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Smart beta's risks and costs

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Executive Summary

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Smart beta strategies currently being promoted by index providers and asset managers differ from both traditional active management and passive management. Investors should understand these differences before deciding to invest in smart beta products.

Growing interest in smart beta

In recent years, major index providers have been actively promoting and piquing investor interest in smart beta indices. Asset managers are likewise promoting investment products based on smart beta, including passively managed funds that track smart beta indices. Smart beta is consequently becoming increasingly accessible to investors.

In contrast to market indices, which comprise a broad selection of stocks weighted by market capitalization, a smart beta index is (1) made up of stocks that possess selected attributes and (2) weighted based on something other than market capitalization. Smart beta indices most notably include fundamental indices and low-volatility strategy (minimum variance) indices. They are often designed to provide exposure to specific factor premia whose existence is systematically verifiable to one degree or another. Many smart beta indices have better long-term performance than market indices, according to backtests.

Investor interest in smart beta reflects two factors. The first is a growing body of evidence indicating that widely used market indices are inefficient. The second is investor skepticism of active management's ability to generate excess returns. Amid recent investor interest in smart beta, many asset managers are pitching smart beta as a cross between active and passive management, an effective complement to passive management, and/or a low-cost alternative to active management.

Smart beta's risks and costs

However, investors need to be aware of several points.

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First, the factor premia targeted by smart beta products may not deliver short-term returns. In fact, smart beta indices have sometimes underperformed market indices over multiyear spans. Investment timing is therefore critical. In terms of structural factors, another concern is valuation distortions. For example, low-volatility stock valuations have reportedly been driven up in recent years by growth in low-volatility strategies' popularity since the global financial crisis[1]. If many investors invest in smart beta indices, the indices themselves would become largely indistinguishable from a market portfolio. Pension investors should, in addition to understanding the source of smart beta returns, start investing at reasonable valuations if possible. Other imperatives include appropriately allocating assets among multiple smart beta indices and having effective controls and governance to avoid short-sighted loss aversion.

NOTE

1) Li, Feifei (2013), "Avoiding Pricey Low Volatility Investing," Simplystated, Research Affiliates.

Second, smart beta investing shifts responsibility for performance to the investor. When a conventional actively managed fund underperforms its benchmark, the manager has an incentive to improve the fund's performance. In the case of smart beta, however, index providers (the de facto portfolio managers) have little if any such incentive because they are responsible for index consistency and consequently cannot easily revise index construction rules. If investors use smart beta as an alternative to active management, those who decide to invest in smart-beta indices assume responsibility for their performance.

Third, smart beta indices entail higher replication costs than market indices. Unlike passively managed market indices generally conducive to buy-and-hold replication, passive management of smart beta indices requires periodic trading. The resultant transaction costs are a source of underperformance relative to the index. To the extent that asset managers must devise means to avoid such underperformance, they would incur additional administrative costs that, together with license fees paid to the index provider, are likely to be passed on to investors in the form of higher management fees. In addition to carefully scrutinizing index design features intended to ensure replicability (e.g., turnover restrictions, liquidity considerations), investors should also assess the reasonableness of fees charged by asset managers.

Is the JPX-Nikkei Index 400 smart beta?

The JPX-Nikkei Index 400, launched in January 2014, is a Japanese equity index whose constituents are selected based mainly on their ROE and profit levels (but constituents' index weightings are based on free-float-adjusted market capitalization, subject to a weight cap of 1.5%). A number of asset managers are already

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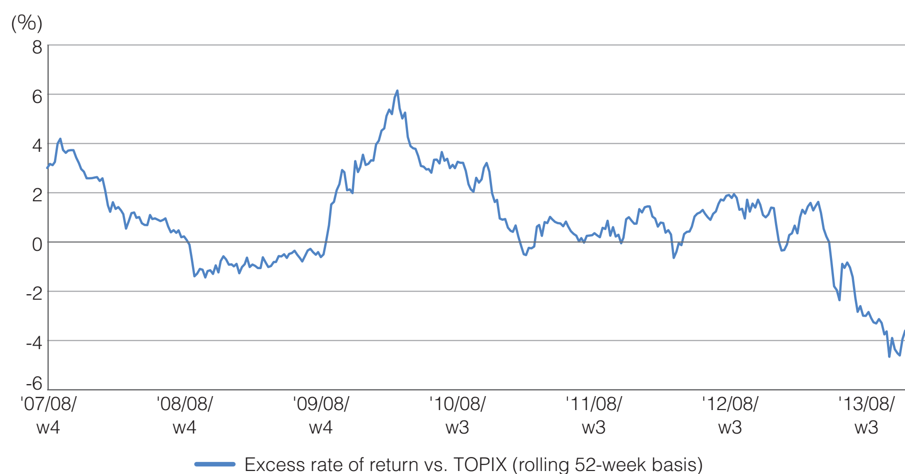

Source: NRI, based on Japan Exchange Group, Tokyo Stock Exchange and Nikkei data

constructing passively managed JPX-Nikkei Index 400 products. The JPX-Nikkei Index 400's excess rate of return over the TOPIX is plotted in the accompanying chart.

Of the JPX-Nikkei Index 400's constituent selection criteria, ROE is widely used as a quality factor in smart beta indices while profit level is often used as a size screening criterion for fundamental indices. The JPX-Nikkei Index 400 is thus ostensibly similar to smart beta indices.

In contrast to smart beta, however, the true intent behind the JPX-Nikkei Index 400's design is to broadly motivate Japanese nonfinancial companies to endeavor to gain inclusion in the index, thereby boosting their real-world capital efficiency. This aim would prove unattainable unless investors actually invest in the JPX-Nikkei Index 400, but the Government Pension Investment Fund (GPIF) is largely committed to doing so[2].

In sum, the JPX-Nikkei Index 400 is predominately focused on positive externalities of passive management. As such, it should be regarded as similar not so much to smart beta indices but to SRI (socially responsible investing) and corporate governance indices based on investment approaches other than directly pursuing returns. The JPX-Nikkei Index 400's aim of improving capital efficiency will take quite a while to be realized. Confirmation of improvement in share price performance in response to improved capital efficiency will take even longer. Moreover, such improvement would not be confined solely to JPX-Nikkei Index 400 constituents. Investors should accordingly recognize that they need not necessarily invest in the JPX-Nikkei Index 400 to benefit from favorable long-term returns.

2) The JPX-Nikkei Index 400 was the sole example of an "index that will enable more efficient investment" of passively managed portfolios cited in an expert panel's November 2013 report on upgrading public and quasi-public pension funds' portfolio management and risk management. The report mainly addressed the issue of how the GPIF should best manage its assets.

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