Summa Global Advisors

Perspective Newsletter Vol. 3, 2015

Rachel Wakefield CFA

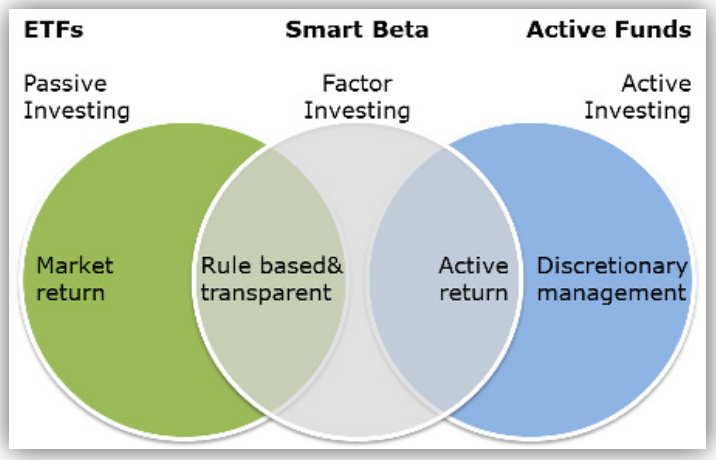
Website
Email Me
Facebook
Twitter
Archive

What's Trending Now?
Smart Beta: The Intersection of Active and Passive Investing

Traditionally, there have been two methods of equity investing – active and passive. More recently, however, a third option has come into play. Claiming that the market is inefficient and that passive indexing can be improved upon, institutional investors set out to create a product that seeks to exploit market inefficiencies by overweighting certain equity characteristics. This new style of investing has come to be known as smart beta or strategic beta.

Portfolio Type	Definition	General Structure	Investments	Results
Active	Stock-picking Strategies	Individuals or teams are paid to construct a portfolio of securities and aim to beat a benchmark of choice.	Separately managed accounts, mutual funds, or closed end funds.	Often underperform passive indices, higher fees
Passive	Index or benchmark investing	Portfolio constructed by duplicating the index. Values track the market capitalizations of the index constituents.	Mutual funds and Exchange traded funds (ETFs).	Close to an index return, very low fees
Smart Beta or Strategic Beta	Constructing a rules-based basket of securities by a factor other than market capitalization	Computer-driven models behave like active managers to tilt holdings toward chosen strategic goals. Models systematically rebalance to bring holdings into line with strategy.	Mutual funds and Exchange traded funds (ETFs).	Insufficient track record. Smart beta portfolio returns vary with market conditions.

To take a trip down memory lane, the first money managers utilized stock-picking strategies to design their portfolios. The advent of what is known as active management took hold of the marketplace when mutual funds were formed in the early 1900's. By the 1960's, billions of dollars had flowed into these mutual funds. In 1971, Wells Fargo established the first index fund. Also in the 1970's, no-load funds also became available. The bull markets of the 1980's and 90's created mutual fund superstars like Peter Lynch and Michael Price.[1] However, in recent years, passive indices have often outperformed fund superstars, and investors have been content to invest in the overall market utilizing passive strategies. In fact, well-known investors John Bogle (Vanguard), Warren Buffett and Charlie Munger suggest that the average investor would be best served by purchasing an index fund.[2]



Smart beta strategies are designed to add value by systematic-ally selecting, weighting, and rebalancing portfolio holdings on the basis of character-istics other than market capitalization (Research Affiliates)

Smart beta portfolios are a natural outcome when big data meets traditional investing. The ability to crunch data and dissect returns has caused the investment world to consider a new option. Since active managers have recently underperformed the passive indices, the concept of being able to take the emotion and personality out of the stock picking (active management) and let the computer generate an unbiased list of stocks that fit a desired set of criteria sounds like a perfect match! Strategies to contemplate might include the following: value, growth, yield, capitalization size, low volatility, dividend growth, high beta, price momentum, equal-capitalization weight (see chart below for explanation).

Popular Smart Beta Factors	
Value	A multi-factor strategy which weights toward stocks cheaper than the overall market when measured by factors including, but not limited to, price-to-book, price-to-cash-flow, and price-to-sales.
Quality	A multi-factor strategy which weights toward stocks that exhibit positive fundamentals (high return on equity, stable earnings growth, and low financial leverage).
Momentum	Exposure to large and mid-cap stocks exhibiting relatively higher price momentum than the overall market (high beta).
Size	Weighting of a portfolio of stocks by a size factor other than market capitalization (addition of mid cap, small cap, or equal-weight).
Dividend	Weighting a portfolio of stocks by the amount of dividend they pay or the company's history of raising dividends over time.
Volatility	Weighting a portfolio by stocks with comparably higher or lower volatility.

At this point, computer-driven models do not have a track record that would verify outperformance over the long run. As Ronald Coase, a Nobel Prize winner in economics, stated, "If you torture the data long enough, it will confess to anything." So, although the idea of overweighting has merit, it is mostly a product of back testing at this point. If outperformance versus a passive index persists over the market cycle, then smart beta will be here to stay.

Footnotes:
1. http://www.investopedia.com/articles/mutualfund/05/mfhistory.asp
2. http://finance.yahoo.com/news/investing-pros-john-bogle-warren-160000796.html