Evolution of Smart Beta

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Agenda

• The origins of smart beta
• The emergence of smart beta
• Key challenges in smart beta
• Smart beta and risk premia
• What is a “good” smart beta index
• Product
• Pricing
• Process and People
• Summary
The origins of smart beta

- Historical choices for Equity investors – 1970-1990
  - Traditional active managers
  - Emergence of passive investing strategy
- Evolution of financial theory 1990-2005
  - 1990s: Explaining the market return using factors: Fama-French-Carhart four factor model
  - Predominantly theoretical
  - Basis of some traditional active quant strategies
- 2005-2015
  - Popularisation of index based ETFs
  - Significant price competition in passive products
  - Financial crisis, disappointing returns from active management
  - Regulatory pressures on transparency and fees
  - Pressure from investors for products that deliver active returns at passive costs
  - Morningstar survey – 95% of new active flows into low cost funds
The emergence of smart beta

- Smart Beta as a “passive” index
  - Investors were long aware of risk premia factors but they were only sold in “active” products
  - By making these ideas transparent and investible a new product is created
  - Choosing active managers requires framework, understanding, due diligence
  - Choosing passive managers is a much easier decision to make

- New product was a winner in everybody’s eyes
  - Consultants: new products to advise on. Passive, yet different
  - Investors: cheap access to “outperformance” of market capitalisation indices
  - Smart beta providers: provide the intellectual capital and outsource the management and risks
  - Index vendors: plethora of new indices
  - Asset managers: new business
The emergence of smart beta

• Early adopters begin to invest in smart beta products

• Large number of smart beta strategies appear
  – Equally weighted
  – Fundamental indices
  – Low volatility
  – Other…..(GDP weighted, Sales weighted etc..)

• Investors liked the simplicity, transparency and cost

• Discussion gradually moves to multifactor smart beta
Key challenges in smart beta strategies

- Investors become confused over complexity
- Proliferation of smart beta strategies (over 400 funds)
- No single definition, level of transparency or construction
- Finite number of risk premia factors
- Infinite smart beta products. How can this be?
Smart beta and risk premia factors

- Smart beta has no “alpha” skill
  - Any excess return can only be gained via exposure to risk premia factors
  - 5 recognised risk premia equity factors which reward investors for additional systematic risk taken
  - Various smart beta products have exposures to some of these factors
    - Monkey’s darts (size)
    - Equally weighted (size)
    - Min Volatility (low volatility)
    - Others could have multiple exposures
  - The more positive exposures the better the risk adjusted returns
  - Difficult to achieve and control in a single product

Source: Aberdeen, Factset. Simulated performance
What is a “good” smart beta index?

- What determines which one is the “best”?

- What if you have 4-5 different types of min vol?
  - Performance?
  - Risk adjusted return?
  - Clarity of message?
  - Transparency?
Product

• Learn lessons from passive investors
  – 1. Investible,
  – 2. Complete,
  – 3. clear, published rules and open governance structure,
  – 4. Accurate,
  – 5. Accepted by investors,
  – 6. low turnover and related transaction costs.

• Clarity about risk premia exposures
  – Sources of excess return
  – Sources of risk
• Is Smart Beta a threat to active management?

• Exposure to smart beta is not the issue. The price you pay for it is

• Rethink of fee levels

• Clearly quantify what you are paying for

Pricing

Index +2%
Active equity fund pricing

Passive
(10bps to gain access to market beta)

Active Returns
(weighted average fee)

Smart Beta
(15bps for efficient access to risk premia)

Alpha
(50bps)
• Naturally the industry would become more transparent

• Potentially the products would move to
  – Single factor building blocks
  – Multi factor portfolios

• Investors would need managers with experience in
  – Managing index portfolios efficiently
  – Experience in factor investing and exposure monitoring
  – Experience in tactical asset allocation
Summary

• Smart beta products have evolved very quickly

• Product consolidation is a prerequisite

• Smart beta is both a threat and an opportunity

• Changes in pricing structures required

• As smart beta becomes more mainstream, experience in the area counts
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