IFAs wary of more choice in smart beta

**SPECIAL FEATURE** Smart beta

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There has been a glut of so-called smart beta investment products coming to market in recent years. This brings more choice to investors when selecting a passive portfolio construction and fund manager style. Advisers are cautious about smart beta, though, and uptake has been limited.

Smart beta strategies are added-value trackers, using, for example, weightings tilted towards value, small cap, low volatility or momentum.

For example, a fund could take the S&P 500 index but overweight stocks with lower volatility to create a new, ‘smart’ index. Smart beta strategies have the potential to outperform the original benchmark index, or smooth returns.

Dan Kemp, a partner at investment consultancy Alrebarie Street researchers, says: ‘Smart beta is an understandable reaction to the dearth of alpha that has accompanied the post-crisis recovery. As investors lose confidence in active management, smart beta products emerged to bridge the gap between simple tracker funds and high-cost active management.’

Market capitalisation investment strategies favoured by traditional trackers have underperformed those that use an alternative weighting, such as one focused on companies’ sales, a study by Cass Business School researchers in April shows.

They analysed monthly US share data from 1968 to 2011 and found all 13 alternative indices studied produced better risk-adjusted returns than passive exposure to a market capitalisation-weighted index. Of the alternative indices, the company sales-weighted index performed the best, beating 99% of randomly constructed indices.

**Enhanced passive strategies**

A growing number of institutional investors are turning to enhanced passive strategies to outperform the index while keeping costs down. More than 40% of investors have already adopted alternative-weighting schemes, according to an EDHEC-Risk Institute survey of investors in Europe and North America.

At least $20 billion of pension fund assets tracked by consultancy Towers Watson is already invested in smart beta strategies.

Some advisers are still not convinced though. Doug Brodie, managing director of London-based Master Adviser, says: ‘These funds are so new you’ll struggle to find any advisers who have selected them. We certainly haven’t, not least because we don’t have access to relevant information for our analyst to research.

‘And if this is “smart” beta, what kind of beta is the other stuff? Dumb beta? Isn’t this what they’re supposed to be doing anyway? I thought we paid fund managers to be smart.’

**Pros and cons**

The pros of a smart beta strategy are potential outperformance of the benchmark index, but to achieve this they risk underperformance.

‘Smart beta strategies are investments solutions that allow investors to access the various long-term true risk premia of the market, profile their risk exposures and diversify away their risks,’ says Fahd Rachidy, senior business development executive at ERI Scientific Beta, the EDHEC-Risk Institute’s recently launched smart beta venture.

Determining all the risks involved, however, can be difficult. The construction of smart beta funds often means they are tilted towards certain risk factors and these are not always evident. For example, high-yield funds are vulnerable to dividend cuts and interest rate changes.

‘Smart beta investments [carry] risks associated with their design (specific risk or model risk) and risk of underperformance as different betas will perform differently in different market conditions (systematic risks). Smart beta solutions should be transparent and clearly state risk exposures,’ says Rachidy.

**Risk control**

EDHEC-Risk Institute has developed a new approach to beta investing, dubbed ‘smart beta 2.0’, which allows investors, both institutional and retail via IFAs, to choose and control the risk of benchmarks on its new platform.

The first generation of these indices, or ‘smart beta 1.0’, benefits from a rules-based approach and low implementation costs, and aims at outperforming cap-weighted indices over the long term,’ says Rachidy.

‘However, smart beta 1.0 indices providers impose the choice of systematic and specific risks upon the investor. Investors should be free to choose the risks to which they wish, or do not wish, to be exposed. The smart beta 2.0 approach aims to control the risks of smart beta investing.’

It is based on three key ingredients:

- Measuring and controlling systematic risks (using two complementary methods: stock selection and implementation of constraints), measuring and controlling the specific risk, and managing tracking error risk.
- Investors can access 2,442 customised indices on the Scientific Beta platform, and there are plans to increase this number to 6,000 in 18 months’ time.
- Counting costs

The cost of accessing smart beta strategies tends to be lower compared with active asset managers’ fees. However, they can prove expensive compared with market cap-weighted passive funds.

Andrew Whiteley, a partner at Assetfirst, a fee-based model portfolio provider, says: ‘These funds tend to be more expensive than traditional index-tracking funds as they rely on some additional intellectual property. This means outperformance must overcome this higher charge.

‘The recent minimum volatility offerings from iShares are not seeking outperformance of the index, but instead looking to dampen volatility. These funds are actually cheaper than the commensurate traditional exchange traded fund, so could offer a genuine advantage to risk-averse investors or for drawdown investors taking regular withdrawals from their portfolios.’

Kemp says another potential drawback is the lack of availability of some strategies on platforms.
Smart beta competes to receive core place in portfolio construction

Passive-plus strategies are no longer a fringe activity for some advisers, but they say that the jury is out on newer strategies such as low variance tracking

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The smart beta universe is diverse and while some strategies have a long and successful track record, others have been met with limited investor interest.

M.J. Lytle, chief development officer at Source, the exchange traded fund (ETF) provider, says: ‘A handful of products represent a significant portion of the assets [in smart beta]. There is a yawning gap between strategies that have struck a chord and those that have not.’

Sam Adams, head of financial adviser services in Europe, the Middle East and Africa for Dimensional Fund Advisors (DFA), says: ‘The phrase smart beta is gaining popularity because people are beginning to realise that you can think of investment management in more ways than just the binary concepts of active and passive. Our strategies capture dimensions of higher-expected return without giving gains away to high fees.’

Portfolio tilts

DFA’s investment philosophy is rooted in academic research, which shows that small and value companies have historically outperformed the main market over the longer term, albeit with added risk. So Dimensional tilts its portfolios towards these stocks. It also offers fixed-income funds, with targeted exposure to the appropriate term and credit risks.

Adams says: ‘This is not a fringe activity for the advisers we work with; many use our strategies as the core part of their model portfolios.’

Adviser firms that buy into this ‘focused tracking’ approach include Evolve Financial Planning; Yellowtail Financial Planning; Prospetto Financial Planning; Wealth Matters; Donald Asset Management; and Finance for Life.

Bob Bassi, co-founder of Finance for Life, says: ‘Dimensional provides the range of passive funds we need through highly active scientific trading strategies that combine the best of both disciplines.

‘Dimensional applies a number of filters in the construction of its funds, such as pricing and trading concerns, to exclude stocks that have the potential for a negative impact and arrive at an optimal number of stocks for each fund.’

Evolve blends Dimensional funds with main market index funds from Vanguard to reduce the risk of tracking error.

Managing director Antony Williams says: ‘DFA funds provide access to market segments that are higher risk/return, but at a cost far lower than active managers. Costs are slightly higher than pure index funds, but not dramatically so.

‘Smart beta solutions, by their nature, deliver performance which varies from main market indices. This creates a risk of disappointing performance. It’s essential to train clients to expect these variations.’

Fundamentally weighted styles

John Feyerer III, head of product strategy and research at smart beta fund provider Invesco PowerShares, says: ‘For example, Ossiam, a specialist smart beta provider, offers the ETF FTSE Minimum Variance. Since it launched in December 2011, it has outperformed the FTSE 100 by more than 5%.’

Low-cost active funds

Williams believes some fund managers are using the term smart beta to counter the loss of business to other funds.

Andrew Whiteley, partner at AssetFirst, agrees, branding recent attempts by fund managers Schroders and JP Morgan to enter the smart beta arena as ‘a cynical attempt to stem the outflows from some of their active funds to index fund providers.’

Both entered the market in early 2011 with the launch of low-cost active or ‘passive plus’ funds. JPM UK Active Index Plus was originally launched in June 1997 as the JPM UK Active 350 fund and was renamed on 1 February 2011, with a significantly reduced annual management charge. Meanwhile, Schroders UK Core fund, the first in a series of three low-cost UK equity fund launched in the first half of 2011, targets smaller outperformance of the index than its mainstream active fund.

A spokeswoman for Schroders says: ‘We launched our low-cost fund range with a longer-term view in mind. As the funds become available on more platforms, demand is picking up.’

JP Morgan declined to comment. Whiteley says: ‘Institutional investors are making use of [new] smart beta products, but uptake in the retail sector has been muted.’

Low variance

Low-variance funds, which aim to give investors exposure to main markets but with lower volatility, have received greater attention in recent months amid robust performance.

For example, Ossiam, a specialist smart beta provider, offers the ETF FTSE 100 Minimum Variance. Since it launched in December 2011, it has outperformed the FTSE 100 by more than 5%.

This outperformance, though, is not expected to continue: in theory, such funds should give lower performance than the index, with lower volatility.

Some advisers express concern that investors might assume that low variance equals low risk and pointed to their substantially lower diversification: the iShares S&P 500 Minimum Volatility fund holds fewer than 200 stocks.

Whiteley says: ‘I can see a place for minimum volatility funds if they can be made to work. History is littered with examples of funds that purported to have found the holy grail of high growth with low volatility but failed miserably: the jury is out.’