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Is smart beta really that smart, inexpensive and good for investors?

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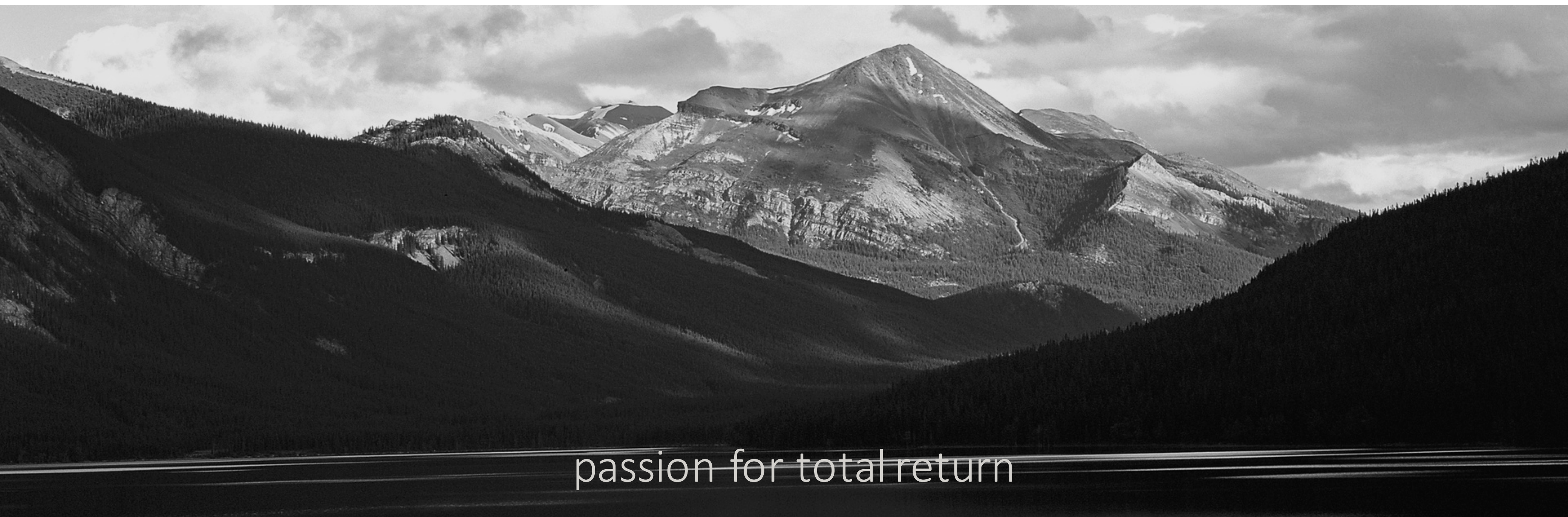


The source of beta and is there really „dumb" beta?

- origins of „beta“ in the CAPM
- „beta“ in its original meaning measures sensitivity of an asset or portfolio to the market portfolio
- market portfolio:
  - aggregate portfolio of **all assets** = aggregate portfolio of **all investors**
  - must hold each asset in proportion to its market capitalization
  - earns systematic risk premium
- the average investor is not “dumb”
- issues with market cap weighted portfolios as benchmark are well known:
  - empirically inefficent
  - allocation of capital along “size” of a company
  - size measured by “price x number of stocks”

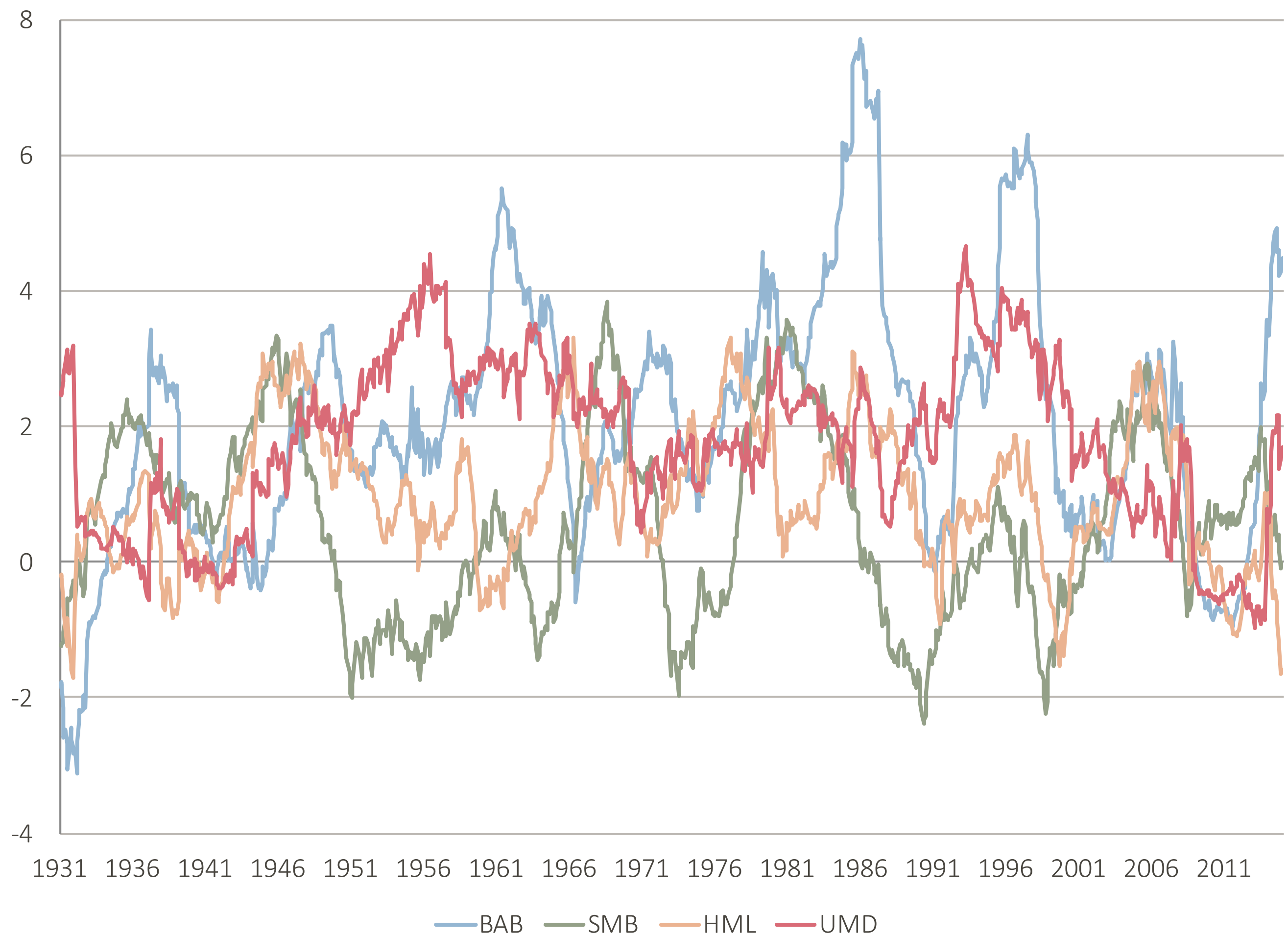
The origins and evolvement of smart beta

- compared to the market portfolio all "smart beta" strategies differ in two dimensions: stock selection and stock weighting
- supposed to be “smart” because they are build on **for decades** well known anomalies
  - low-vol anomaly: Haugen (1972)
  - firm size effect: Banz (1981)
  - value effect: Basu (1977)
  - momentum: Jegadeesh/Titman (1993)
  - and of course Fama/French (1992)
- triumph of quants: active quant equity has **always** been smart beta investing

Why so much excitement now?

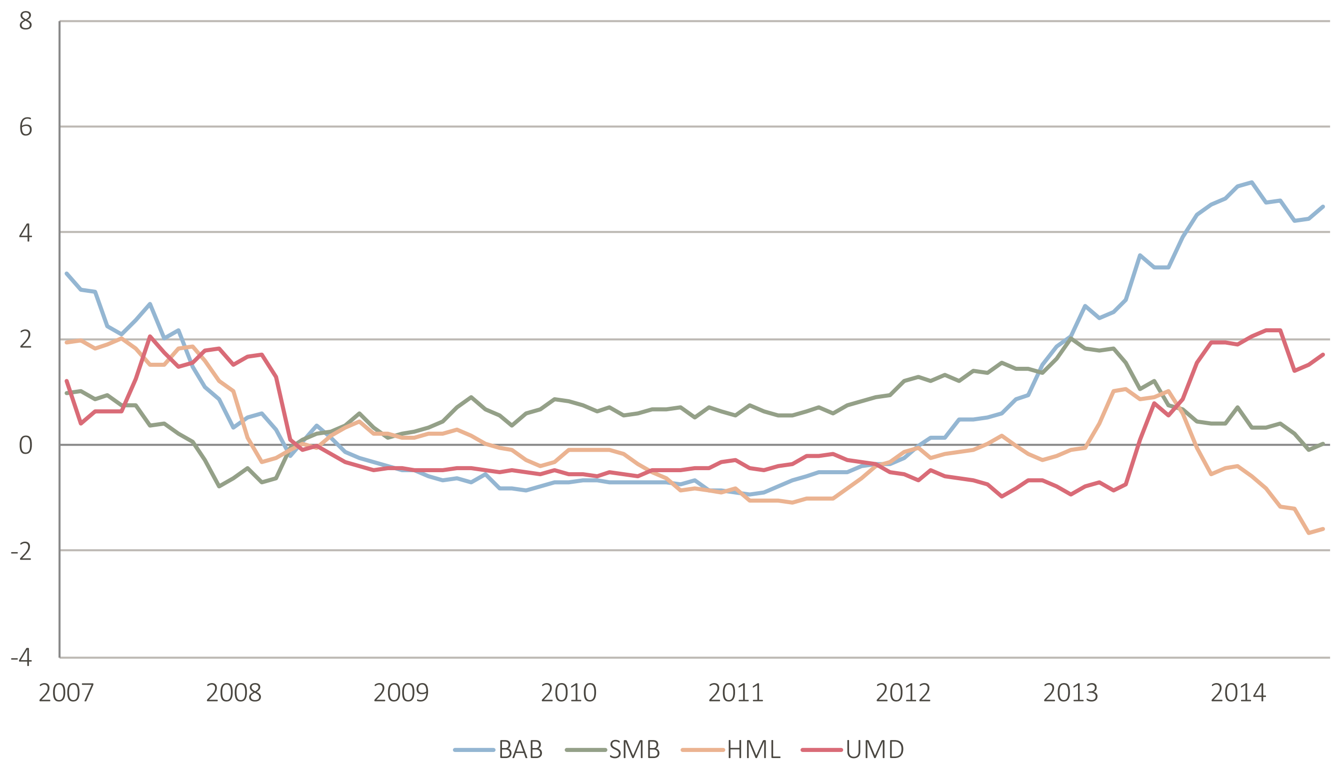
- anomalies are know for decades
- low volatility equity strategies attractive after the financial crisis
- disappointment with traditional managers
- advances in computer and data technology: everyone can become a quant
- measuring “factor exposure” for performance evaluation has become industry standard (what is true alpha?)
- perfect naming
- “promise” of cheap, easy and transparent access to quant strategies and factor exposure

US equity factors: rolling 5-year t-stats



source of raw data: www.aqr.com/library/data-sets

US equity factors: rolling 5-year t-stats



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Smart beta as a blend of active and passive?

- genuine smart beta is a **highly active** and sophisticated portfolio strategy

    - how is Value/Growth/Quality measured?
    - risk model in low volatility strategies
    - rebalancing interval

- smart beta ETFs are **not** a "blend" of active and passive

- passive:
    - easy to replicate
    - transparent for everyone
    - no discretion, clear rules

- as an index (and ETF) smart beta strategies need to be heavily “constrained”

Smart beta not cheap anymore

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	STOXX® Global 1800 Minimum Variance Unconstrained	STOXX® Global 1800	STOXX® Global Total Market
Gross dividend yield[2)]	2.8%	2.3%	2.2%
Price/earnings (trailing)[3)]	19.06	19.56	19.38
Price/earnings (projected)[3)]	18.64	16.02	16.03
Price/book	2.22	0.46	0.55
Price/sales	1.33	1.32	1.32
Price/cash flow	2.03	1.16	1.16
Beta (3y) vs STOXX Global 1800	0.54		
5y volatility	8.5%	13.7%	13.2%
3y Sharpe ratio[2)]	0.19	-0.25	-0.48
Maximum drawdown[3)]	8.3%	21.8%	22.9%

source: STOXX

Smart beta performance

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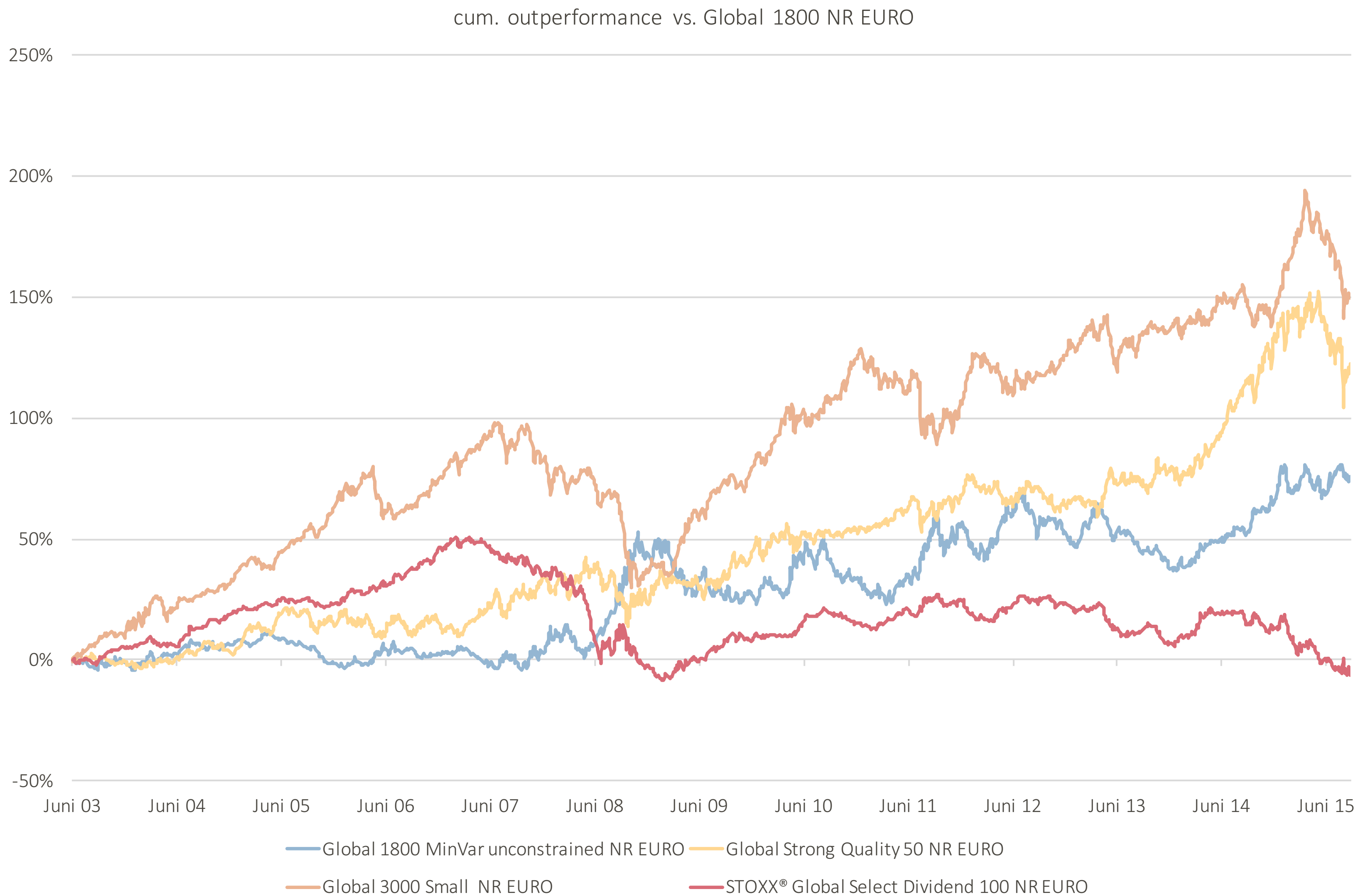

source: STOXX

Summary

- moving away from market cap weighting makes a lot of sense
- it will **still** be more important to decide when to invest in what beta than the decision between smart and dumb beta
- “factor investing” : be aware of the difference between risk premia and **systematic** risk premia
- NEVER buy smart beta because of historical outperformance
- beating the market is not easy (it looks easier on paper …)
- the average investor is not “dumb”

Conclusion

Is smart beta really

that **smart** ✔

inexpensive ✘

and **good** ✔

for investors

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