



# SMART BETA INVESTING



**DANIEL LEVEAU**  
CEO, 1741 Asset Management Ltd



**FELIPE MARIN**  
Head of Investment,  
Inversiones Security



**DR. FELIX MIEBS**  
Quantitative Analyst, Lupus alpha



**IAN WEBSTER**  
Managing Director, Europe,  
Axioma Inc

## SEEKING A BETTER RISK- RETURN TRADEOFF WITHOUT TRADITIONAL MARKET-CAP WEIGHTED INDICES

In a market starved for yield, smart beta investing is gaining new attention and adherents. STOXX Pulse talked to four experts, including asset managers, an analyst and a researcher, to get their view on really how smart is smart beta.

The Financial Times, quoting an analysis of Morningstar data by State Street Global Advisors, reported in June that inflows into advanced beta funds reached \$15 billion in the first quarter of 2013, up 15.3 percent. Up 45.3 percent compared to the year-ago period – the strongest quarterly inflow in three years.

**Daniel Leveau** is the CEO of 1741 Asset Management Ltd., a Switzerland-based asset manager that develops and implements quantitative investment strategies and a pioneer in the field of alternative indexing. Leveau, who joined 1741 Asset Management Ltd. in 2001, has almost 12 years of experience in implementing alternative index investments. 1741 Asset Management Ltd. currently has \$2.5 billion of assets under management. Leveau holds a master's degree in finance from the University of Lund, Sweden.

**Felipe Marin** is Head of Investment at Santiago, Chile-based Inversiones Security, a division of financial holding company Grupo Security SA. Inversiones Security, with \$600 million of assets under management, provides asset management and stock brokerage services. As head of the division since November 2010, Marin advises clients who invest more than \$1 million in the areas of equity, fixed income and currencies. Marin has more than six years of experience in asset management.

**Dr. Felix Miebs** is a Quantitative Analyst at Lupus alpha, a Frankfurt-based privately owned asset manager with 5.5 billion euros of assets under management. Miebs joined Lupus alpha in 2011 and is responsible for the developing and maintaining of proprietary volatility databases as well as conducting backtests and developing quantitative models and tools for investment decisions. Miebs holds a doctoral degree in finance from the European Business School in Oestrich-Winkel, Germany.

**Ian Webster** is Managing Director, Europe at Axioma Inc., which develops and markets innovative risk analysis, portfolio rebalancing and performance attribution products for the financial services industry. Webster joined Axioma in 2011 and has more than 20 years of experience in the financial services industry. STOXX's Minimum Variance index family, launched in 2012, was developed using Axioma's factor model expertise.

—  
**WHEN YOU HEAR THE TERM 'SMART BETA INVESTING' OR 'SMART BETA STRATEGIES', WHAT DOES IT MEAN TO YOU?**

**D. LEVEAU:** That finally – and rightly so – the nearly 40-year monopoly of traditional market-cap-weighted indexing is increasingly being questioned and investors are actively looking for alternatives to diversify their exposure to traditional market beta. We are firm believers that investors in general can only profit from this development.

**F. MARIN:** Smart beta investing is a methodology that attempts to achieve a better risk/return tradeoff without the traditional method of market-cap weighted index investing. Smart beta involves a new understanding of assets and markets in the long term, consistent with better risk and return management. It uses maximize and minimize functions (dividend, Sharpe ratio, volatility, etc.) based on rules of investment strategies.

**F. MIEBS:** The term suggests to me that the strategy offers a deliberate, focused exposure to underlying risk premium of the selected asset class. The smartness of these strategies stems from the sophistication of security selection and/or weighting schemes applied to the

investment universe. While intuitively appealing, the added value of the strategies has to be ultimately validated by the realized out-of-sample performance.

**I. WEBSTER:** The term smart beta has been widely used without a clear definition and smart beta appears to be synonymous with other terms such as 'strategic beta', 'systematic beta' or 'alternative beta'. It would seem that the term covers two distinct types of new indices.

One is non-market-cap weighted indices, for example fundamental or equally weighted indices which aim to outperform market-cap weighted indices by weighting the constituents by an alternative method.

The other type is strategy indices, for example quality or low-volatility indices, which aim to outperform market-cap weighted indices by creating indices that systematically replicate what historically might have been considered active strategies.

—  
**SMART BETA STRATEGIES ARE GENERALLY SEEN AS OUTPERFORMING THE MARKET. HOWEVER, WHAT ARE THE DOWNSIDES TO SUCH STRATEGIES IN TERMS OF COST EFFECTIVENESS, TURNOVER AND OTHER FACTORS?**

**D. LEVEAU:** We believe that the general perception that the sole objective of smart beta strategies is to outperform the traditional market index from a return perspective is not entirely correct. Each of these beta strategies – including market-cap weighted indexing – has a distinct investment objective, be that for instance the reduction of risk or the exploiting of a

value premium. All these strategies come with pros and cons, and each exhibits a particular risk/return pattern. The relative merits of alternative beta strategies have to be assessed along different dimensions, not just in terms of actual transaction-cost adjusted performance. Even when assessed solely along the parameters of your question, our analysis leads us to believe that in general, the oftentimes somewhat higher turnover and subsequent transaction costs of alternative beta strategies is warranted in light of the resulting portfolio performance benefits. Whether the actual investable product (ETF, index fund, etc.) remains 'cost effective' of course then depends on the specific product under consideration.

**F. MARIN:** When we study these kinds of indices, we must always pay attention to the methodology used as the methodology impacts cost, effectiveness and turnover. Our experience shows that the pure model is not applicable because it leads to transactions almost daily and the cost can be greater than the alpha. So, in order to keep it efficient and gain a consistently bigger alpha over the market, a smart beta strategy has to be less constrained in its optimization process to avoid falling into the trade-off of excess turnover for bigger incomes and the justified search for bigger returns. A smart beta strategy is still better than the traditional way of investing in market-cap weighted indices and the costs are manageable.

**F. MIEBS:** Since any deviation from the market-capitalization weighting scheme incurs an increase in turnover and accordingly in costs, investors should be paying attention to the generated turnover of strategies. More importantly, however, is the exposure of smart beta strategies towards other risk factors. Popular screening schemes based on dividend-based metrics provide strong value tilts which are accompanied by the concurrent risk exposure. Similarly, low volatility and minimum variance strategies are exposed to value and reversal risks.

