Cammack Retirement Investment Research: Is "Smart Beta" Wise for You?

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INTRODUCTION

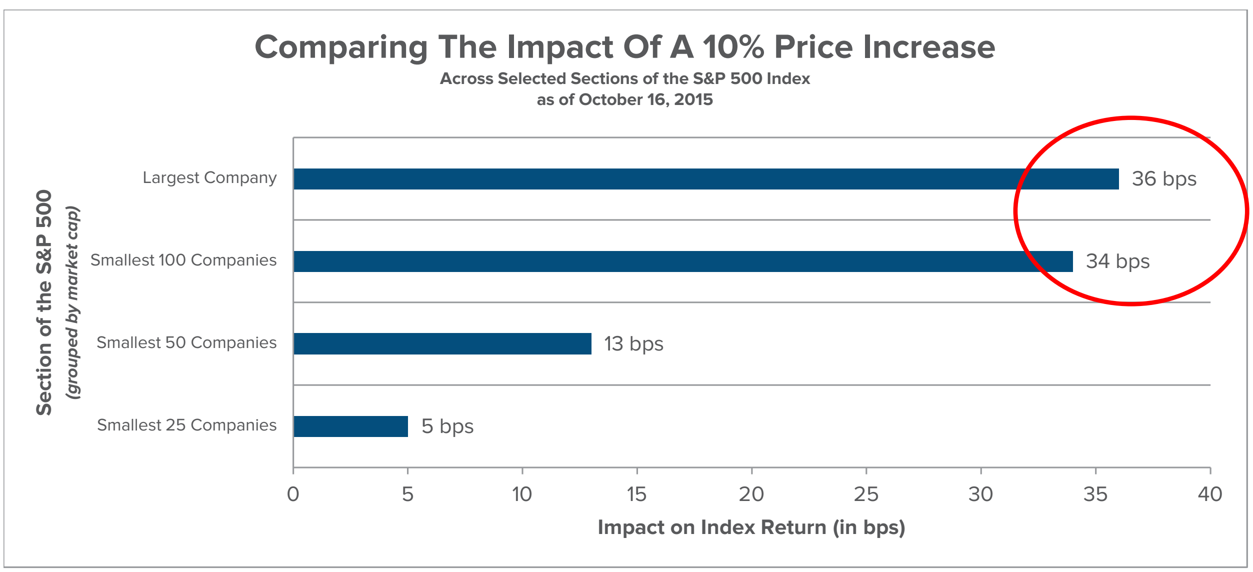
Smart beta funds have garnered significant attention in the investment community in recent years. The potential to combine the favorable attributes of active and passive management into a simple and transparent product is appealing to plan sponsors and institutional investors alike. Enhanced returns, lower volatility and reduced fees are all potential benefits of these new smart beta funds.

This paper will examine the advantages and limitations of smart beta strategies, as well as their suitability in a retirement plan investment array. We will clarify what smart beta refers to, how smart beta funds are managed, and what makes them unique compared to traditional index and actively managed funds.

TRADITIONAL INDEXING METHODOLOGIES

A traditional market-cap weighted index is constructed by holding securities in proportion to their market capitalization. Given this methodology, companies with the largest market cap will have an outsized impact on the performance of the index. The term "smart beta" is used to describe an index fund that does not follow the traditional market-cap weighting rule and thereby avoids the market-cap bias.

Exhibit 1: Illustrating the Market Cap Bias



Source: Morningstar, 2015

Exhibit 1 illustrates the impact of a 10% price increase across various sections of the S&P 500 on the returns of the index. The large-cap bias is readily observable, as a 10% price increase in the largest company *outweighs the impact of an identical price increase across the 100 smallest companies combined.*

Given the large cap bias associated with passive indexing, the advent of non-market cap weighted index funds was only inevitable. The opportunity to move beyond traditional index products has created a wide variety of approaches to portfolio construction.

ALTERNATIVE INDEXING METHODOLOGIES

Smart Beta funds look to move away from the traditional market cap methodology by using alternative rules for portfolio construction. These alternatively constructed portfolios can generally be placed into two broad categories: **Fundamentally Weighted** and **Factor Weighted**. Categorizing Minimum Volatility strategies is the topic of extensive debate in the investment community: some view Minimum Volatility as a distinct category within the smart beta umbrella, while others view it as a subset of the Factor Weighted category. In order to clarify, we will explain these various approaches in greater detail below.

Exhibit 2: Comparing Smart Beta Categories

	Fundamentally Weighted	Factor Weighted	Minimum Volatility
Objective	To outperform a traditional market cap weighted index by screening securities based upon financial measures.	To increase exposure to a desired investment quality with the aim of outperforming the traditional index.	To produce the lowest volatility portfolio for a given set of constraints.
How is the index portfolio constructed?	Weights companies based on accounting variables such as sales, earnings, cash flows and dividends, and others.[1]	Weights companies based on characteristics such as momentum, quality, size, among others.	Weights companies in an index by using predefined limits on factors such as sector and country exposure, historical volatility and correlation with the other securities in the portfolio.
When would an investor use such a fund?	An investor would use this strategy if he believed that companies should trade at or near their “fair values” as measured by the valuation ratios of the underlying business.	To exercise a unique view on the market. For example, if someone believed in “investing in winners”, they may chose to allocate to a momentum fund.	An investor would use this strategy if he wanted to increase downside protection while retaining upside exposure.
Limitations	This approach does not factor in the risks and growth prospects of the business, both of which are hard to detect and incorporate into a rules-based approach.	There are hundreds of factors that can be quantified, and used to construct a portfolio. Choosing a particular factor exposes the investor to the risk of sustained poor performance relative to a traditional benchmark.	This kind of strategy may be complex for an average investor to fully understand. Tight risk parameters may increase portfolio trading activity leading to increased transaction costs and fees paid by the investor.

[1] www.researchaffiliates.com, 2015

IS SMART BETA JUST ACTIVE MANAGEMENT IN DISGUISE?

Some smart beta strategies resemble active management more than others. For the more esoteric strategies, the answer to the question above is often close to yes. The big difference lies in the underlying assumptions which drive each fund.

An equal weight fund is a good example of a strategy that straddles the passive-active boundary. The rule guiding the investment process of an equal weight index fund is very straightforward: rebalance the portfolio at some predetermined interval in order to bring the weights of each security back to their starting (and thereby equal) weights. In doing so, equal weight funds avoid weighting securities by market cap, but instead give an equal weight to each underlying security. This strategy is considered to be more passive because it does not require fundamental analysis or subjective assumptions from the investment manager.

Minimum volatility, on the other hand, is a prime example of a smart beta strategy that is more similar to active management because it relies heavily on assumptions made by the investment manager. For example, Manager A might use the historical volatility of a security to determine its weight within a portfolio, while Manager B might use a different risk parameter to determine a securities' weight. Setting the rules governing a minimum-variance portfolio requires a good deal of judgement and analysis from the manager; which makes such a strategy more comparable to active management. Other subjective rules driving smart beta strategies include dividend yields for dividend-focused funds, earnings growth levels for momentum funds, debt to capital requirements for leverage-focused funds and many others.

Regardless of where the strategy lies on the passive-active spectrum, all smart beta funds share a common goal: that is to provide exposure to a given index, while avoiding the market-cap bias associated with traditional index funds. But can smart beta yield enhanced returns for investors?

PERFORMANCE EXPECTATIONS FOR SMART BETA FUNDS

One of the main advantages of smart beta, is the ability to exercise a particular view on the market. For example, an investor who is wary of the current market's appetite for speculative biotech names (which represent a growing portion of the Russell 2000 Growth Index), could invest in a fundamentally weighted small cap ETF. This type of a fund would screen for companies with higher levels of financial stability as measured by real earnings and more stable balance sheets. Hypothetically, an investor in a fundamentally weighted small cap ETF would outperform if there was a correction in the biotech space, as he or she would be underweight in this sector by virtue of the fundamental screen.

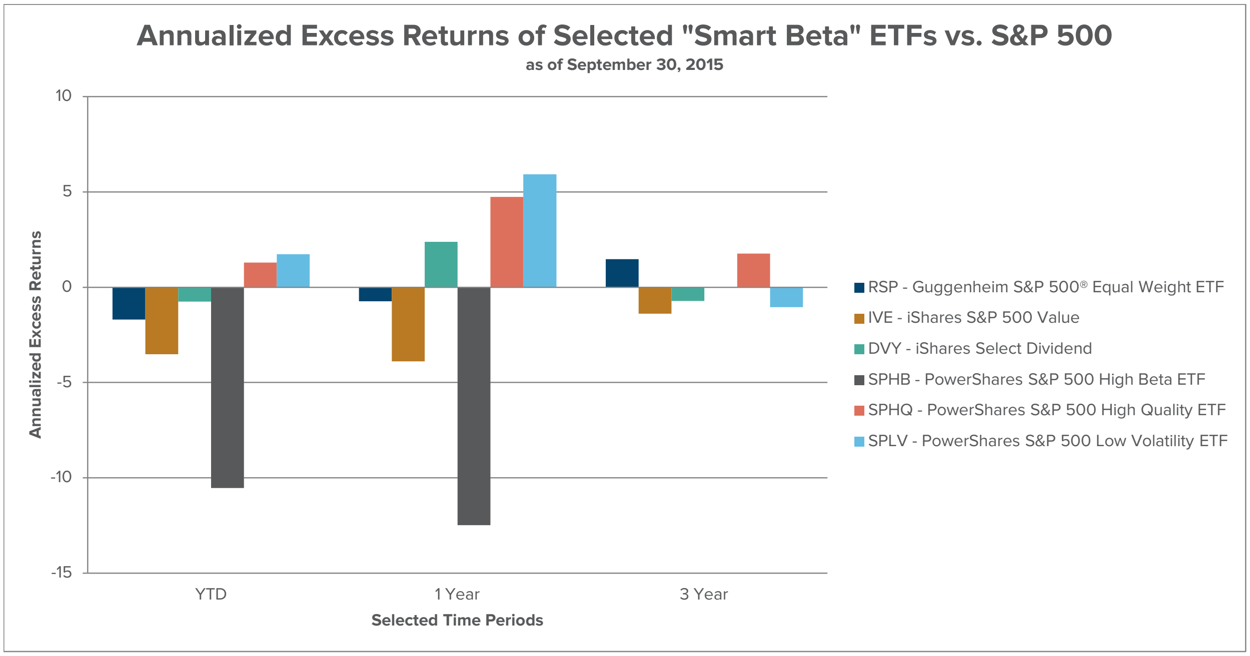
Despite the advantage of being able to express a view on the market with relative ease, a smart beta label is no guarantee of superior returns. In fact, choosing between various smart beta strategies exposes the investor to the risk of sustained underperformance or being uncompensated for added risk.

Let's use the PowerShares S&P 500 High Beta ETF (Ticker: SPHB) as an example*. "High Beta" in this instance, refers to a strategy that overweights securities that exhibit higher sensitivity to movements in the broad equity market. In other words, one would expect a high beta strategy to produce higher returns in up-markets and lower returns in down markets than the broad benchmark.

* This fund was chosen purely for demonstrative purposes. It is not reflective of any opinion of Invesco/Powershare products

Despite strong equity performance in the broad market, the high beta ETF performed only in line with the S&P 500 index over the trailing three year period, while assuming a higher level of risk. Over the past year, the high beta ETF underperformed the S&P 500 index by over 10%. This example helps to demonstrate that smart beta strategies can underperform broad benchmarks even when rational expectations prior to investing would lead one to believe otherwise.

Exhibit 3: Performance of Selected Smart Beta ETFs vs. S&P 500



Source: Morningstar, 2015

While smart beta funds can potentially outperform their benchmarks, the real challenge for an investor lies in choosing a winning strategy; that can be a difficult decision for a professional investor, let alone for the average plan participant.

SHORT PERFORMANCE TRACK RECORDS

Evaluation of a fund's track record is essential to determining its fit in a plan array. Many smart beta products were created and distributed in recent years; therefore, these funds may lack long-term performance records. Asset managers will often point to successful back-tested performance as validation of a particular strategy. It is important to take simulated performance with a grain of salt. Back tests may not fully account for the transaction costs and other challenges associated with implementing a given strategy.

SMART BETA FUNDS IN RETIREMENT PLANS

The trend towards consolidation of investment arrays is important to consider when adopting smart beta funds into a retirement plan. There is ample empirical evidence to support the notion that simplifying an investment lineup may increase employee participation and plan effectiveness. One could make the case that introducing smart beta funds into a plan lineup may complicate the investment options and contradict prior efforts to streamline an investment array.

It is important to note, however, that smart beta funds may in fact offer customization at low cost and may improve participant outcomes if used appropriately. That is why it is important for the plan sponsor to educate the plan participants about each fund, to consider each fund's suitability, and to determine each fund's fit amongst the other options in the investment array.

Adoption of smart beta funds in the retirement plan arena has generally lagged that of the retail market. At least part of the lag is attributable to the fact that recordkeeping systems were not designed to accommodate ETFs that trade intraday. Instead, most recordkeeping systems were designed to service mutual funds that trade at end of day, based on their net asset value.

Regulations governing 403(b) plans limit investment options to mutual funds and fixed or variable annuities. Most ETFs do not meet the registration requirements necessary for inclusion into a 403(b) plan. Regulatory change at the state and federal level would have to take place in order for most smart beta products to be adopted in 403(b) plans.

Given the current regulatory framework and trends in the retirement investment landscape, adoption of smart beta funds in 401(K) and other retirement plans has been limited. Nevertheless, the retirement community is continuously looking for better ways to invest in low cost index funds while gaining exposure to factors other than market capitalization. Plan sponsors can benefit plan participants by offering smart beta funds, assuming they perform the requisite due diligence and provide adequate communication and education regarding each fund.

CONCLUSION

Smart beta is part of a broader investment trend towards products that aim to offer greater customization, lower fees and enhanced returns for investors. Given their positioning between active and passive management, smart beta funds have an inherent appeal to investors and plan sponsors. It is important to remember however, that "smart beta" is only an umbrella term that refers to a wide variety of rules-based investment strategies.

A fair amount of scrutiny and investment acumen is required to evaluate the rules, strategies and potential outcomes of each particular fund. While smart beta funds have enjoyed growing popularity in recent years, they have yet to find their niche in the retirement plan arena. As recordkeeping systems advance, regulations in the 403(b) space evolve and smart beta funds continue to build track records, it is reasonable to expect growing adoption of smart beta funds in retirement plans.

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For more information on our services, please contact **Mike Volo**, Senior Partner, at **781.997.1426** or **mvolo@cammackretirement.com**.

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