Dumb Alpha Plus Dumb Beta Equal Smart Beta?

Stockholm (HedgeNordic) – Factors and factor-based products have entered the mainstream of investing. There is no doubt about that. Smart beta products, one type of factor-based investments, are regarded as an inexpensive way of outperforming traditional market capitalization-weighted indices. But what is smart beta? Does smart beta represent a source of alpha (or dumb alpha)?

Some view the term smart beta as a fancy way of marketing strategies that capture sources of extra return stemming from risk factors such as value, carry, quality, and momentum. Clifford Asness, the co-founder of giant quant fund manager AQR Capital Management, reckons that "smart beta is mostly re-packaged, re-branded quantitative management." The term smart beta means different things to many people, and, given the popularity of the term among investors, some may have stretched the definition of smart beta too far. There is no generally accepted definition of smart beta partly because there are two types of such products.

Smart Beta: Passive Versus Active Dilemma

Investors can get exposure to smart beta by either acquiring so-called smart beta indices, rules-based tailor-made indices that use non-cap weighted indexing to

offer exposure to specific factors, or using a pure active asset manager-led approach that tilts towards particular factors. Smart beta indices represent a classic passive approach to investing, whereas the asset manager-led approach is a form of traditional active investing.

> *Smart beta solutions should retain some of the key benefits of passive investing," including transparency, low cost, among others.*

In an essay by Arnott and Kose (2014), the authors argue that "tapping a reliable source of excess return is not sufficient to merit the label smart beta." This means that active managers attempting to offer investors exposure to risk factors shall not identify their products as smart beta. Instead, the authors argue that "smart beta solutions should retain some of the key benefits of passive investing," including transparency, low cost, among others.

Leaving the debate aside, smart beta is active investing based on an algorithm. To please those who firmly believe the term smart beta applies to tailor-made indices only, one could say smart beta products aim to combine the benefits of both active and passive investing in one product. The benefits of active investing include the attempt to earn above-market returns or exhibit below-market risk, or a combination of both. The benefits of being passive, meanwhile, include the advantages of traditional passive index investing such as simplicity, transparency and relatively low cost.

Debate Aside, Factors Must Work

Regardless of whether smart beta products rely on tailor-made indices or more traditional active portfolio management, targeted risk factors must have a good economic story behind them. There must be valid reasons a risk factor is expected to generate positive excess returns. Smart beta or pseudo-smart beta strategies should aim to target those sources of excess returns that arise and persist due to behavioral or structural anomalies.

Although no consensus has been reached on how many smart beta factors exist, there are five main proven factors: value (cheap securities tend to outperform expensive ones), momentum (winners keep winning, and losers keep losing), small size (smaller-sized firms tend to beat larger ones), low-risk or quality (higher-quality, lower risk, less volatile securities tend to outperform), and carry

(tendency of higher-yielding assets to provide higher returns than lower-yielding assets).

These are just several factors a large body of academic literature has found to generate long-run hypothetical excess returns with low correlation to traditional markets, in multiple geographies and asset classes. These factors, however, do not necessarily have to be identical for all managers or smart beta products. Value, for instance, can be defined by a simple single measure such as the price-to-book or price-to-earnings multiples, or as an average of a combination of various measures.

Smart Beta or Dumb Alpha?

Factor-based investing represents a superior alternative to traditional market exposure (beta), which, perhaps, justifies the "smart" part of the smart beta term. In essence, smart beta strategies are smart because they represent a smarter way to load up on market beta with alpha (or dumb alpha). Consider the following equation:

Smart Beta = Market-Cap-Weighted Index + (Smart Beta – Market-Cap-Weighted Index)

Based on this equation, one could easily argue that long-only smart beta products (and there are only long-only smart beta products; the other more complex strategies harvesting factors are termed alternative risk premia) represent a tie-in sale. Investors get two items when buying a smart beta product. The first item is a traditional cap-weighted index vehicle and the second one is a long/short portfolio betting on an isolated factor such as value, momentum, or quality.

Simply put, smart beta products offer exposure to market-capitalization-weighted indices plus an attempt to beat those indices by getting exposure to sources of excess returns (a.k.a. dumb alpha). Investors buying smart beta products cannot choose how much of the long/short stuff they can get their hands on. Strategies that go long the smart part and go short the "dumb" part are called alternative risk premia strategies.

> *No strategy or factor tilt outperforms in all market environments, and various factor tilts outperform in different parts of the economic cycle.*

Single-Factor Versus Multiple-Factor Smart Beta Strategies

Most smart beta products are long-only equity strategies with tilts toward one factor. The family of smart beta products, however, has expanded to include a combination of several factors into one product. The excess returns generated by the above-mentioned proven factors tend to be uncorrelated (or relatively lowly correlated) with one another, with each factor's returns coming at a different point on the economic cycle.

No strategy or factor tilt outperforms in all market environments, and various factor tilts outperform in different parts of the economic cycle. Therefore, combining more factors into one product can represent a more consistent approach to beat traditional benchmarks. There are two broad options of how to get exposure to multiple factors: invest in separate single-factor funds (e.g., a separate value product, a momentum product, and so on), or investing in a single product that integrates multiple factors simultaneously. Although both approaches are useful, the second choice appears more efficient partly because of lower transaction costs, as the multi-factor approach can avoid excessive turnover.

Conclusion

Although all smart beta is factor investing, not all factor investing is smart beta. There are more complicated ways to isolate and target risk factors, including simultaneously taking long and short positions or adding leverage. Yet, long-only smart beta strategies represent an inexpensive way of getting exposure to sources of excess returns. Many smart beta products are popular for a good reason. These represent transparent products offering exposure to sources of excess returns, usually associated with low management costs and, with proper design, low transaction costs.

Picture: (c) By-patpitchaya—shutterstock