performance of the whole index. For example, in South Africa the top five stocks in the FTSE/JSE All Share Index accounted for 39% of the index as at 31 December 2014 but has been as high as 50% in June 2008. By construction, an index weighted by market capitalisation will inevitably overweight stocks that have been increasing in value and underweight cheaper ones.

Having large weights on small capitalisation stocks raises a capacity issue. The index could potentially take a major position within a particular small cap stock, moving the price against the index as the stock trades and poses a liquidity risk. A liquidity screen is usually applied prior to the construction of the index to remove stocks that might create that risk. Research has shown that such a screen has no meaningful impact on returns.

LOW VOLATILITY INDEX

Low-volatility indices emphasise stocks that have exhibited a more stable return pattern over time i.e. they have experienced fewer large deviations in price. The concept is based on empirical evidence that suggests stocks with lower volatility offer stronger, more consistent performance. Constituents are weighted on the inverse of their volatility with the least volatile stocks receiving the highest weighting. This can be described as a conservative equity strategy and is often blended with an existing core equity holding to reduce the overall volatility of the equity portion of a portfolio.

A variation of this is to weight the constituents to ensure they all have an equal risk contribution.

MOMENTUM INDEX

Momentum strategies increase weightings to stocks that have performed well over a recent period. It is based on the premise that “what goes up continues to go up.” In behavioural finance it can be explained by the band-wagon effect. The momentum index is considered to be an aggressive strategy. The S&P Momentum SA index takes it one step further by risk adjusting the momentum factor using the historical volatility of the stock. Risk adjusted momentum stocks have better drawdown characteristics. A liquidity filter does not need to be applied as momentum stocks are typically already highly liquid. The index is rebalanced semi-annually. This strategy tends to be used more tactically in a portfolio. This smart beta momentum strategy does poorly during down markets.

FUNDAMENTAL STRATEGIES

These indices look at fundamental factors of stocks that a traditional active manager, who follows a fundamental, bottom up approach, would also consider. An example of a fundamental index is the FTSE/JSE RAFI 40 Index. It is designed to reflect the performance of the top 40 companies by fundamental values from the universe of the ALSI. The four fundamental factors used to rank and weight the constituents are sales, cash flow, book value and dividends.

VALUE INDEX

The value investment style is one of the most popular styles pursued by investors globally. Extensive empirical research supports the existence of the value risk premium. These indices take advantage of mispricing in the market by rebalancing towards stocks that are priced at a large discount. An example is the Russell High Efficiency Value Index (HEVI) which uses the book-to-price ratio and the earnings-to-price ratio of a stock to create a value score. This score is then used to weight the constituents of the index

DIVIDEND INDEX

The theory behind the creation of this index is that companies who can grow or maintain dividends are well managed. It indicates that a company is able to consistently increase earnings over time and is disciplined about paying out a portion of earnings to investors despite the stage in the business cycle or short-term market performance. This signals that company management is focused on growth of the firm and effective use of capital. Below are two examples of indices that focus on dividends as a factor. The S&P South Africa Dividends Aristocrats Index looks at companies that have increased or maintained stable dividends for at least five consecutive years. No ranking measures are applied with all constituents being equally weighted. This practise reduces sector concentration risk and stock specific risk. This index excludes property stocks and there are currently 27 companies in this index.

The FTSE/JSE Dividend Plus index is constructed by weighting the one-year forecast dividend yield. This index is based on forward looking metrics as opposed to the

previous example that looks at historical dividends. This index has 30 constituents and is rebalanced semi-annually.

QUALITY INDEX

Admittedly there is an element of subjectivity in deciding which factors or characteristics to look at when defining quality. S&P use a combination of a company's profitability, earnings quality and financial robustness as a proxy for the quality factor. The measure used to evaluate a company's profitability is the Return-on-equity (ROE) ratio. The Balance sheet accruals ratio is used to assess the reliability of financial information and hence the quality of the earnings being reported. Lastly, the Financial leverage ratio is used to gauge the financial health and sustainability of a company. A liquidity filter is applied and the index is rebalanced semi-annually. There is a 10% cap to each share and there is a minimum of 15 stocks that should be in the index at any given time. The strategy protects well during draw downs and continues to produce robust returns in a slowing economy. The metrics used in this index do not measure the valuation of the stock therefore this index could be combined with a value index.

MULTI-FACTOR STRATEGIES

Multi-factor strategies seek to address multiple factors simultaneously. The factors that are chosen are often complementary in the sense that they capture different risk premia which are not highly correlated. As an example the S&P GIVI index combines an intrinsic value weighting with a low volatility strategy. The first step in calculating this index is to exclude the top 30% of market-cap of the most volatile stocks. The remaining stocks are then weighted by a measure of their intrinsic value, which is derived from the stock's book value and discounted projected earnings. The index is rebalanced semi-annually where very volatile stocks are removed and intrinsic values are updated.

PERFORMANCE

The performance of the various strategies can differ to a great extent, depending on which factors have been rewarded by the market. For example, in 2013 there was almost a 25% difference in performance between the best performing strategy, momentum, and the worst performing strategy, quality. In 2014, however, the difference was much lower at 7%, with the equally weighted strategy being the worst performer and the dividend and quality strategies being the best performers.

HOW IS SMART BETA USED

Smart beta has been seen to work with active management to enhance returns or reduce risk. In a survey compiled by State Street Global Advisors, the results of which they released in 2014 in a report titled “Advanced Beta Comes of Age,” 42% of the 300 institutional investors surveyed made a clear commitment to allocate part of their portfolios to smart beta, while a further 24% expressed interest in doing so in the near future.

Smart beta strategies are often used to control portfolio exposure by limiting unintended portfolio bets or to tilt the portfolio to factors that the investor believes have higher risk premia, which are not being captured to the magnitude they desire in their current actively managed portfolio.

Not all factors outperform the market index in all environments. Sometimes it is beneficial to blend different strategies with various factors that have a low correlation to each other, to create some diversification and low volatility outcomes.

SMART BETA ACROSS THE ASSET CLASSES

Smart beta strategies are typically found in the equity, commodity and fixed income space. They are, however, starting to extend their reach to listed property, infrastructure, foreign exchange carry and emerging market currencies.

The sources of risk premia in the various equity strategies have been described above. In commodities the systematic risk factors include the forward curve, value and momentum. In the fixed income space, the development of smart beta strategies is still in the initial stages. The development in the international bond space has focused mainly on fundamental-based indices that overweight sovereign issuers who have better fiscal health and corporate issuers with lower credit risk. This is the opposite of traditional capitalisation weighted bond indices which assign the highest weights to the most indebted issuers.

COSTS

Smart beta strategies passively follow an index designed to take advantage of perceived systematic biases (factors) in the market. It therefore costs less than active management, since there is less day-to-day decision-making for the manager, but since it will, at the very least, have higher trading costs than traditional passive management (which minimises those costs), it is a pricier option. Hence, the cost of smart beta strategies falls somewhere in between the cost of pure passive investing and active fund management. The strategies are often used in conjunction with traditional active management mandates, thus bringing down the cost for the entire portfolio being considered.

THE SOUTH AFRICAN SMART BETA LANDSCAPE

To date no surveys have been conducted in the SA market, making it difficult to know the exact assets under management invested in these strategies. Estimates vary from R5 billion to R10 billion. The three big index providers each calculate a suite of smart beta indices, namely S&P, MSCI and FTSE. Customised indices are also possible. There are a number of product providers that manage funds that track a selection of the indices available. These include Satrix (Sanlam), Old Mutual Global Index Trackers (OMGxT), Grindrod, ABSA Capital and African Alliance.

CONSIDERATIONS FOR INVESTORS

There are many active decisions to be made when deciding on a smart beta investment. The first choice depends on the investor's objective of reducing risk or enhancing return or both. The factors that will best assist the investor in achieving this must then be selected. Next, one should examine the universe of available indices, including the indices with multiple factors, to find the strategy that will best match what the investor is trying to achieve. Thereafter a product provider must be chosen. A due diligence on the product provider's process should be conducted as well as examining the track record. The size of the investment will help determine the vehicle chosen. For large institutional allocations segregated mandates will be possible. Alternatively many ETFs are available for smaller allocations which may be used to implement the strategy.

Customised indices are also offered with the index providers and product providers working together to design a bespoke solution to fulfill specific investor needs. Fees are another factor that investors should consider.

Lastly, each strategy will not outperform in all market environments. This is critical to understand especially if the smart beta portfolio is part of a portfolio that is benchmarked against a traditional market cap-weighted index like the FTSE/JSE Shareholder Weighted Index (SWIX) or the FTSE/JSE All Share Index (ALSI).

The factors used in smart beta strategies usually deliver their risk premia over the long term, but in the short term they can be volatile. It is therefore important to have the right investment time frame when choosing and evaluating a smart beta strategy.

CLOSING COMMENTS

Investors are now increasingly faced with a wider range of investment strategies to choose from, rather than simply having to decide between active and passive management. Smart beta funds attempt to capture excess return in a systematic - or rules based - way. Smart beta adds to the investor's tool box allowing them to fine tune their exposure while managing investment costs. It is, however, important to bear in mind that the strategies can be very different resulting in varying return outcomes, hence it is imperative to choose the strategy or strategies wisely.

References:

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