GLOBAL FOCUS CAPITAL LLC
INSIGHT THAT MATTERS

Is Loving My Smart Beta All That Wrong?

Investors are madly in love with "smart" beta strategies and asset managers offering such products have been shown the love. It was almost inevitable that as active management has gotten a bad rap investors would flock to the next great thing. Just like in the comedy "If Loving You is Wrong" by Tyler Perry there is the potential for significant turbulence ahead when falling head over heels in love with these "smart" beta strategies.

But before we become all judgmental, what is "smart" beta?

I think that there are as many versions and interpretations as colors in a rainbow. If there is one thing you can always count on it is the creativity of marketers in creating a buzz about a concept old in origin but in need of a fresh coat of paint. What I am referring to is plain old "factor" investing as practiced by quantitative portfolio managers over the last half a century. [1]

Now one thing that quantitative investors are not known for is an abundance of marketing pizzazz and loud proclamations of having found the next great thing in investing. Rather the process of quantitative investing generally tends to slowly digest lots of academic research and then quietly "borrow" ideas deemed worthy of implementation and palatable for broad investor consumption.

Factor investing has been a staple of investment approaches for decades starting with the focus on inexpensive stocks (referred to as the valuation factor) as well as a tilt toward lower capitalization equities (the size factor). Other typical factors almost always part of quantitative approaches are momentum and quality.

Some of these concepts are a bit fuzzy to define, but, in general, the investment world seems to have settled on an extension of the three factor model of Nobel Prize winner Eugene Fama and Ken French[2] with the addition of a momentum factor suggested by Mark Carhart[3] – the market (plain old beta), value, size and momentum. Index provider MSCI (www.msci.com) also adds low volatility, high quality and high yield as legitimate equity factors.

"Smart" beta strategies play on these academic findings and there is nothing wrong in principle with falling in love with these strategies. The idea behind emphasizing these equity factors is simple. These are all stock characteristics that when found in above average amounts in a portfolio are expected to translate into higher

[1] In this note the focus will be on the more commonly used versions of "smart" beta based on specific single factors of return. In a subsequent note we will explore another form of "smart" investing related directly to the weighting scheme of the portfolio.

[2] Fama, E. F.; French, K. R. (1992). "The Cross-Section of Expected Stock Returns". *The Journal of Finance* **47** (2): 427. doi:10.1111/j.1540-6261.1992.tb04398.x. JSTOR 2329112

[3] Carhart, M. M. (1997). "On Persistence in Mutual Fund Performance". *The Journal of Finance* **52**: 57–82. doi:10.1111/j.1540-6261.1997.tb03808.x. JSTOR 2329556

returns. Buying inexpensive stocks will, for example, have a higher probability of superior returns down the road.

While academics will heatedly debate until dawn which of these factors are really legit and which are bogus or transitory, savvy investors will universally agree on one thing – that is, that none of these factors will result in superior performance at all times and in all market environments. Indeed, the search for the Holy Grail of investing continues unabated to this day!

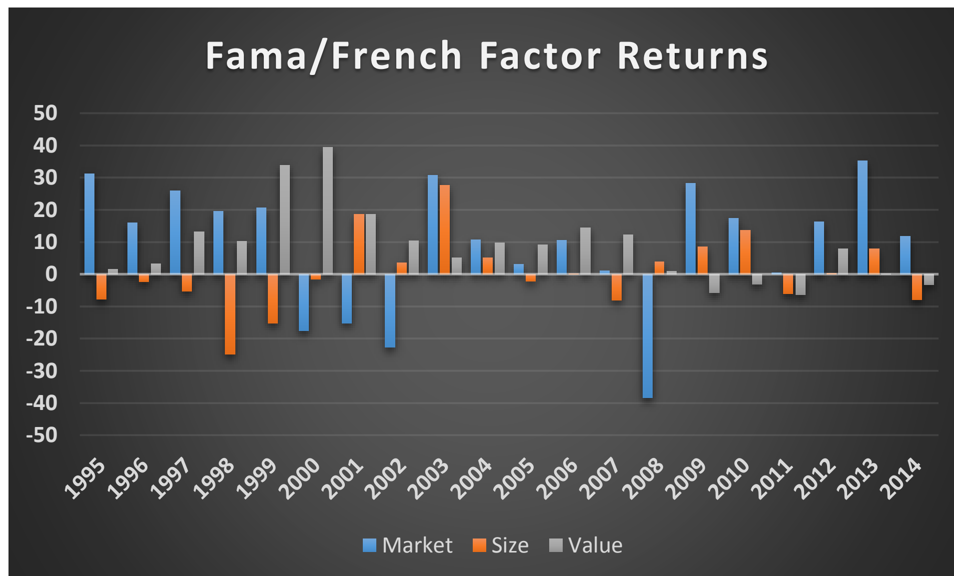
In fact, this is why most investment approaches emphasize various combinations of several of these factors. As most people know, relying on one factor only, as well researched as it may be, frequently results in painful periods of under-performance. Most investors simply can't stomach the drawdowns. Think back, for example, to the fate of value and small cap stocks in the late 1990's as the TMT bubble was at its peak. All the above mentioned factors show up well in back-tests performed over long-periods of time, but none of the single factor strategies is immune to drawdowns sometimes extending over long periods of time.

So, that leads me to the next question which is, how do I know whether falling in love with "smart" beta will be a good decision?

The answer, as all know from experience, is that there is no free lunch either in love or investing. Every single strategy suffers at times from disappointing returns even though over long holding periods the performance may prove to be market beating.

The conceptual rationale for owning these "smart" beta strategies is rooted in solid academic research, but nobody guaranteed an uninterrupted path to wealth, did they? Take a look at the Fama-French annual factor returns (the market, capitalization and value) for US stocks.

Figure 1



Source: http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html

Clearly, none of these three factors works in every single year. There are several periods of significantly negative returns. Being plain old "dumb" would have worked better in those years, but over longer holding periods being "smart" would still have worked better.

If nothing works all the time, what realistic options do we have?

Well, the investor considering investing in "smart" beta strategies either has to have a crystal ball and forecast when the specific factor underlying the strategy will out-perform, or be willing to buy into the long-term prospects of superior returns and accept interim results that may be disappointing.

Timing the performance of the typical set of factors used in "smart" beta strategies is not easy even for professionals. While factors tend to exhibit performance tendencies especially in relation to the business cycle and the balance of fear and greed among capital market participants the ability to time when these "smart" beta strategies will outperform the broad equity market will disappoint most investors. Being "right" 60 percent of the time is deemed outstanding by professionals, but I doubt that most investors would be amused after a long sequence of strike outs.

A more realistic option for investors is to extend their time horizons when buying into the "smart" beta concept, but given human nature this requires significant mental fortitude. Unfortunately, while we would all like to believe that we are in it for the long-term, we are by nature inquisitive and we take peeks at our investment accounts from time to time. We may even check in daily just to make sure that everything is on course! Some may even see a resemblance to the process of falling in love!

If you are lacking a crystal ball and you know that periods of under-performance make you nervous and question your decision-making the solution may be a variant of "smart" beta. Instead of focusing on one or two "smart" factors why not play it a bit safer and buy into a "smart" portfolio instead?

What do I mean by a "smart" portfolio?

Simply put such a portfolio emphasizes several of these "smart" factors all at once. In a sense it is a package of "smart" strategies bundled in one. For example, the portfolio could emphasize inexpensive, high growth, low capitalization stocks with superior price momentum. I know this sounds like a mouthful, but to come back full circle these "smart" portfolios are exactly what quantitative professionals have been offering over the last few decades. The difference is that in recent times marketing people have applied a fresh coat of paint and some pizzazz to a tried and tested approach.

The key idea is that by having a portfolio of "smart" factor exposures with a high probability of long-term success we can trade off "smart" betas that are working as expected against those with current disappointing performance. As an example value strategies are frequently negatively correlated with the performance of momentum strategies. Both value and momentum approaches exhibit superior long-term performance, but that performance occurs at different points in time. Mixing the two approaches has historically resulted in a smoother path to out-performance.

Not that a portfolio of "smart" factor exposures is a panacea for all ills or that under-performance may not occur (for example if all "smart" factors stop working at once), but if you are looking for exposure to "smart" beta why not do it in a more certain way and not rely on timing factors or having to hold forever?

Where does all of this leave us?

Too many of the "smart" beta strategies sold to investors are positioned as something akin to the Holy Grail allowing investors to go on cruise control. But just like it is not advisable to drive in cruise control through road construction areas as we are bound to hit potholes, investors facing ever-changing capital market conditions are advised to refrain from thinking that there is a magical "smart" factor just waiting to be plucked.

"Smart" factors do exist as academic research has shown, but we can never be sure which one of these factors will work at any given point in time and we are therefore better off diversifying our exposure to several of these time-tested concepts. Buying the package of "smart" beta exposures may lead toward longer lasting love.

Investors are also reminded that the overwhelming risk permeating all of the "smart" beta strategies whether packaged as a single factor or a portfolio of factor exposures is what happens to the overall equity market. All equity strategies whether smart or dumb are highly correlated with each other. An equity is an equity is an equity is an appropriate way to think of the pre-eminent role played by the overall market itself. In a bull market all boats will rise with the tide and in a bear market "smart" beta investors will still feel significant pain.

Nothing substitutes for properly aligning your portfolio asset allocation with your goals and ability to withstand periods of stress.

At Global Focus Capital our bottom-up stock selection and top-down regional/sector methodologies are all rooted in the academic concepts imbedded in "smart" beta but we prefer to love these concepts in moderation and as part of an overall package.

This note has been focused on the conceptual nature of "smart" beta investing and its roots in academic research. A key message has been a preference for investment approaches mixing several of these "smart" factors together rather than putting all your eggs into one "smart" beta basket. A subsequent note will address the specifics of popular "smart" beta strategies highlighting some of the "unintended" exposures that these products typically possess and the welcome emergence of strategies incorporating a package of "smart" beta strategies.

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