How Smart is Smart Beta?

Exploring the Evolution of Smart Beta

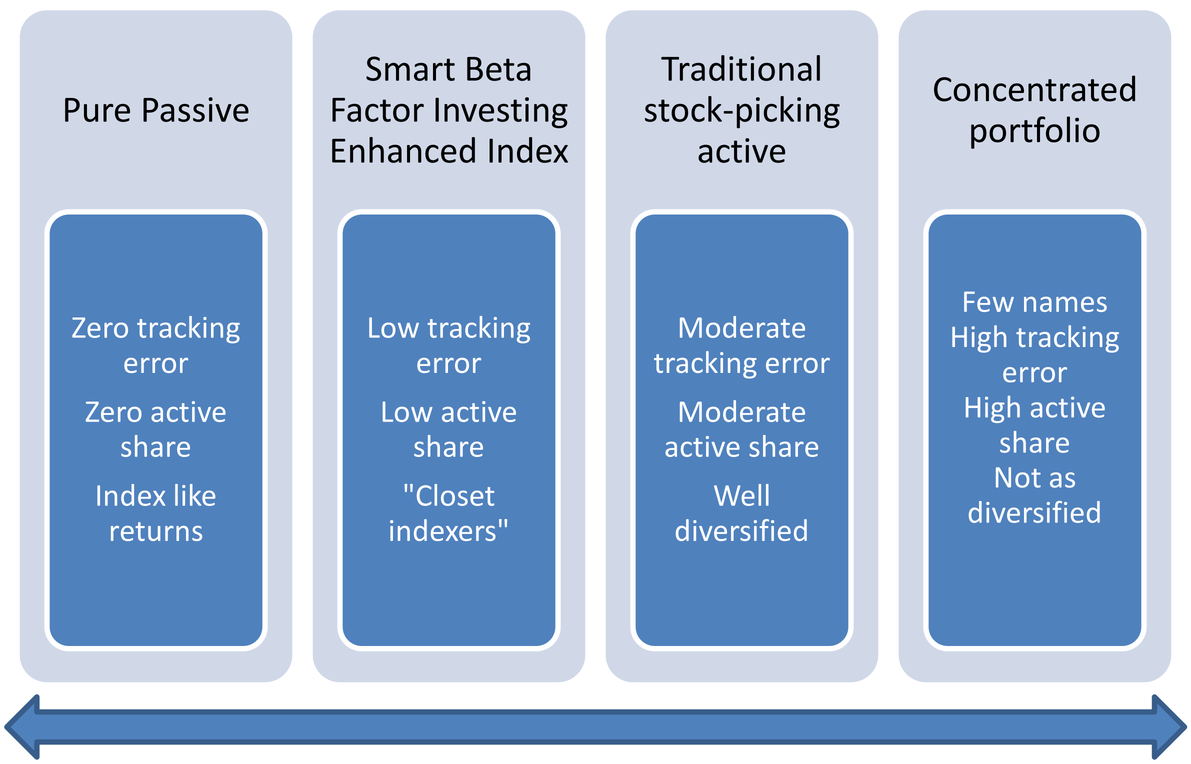
Marc Odo, CFA®, CAIA®, CIPM®, CFP® | November 2, 2017 | Swan Blog

Is Smart Beta the Best of Both Worlds?

In a recent blog post, we made the argument that debate between passive and active management is irrelevant. By focusing on small differences in relative performance, investors risk losing the forest for the trees. Both passive and active managers are heavily exposed to market risk. Also known as systematic risk, market risk is the biggest risk an investor faces.

But what about “smart beta” or “factor investing”? These managers often present themselves as a third way, combining some active bets with inexpensive, passive investing. Smart beta managers claim to be the best-of-both-worlds.

We at Swan Global Investments reject this line of thinking. In our view, smart beta or factor-based investors occupy a spot on the same continuum and are every bit as exposed to market risk as traditional active and passive managers. If markets sell off by 30%, 40%, 50% or more during a bear market, all managers on the spectrum will be exposed.



History and Evolution of Smart Beta

To understand smart beta and factor investing, it is useful to understand its history and evolution. Half a century ago, people started using the Capital Asset Pricing Model (CAPM) to explain how sensitive an individual investment was to movements in the market. The CAPM was the original factor model, and there was only one factor: the market.

Variations on the Same Theme

Over the following decades, refinements were made to the original CAPM model to capture and quantify additional variables. Eugene Fama and Kenneth French determined that small cap stocks and stocks with a value tilt tended to outperform over time. Fama and French added both these factors to the original CAPM.

Dimensional Fund Advisors built their highly successful fund family upon these theories. Instead of paying active managers hefty salaries to research companies and assemble portfolios, DFA instead simply assigned “value” and “small” scores to stocks, sorted them from highest to lowest, and built their portfolios around those biases.

Once the concept of factor-based investing and cheap computing power became widely available 20 years ago, the floodgates opened. There was a surge in quantitative money managers, many using Barr Rosenberg’s Barra Risk Factor Analysis platform to construct portfolios. A whole new breed of “quants” spent their days trying to identify new explanatory factors or design optimization algorithms.

Smart Beta: All that Different?

This idea of factor-based investing eventually merged with the nascent exchange traded fund industry to coalesce into the “smart beta” movement. The basic thesis behind smart beta is that indices based solely upon market capitalization are lacking. The idea is systematic biases exist that would generate excess relative returns if these factors were over- or under-weighted relative to the cap-weighted market.

Every deviation from the original Capital Asset Pricing Model is some variation on this basic premise. Fama-French, BARRA, factor analysis, smart beta…it’s all variations on the same theme.

All Way Stations on the Same Road

The main objection Swan Global Investments has with all these strategies is that systematic risk remains unaddressed. In all of the CAPM-based models, the biggest factor is always simple market risk. Market risk represents absolute risk: the risk of catastrophic loss, the risk of running out of money.

Of the 787 large cap mutual funds analyzed, 746 had R-squareds of greater than 80% to the S&P 500. This means that for almost 95% of the large cap funds studied, over 80% of their return patterns could be explained by movements in the S&P 500. Over two-thirds of the funds had R-squareds greater than 90%.

Clearly, the market is the primary driver of returns for most large cap funds, regardless if they are passive, smart beta, or active.

In the white paper “Losing the Forest for the Trees,” we explore these topics in-depth.

About the Author:

Marc Odo, CFA®, CAIA®, CIPM®, CFP®, Director of Investment Solutions, is responsible for helping clients and prospects gain a detailed understanding of Swan's Defined Risk Strategy, including how it fits into an overall investment strategy. Formerly, Marc was the Director of Research for 11 years at Zephyr Associates.