Better Outcomes, Less Risk

Smart Beta Investing

What Retirement Program Fiduciaries Need to Know

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Executive Summary

Smart beta (or factor-based) investing is growing in its understanding, acceptance and usage in the asset management industry. While the use of stand-alone options using these strategies in retirement plans is limited due to their primarily ETF presence, their usage inside of asset allocation strategies like target date and target risk funds, including custom target date solutions, is expanding. As with any investment option, it is important to understand the potential benefits and risks involved. **The opportunity for more (or less) return than index options, and likely lower expense than more traditional active options, can benefit the retirement plan's participants.**

Whether these strategies are embedded in a target date option or are utilized in stand-alone funds, it is an important part of plan fiduciary oversight to assess them. PlanPILOT's goal is to provide an assessment to help you understand the impact of smart beta solutions and the potential benefits and risks on your retirement investment program now and going forward.

History of Smart Beta

Smart beta or factor-based solutions are generally credited as beginning with ground breaking research by Research Affiliates over a decade ago. They identified the biases in traditional indexes, particularly the impact from the market capital or size weighting approach. A small number of heavily weighted securities has a disproportionate impact on the overall benchmark. Research Affiliates asserted that a simple smart beta methodology, that of equal weighting the securities in the benchmark, could remove the size bias and produce better return/risk outcomes.

Others also observed that active managers often underperformed and charged higher fees than passive benchmarks. Research Affiliates thereby introduced new thinking about using fundamental approaches to weighting the investable market and selecting securities in a more efficient manner than either cap-weighted benchmarks or traditional active approaches. These fundamental approaches focused on market attributes that they believed were better measures of the securities making up an investible market. These attributes included book value, sales, cash flows and dividends.[1]

Thus, began the

SMART BETA MOVEMENT

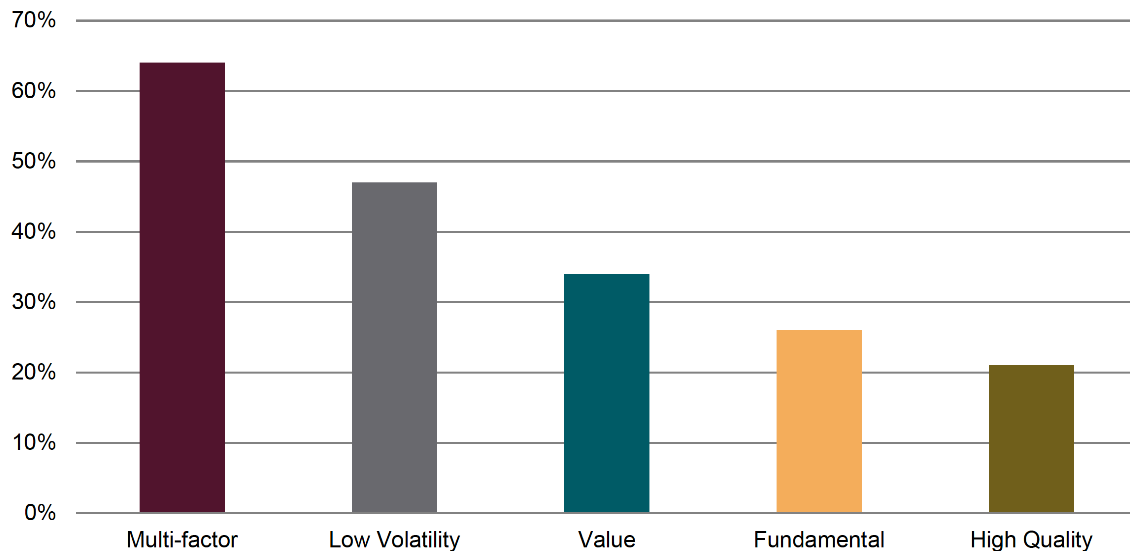
that has escalated more recently.

1 Robert D. Arnott, Jason Hsu, Phillip Moore, "Fundamental Indexation," Financial Analysts Journal, https://www.researchaffiliates.com/documents/FAJ_Mar_Apr_2005_Fundamental_Indexation, March/April, 2005

What is Smart Beta?

Smart beta or factor-based strategies focus typically on elements of a security and market that can be reliably predictive of performance and risk characteristics over extended periods of time. These factors typically fall into these buckets:

Exhibit 4. Top five smart beta strategies—2017



Source: FTSE Russell

These factors are quantitatively defined, measured and weighted by design without a portfolio manager's discretion over security selection.

More specifically, valuation is a common factor emphasized. As identified by the well-known and regarded research by Fama and French, lower valued stocks tend to outperform more consistently, and over longer periods of time compared to growth stocks. A smart beta solution could be designed to broadly, systematically overweight lower valued equities in a given segment of the market to capture the expected premium from lower valued stocks, rather than to pick select equities with that characteristic.[2]

2 Eugene F. Fama, Kenneth R. French, "Common risk factors in the returns on stocks and bonds," Journal of Financial Economics, https://faculty.fuqua.duke.edu/~charvey/Teaching/IntesaBci_2001/FF_Common_risk, September, 1992

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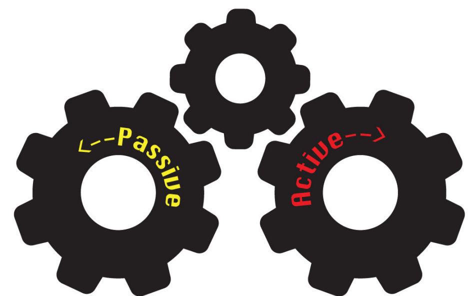
According to a 2017 FTSE Russell survey on smart beta, 71% of investors who have employed a smart beta strategy in the last two years, and 74% of them currently considering one, are focused on multi-factor strategies.[3] These involve pairing different factors, such as valuation and low volatility, to improve the anticipated return/risk results over a significant period of time versus using a single strategy.

Quality is also a common attribute. Definitions of quality vary between managers, but typically involve measures of earnings, cash flows, debt levels and management stability. Overlaying quality with a factor like valuation can create the environment for more positive expected outcomes.

Is Smart Beta Active, Passive or Both?



Are they active strategies? Yes, they can be considered that. Many active managers employ rules-based or quantitative measures in their investment process. These strategies will produce returns that are different than cap-weighted, broad market benchmarks, thus providing the opportunity for alpha versus an index.

Are they passive strategies? Yes, they can be considered that, as well. Rules are defined in advance to screen quantitatively for stocks to be included in the portfolio or excluded, rather than relying on the fundamental analysis and stock picking acumen of an active manager. Typically, a new benchmark is defined that incorporates the factor(s) being emphasized with the expectation that the portfolio will perform in-line with that newly defined index.

It is appropriate to think of smart beta as being between the continuum of passive strategies to one side and active on the other side, and possessing elements of both.

3 FTSE Russell, "Trends and outlook for smart beta," http://www.ftserussell.com/files/research/trends-and-outlook-smart-beta, 2017

Growth & Usage

Smart beta strategies have expanded coincident with the growth of ETFs. BlackRock and Vanguard are the predominant providers in the space, each with over $100B in smart beta assets under management and growing.[4]

Issuer	AUM ($, mm)
BlackRock	1,365,162.48
Vanguard	868,486.89
State Street Global Advisors	618,168.32
Invesco PowerShares	138,790.47
Charles Schwab	102,642.41
First Trust	60,080.17
WisdomTree	44,496.51
Guggenheim	38,743.37
VanEck	36,567.96
ProShares	30,311.87

ETF League Table As Of Feb. 15, 2018, ***Source:*** *ETF.com*

While ETFs are not held in retirement plans typically, they can be held inside of asset allocation strategies like target date and target risk funds-of-funds, as well as in custom target date solutions. They are held in these for the purposes of providing the attempting potential for outperformance versus index funds, and at lower fees than traditional active funds.

Further, while smart beta has predominantly been used for investing in equities, another area of growth is with environmental, social and governance ("ESG") screening. According to the FTSE Russell 2017 survey, overlaying a factor methodology with ESG is gaining more attention. ESG screening that shifts a smart beta portfolio to overweight positive quantitative scoring on definable, predictive ESG criteria may further enhance the potential return of the portfolio.[5] *Refer to Exhibit on the next page.*

4 Attracta Mooney, "BlackRock and Vanguard are smart beta's biggest winners," Financial Times, https://www.ft.com/content/d82a6032-a9f0-11e7-ab66-21cc87a2edde, November 26, 2017
5 FTSE Russell, "Trends and outlook for smart beta," http://www.ftserussell.com/files/research/trends-and-outlook-smart-beta, 2017

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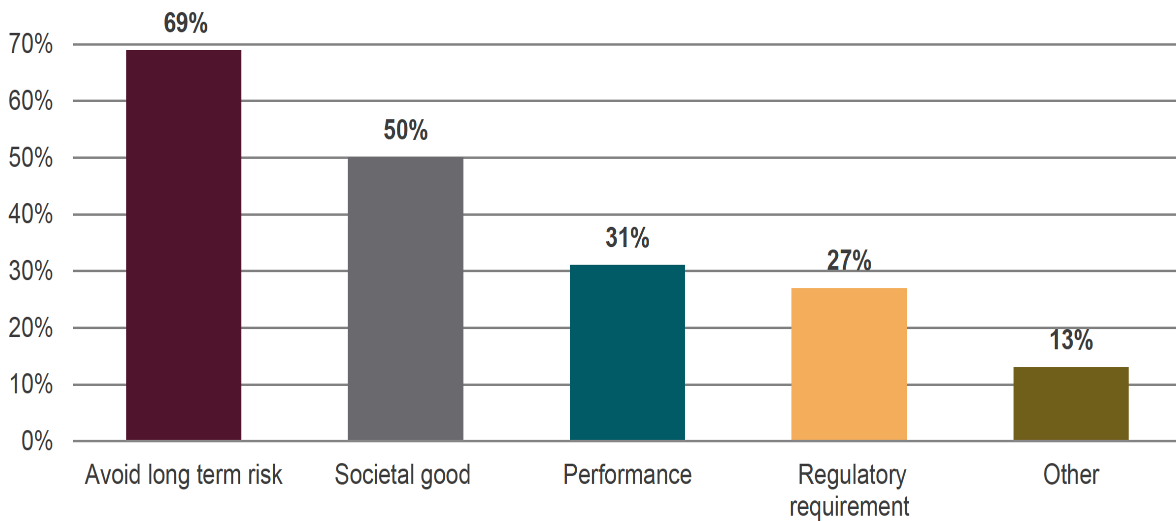

Source: *FTSE Russell*

POTENTIAL BENEFITS

The potential benefits of smart beta include:

- Potential excess positive return over an index investment (alpha).
- Risk management from a defined, quantifiable, predictable investment process consistently applied.
- Leading edge investment management.
- Potential less volatility of performance than an actively managed portfolio.
- Lower fees than an actively managed investment.

POTENTIAL RISKS

The potential risks of smart beta include:

- Potential excess negative return versus an index investment (negative alpha).
- Strategies can be more challenging to understand.
- Factors being out-of-favor for extended periods of time.
- Greater volatility of performance than a passively managed portfolio.
- Higher fees than a passively managed investment.

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Conclusion

Smart beta solutions are growing in their understanding, acceptance and usage in the asset management industry. Their presence especially in asset allocation strategies like target date and target risk funds is expanding, including in custom target date solutions. As with any investment option, it is important to understand the potential benefits and risks involved. The potential for more (or less) return than index options, and typically less expense than more traditional active options, can benefit the retirement plan's participants.

Fiduciaries with responsibility for a retirement program need to be aware of the make-up of their target date funds, as well as the investment strategies of their stand-alone funds offered to participants. To discuss further, please feel free to contact PlanPILOT.

Curious to learn more?

Call (312) 973-4911 for more information or visit us at www.planpilot.com

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