Smart-Beta is…

Slowly, very slowly the concept of smart-beta is beginning to creep into the consciousness of the investment community, though it is probably still a long way from penetrating the retail investment world.

Like many new ideas it suffers from, or perhaps enjoys, a multitude of definitions and descriptions. So, at the risk of muddying the waters even more, here is another.

It was probably around early 2009 that the phrase Smart-Beta began to be used. Before that the approach had been described as fundamental tracking or fundamental indexing. In a brilliant example of why English is such a popular language the strength of the anglo-saxon preference for short words over long ones soon meant that the shorter description triumphed over the long ones.

Using beta in the label immediately helps us to understand what the product is offering. Technically beta is a measure of the volatility of a stock relative to the index it is part of. So a stock with a beta of 0.9 is 10% less volatile than the market; it goes down 10% less when the market falls and lags the market by 10% when it rises. The market, in the form of an index, of course has a beta of one and this has allowed the term to morph into shorthand for the behaviour of the market as a whole.

Beta as slang for the market is therefore quite handy. But what about the smart bit? The market is normally defined as the aggregate capital value of all its constituents. Changes in this value tell us what the market is doing over various periods of time and this is the index conventional market capitalisation based tracker funds use.

The market capitalisation, or price, of a company, calculated by multiplying its share price by the number of shares in issue, is really just a measure of its popularity. There is no direct arithmetic link to any of its financial characteristics such as book value or profitability. Many investors accept that, in broad terms, the market is pretty good at pricing stocks. In other words there is grudging acknowledgement that the Efficient Market Hypothesis largely holds true.

Nonetheless, anyone who has watched capital markets for any length of time knows full well that investors can get too enthusiastic, or too depressed, about individual companies or even whole sectors. That can lead to distorted valuations and provide opportunities for traders to exploit these anomalies.

Doing that for small focussed portfolios can be rewarding but, by definition, that will not cover the whole index and cannot therefore be expected to provide the beta of the market. An alternative approach to portfolio construction across the market is to use a measure other than price to assess and weight each company. In reality there are five main measures that can be applied to any company; price, revenue, book value, profits and dividends. All have strengths and weaknesses but, until recently, all passive funds simply used price. What Smart-Beta funds offer is the opportunity to capture the return of the market but using different measures or combination of measures. That means they hold the same stocks as price weighted tracker funds but in different proportions. Most importantly it takes price out of the portfolio construction process thereby breaking the feedback loop that can make expensive stocks more expensive as they attract a bigger share of new money. Most people prefer to buy stuff, be it carpets, cars or shares that have been reduced in price. Ignoring price allows fundamental factors to become the driving force in portfolio weighting.

To merit a Smart-Beta label a fund therefore has to hold all, or substantially all, of the stocks in its universe and use a logical process to weight those stocks that can be defined by an algorithm based on readily available data that eliminates subjectivity. Doing this gives the fund different characteristics from a conventional beta or cap-weighted fund. These could be a bias to value, or growth or perhaps lower volatility. It is already clear that some Smart-Beta funds have delivered on these features so the differences can be quantified. That now allows investors to discriminate between different types of beta funds for the first time.

Everyone is frequently reminded that past performance is no guide to future returns but at least the range of beta funds now available enables investors to observe how they behave in real life. That allows them to make informed judgements on their merits and decide if there are times when price is not the best measure.