Being smart about smart beta

There is a lot less implementation of smart beta than the hype would suggest and **Jassmyn Goh** finds out how super funds are treating the strategy.

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While smart beta is not a new strategy and the hype surrounding it is growing, superannuation funds and institutional investors are only very cautiously looking to implement smart beta into their portfolios.

Super funds and investors have certainly been spending more time thinking about smart beta but mainly in terms of equities with fixed income only slowly coming into play and despite all the time spent on such considerations, there has not been a lot of implementation of the strategy, according to Willis Towers Watson senior investment consultant, Ben Griffiths.

Griffiths said this was because super funds needed to fully understand the factor or factors they were investing in.

"The super fund owns the decision and so it's a lot of upfront work required to get the level of comfort needed and once the superfunds realise that things slow down," he said.

"It's not the same as active management where you delegate that stuff – you delegate the intellectual property, the research, to the fund managers and you can hire and fire the fund manager on that basis.

"With a smart beta product you're taking that effort on yourself, the burden is on your shoulders, you can't hire and fire yourself so much."

The lengthy investigation of the strategy has been a product of super funds looking for a balance between good returns and low cost.

At the same time, super funds have been considering smart beta strategies as a means to find a more efficient way of achieving investment objectives and to alleviate fee pressures.

Northern Trust head of institutional business and strategy for Australia and New Zealand, Bert Rebelo, said super funds that had pension funds with a lot of active managers and had a return target of two or three per cent found that when they put the managers all together they ended up getting a much lower than expected return.

"Super funds are looking to see whether they should reduce the number of managers they use and if there is a

way they can complement that with a factor-based strategy," Rebelo said.

"The other thing that we've been working with clients on is[that] sometimes they'll be looking at factoring strategy based on completion to their current portfolio.

"For example, they might want one of their portfolios to have lower volatility and could put in a single factor overlay to complete the portfolio to make it more balanced and reduce the unintended exposures that they don't want."

Governance

On the time taken to implement a smart beta strategy, Rebelo noted that the super funds that had better governance or a better governance structure would more likely be much quicker at implementation.

"With factors you're making a call around if you want value, or growth, or low volatility, or momentum in your portfolio and if you just hire fundamental managers you're just sort of outsourcing the decision to them," he said.

"But with factors there is a certain level of oversight that comes with implementing factor strategies and I think it requires better oversight, governance, and reporting. The investment committee has to ask 'How is this working? Does it make sense?'."

State Street Global Advisors head of portfolio strategies, APAC, Jonathan Shead, said the governance challenge of who owned the allocation decision had been the biggest challenge with smart beta for the last five to 10 years.

"Most super funds are fairly clear that they own the asset allocation decision in most cases. When they appoint a full active manager they are usually clear that the active manager has full discretion on the securities they are going to include in the portfolio," Shead said.

"Typically we would argue that the trustee owns the decision to gain exposure to value, quality, momentum, or the factor they would like exposure to, and either the fund manager or the index provider then takes responsibility to how that exposure is to be achieved. Being clear on that

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governance question is I think the biggest challenge."

Shead said this had been a challenge for so long because people still looked at performance.

"Value, for example, is one of the factors with the longest history in academic research but it hasn't had great performance over the last few years. Do you blame the manager that has implemented the value based factor? Or do you blame the trustees who chose value?" he said.

"Same as low volatility which has had a good run over the past few years – do you credit the manager or do you credit the trustee for selecting that factor?

"It's very hard to go against the instincts to blame a manager or claim a manager's done a fantastic job when in fact the primary responsibility for good or bad performance of a smart beta strategy may actually rest with the trustee."

Single v. multi factors

Rebelo said because it was still early days for smart beta one of the biggest challenges was deciding how many factors to implement in a portfolio, and then how to monitor and evaluate the performance.

He said very large funds were leaning towards using a single factor because they were worried about combining more than one factor together and did not understand why each factor behaved the way it did as there was more than one factor at play.

"Some industry funds, and not only in Australia but globally as well, may want to take the view as to go down the single factor approach because they may choose to be have more value, or more low volatility, or quality. By going down the single factor it gives the opportunity to adjust how much you want to be in each factor," he said.

However, Northern Trust said they thought the using multifactor approach was the way to go.

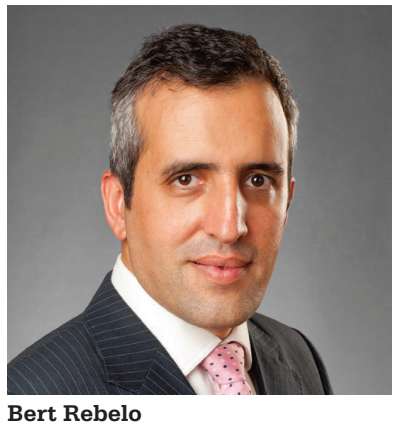
"But if you're very big I think there's an argument to be made that if you go down the single factor you can better manage your portfolio accordingly," Rebelo said.

"A really good way super funds could think about factors is looking at their member base and thinking 'How much risk do you want to take in this portfolio?' and therefore the factors you use depend on how much risk you're willing to take in that portfolio".

AXA Investment Manager client portfolio manager for Rosenberg equities, Patrick Kuhner, said while it was acceptable in the past to use single dimensional smart beta factor investing strategy, the challenge now was to evolve additional insights along these dimensions.

"When we look at our own research and we look along these dimensions we found that by combining multiple risk premia you can do a much better job in delivering an investor outcome, than you can by a single risk premia," Kuhner said.

"One of the challenges for all of us is to help educate and inform and in a sense teach both retail and



Bert Rebelo

institutional investors about the evolving classes of risk premia that are out there and to educate people to understand these risk premia are time bearing – they're not going to work each and every cycle."

He said the challenge for many investors was that they used a certain risk premia because performance had

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been good but the reality was that performance would vary.

"The challenge is to still stay invested when your performance is challenged. Some of the work we need to do as investment managers is helping educate our clients and investors that time varies but you need to stay invested," Kuhner said.

"The time horizons are fairly long, three to five years I would argue, and just to help them not to jump ship when the inevitable underperformance does occur with low volatility, value, or quality factors."

First State Super also believed that that single factor smart beta investing was not best approach.

The super fund's portfolio manager, Eben van Wyk, said: "We are building a platform that will enable us to have a high level of customisation in everything we do and we don't believe in any single factor smart beta investing, we believe in a sensible investment approach or aspects of the exposures you get".

"For example, if you were to invest in a single value factor that exposes you to stocks in distress or were highly illiquid – those stocks don't tend to provide a positive return," he said.

"You want to be focusing on quality stocks and avoid value traps. Our approach is to construct sensible investment strategies based on measureable metrics."

Is it smart beta?

Earlier this year, Willis Towers Watson published an analysis that found that not all smart beta products were created equally and that some were often poorly implemented and seemed naïve about the inherent risks.

The analysis also pointed to the fact that there had been a proliferation of products claiming to be smart beta but were not.

"Some people do things in ways that we don't necessarily agree with and we use our research to help our clients to sort that out, which product they should look at, and what they should ignore," Griffiths said.

"That sort of approach is in the world of single factor smart beta where it is important for clients and fund managers to keep things simple and straightforward in order to keep it cheap, or keep the fee reasonable.

"Some fund managers are responding to this by trying to maintain a certain fee margin by convincing the client that they are getting all the bells and whistles and it's worth it. Whereas in our view it may perhaps not necessarily be worth it."

Griffiths said as all smart beta products were not created equal super funds needed to do all the upfront work before buying a product to have a good understanding of not only the factors involved but also the portfolio weightings being used.

He said there were instances where clients only learnt what they bought and the implications of the product after buying the product.

"Some clients are surprised by how it works and it is also the old classic that past performance doesn't necessarily indicate future performance. Sometimes a strong back test does not always lead to a pleasing performance outcome," Griffiths said.

Shead said the best way to use a smart beta portfolio was to understand what part of the portfolio was giving exposure to value, quality, or low volatility.

"As long as you have a clear understanding of what factor you're gaining exposure to I think that's the most important step, or governance step, for trustees," he said.

"If you lose sight of the factors that you're targeting and why you targeted those factors and the role they play in the portfolio then I think you're in trouble."

Northern Trust said they agreed that there was a proliferation of products that claimed to be smart beta.

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>
> – Damian Graham

"I think a lot of funds claim to be sort of offering a product and the design is not very thoughtful and I think some people they're buying something because they think its low risk but some of the low risk products take huge bets," Rebelo said.

He said when his firm designed smart beta products they made sure it did not take on too many bets on sectors or countries to constrain the amount of sector capturing as a means to avoid unintended consequences.

"We think there are a lot of products out there and we think some of them are not well designed, and people think they're buying something but they're buying something else," he said.

First State Super chief investment officer, Damian Graham, said the issue was more about the fact that any time the portfolio moved away from the market capitalisation based outcome it could increase concentration on an individual security perspective and that needed to be carefully managed.

"For example, if you look at low volatility investing it would traditionally you to hold a lot of utility companies in Australia. The utility sector in Australia is very small and quite illiquid but if you run a very naïve simple approach to low volatility investing you'd probably end up with quite a lot of companies in that space and then the idiosyncratic risk of those companies is higher along with unintended biases," he said.

"This mean that you may get the smart beta that you're asking for but if you don't think about it more deeply and manage it closely you can find yourself with risk you don't want."

Graham noted that this was a reason for building a function internally as it would help reduce the risk of unintended consequences in a portfolio. **SR**