



Everyone wants it,
not everyone can have it:
Is the first-mover advantage of
smart beta already gone?

Leanna Orr reports.

The Smart Beta Tragedy

"Syed—he's God to us."

For this admirer and his peers in the risk-steeped world of alternative indexing, Syed Haque represents a sort of industry-wide angel investor—one who writes \$5 billion checks.

In 2010, Haque, head of global equities for UPS' \$27 billion pension fund, was not inclined to write any manager a check. The cost-conscious organization saw no active manager with a compelling edge, and yet the passive products available fell far short of what they promised. "Say you're looking for an index with frontier exposure," Haque explains. "What typically happens is that you'd get a huge amount of Nigerian stocks and financials. We don't want that. Pure cap-weighted indexes tend to have trend-following characteristics. On the one hand, they are inexpensive and very easy to build. But on the other hand, a cap-weighted product doesn't care about any other risks—especially concentration risk." He cites the MSCI USA consumer staple index as an example: Procter & Gamble, Coca-Cola, and Philip Morris alone account for nearly 30% of its holdings.

"Or consider when BP had the Deepwater Horizon oil spill," Haque continues. "Investors holding the FTSE 100 would have had substantial losses that month. But if you were holding smart beta strategies, the impact would have been minimized. Cap-weighted indexes come with a number of challenges—and most of them are removed by smart beta."

Haque became convinced of this through research and back-testing in late 2010, and UPS moved swiftly. By mid-2011, the fund had begun pulling assets from cap-weighted passive vehicles and reallocating to customized smart beta indexes. Withdrawals from active managers followed. Now, these vehicles house nearly half of the pension's roughly

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\$11 billion equities portfolio. Many institutional asset owners have ventured into the strategy since then, but almost none with such scale and conviction.

Risk nerds have been waiting for this moment. For years—decades—researchers have been expounding the persistent value, volatility, and size premia in equities markets. Standard & Poor's launched the first market capitalization-weighted index in 1923, setting a standard that continues to this day. In 1992 and '93, Eugene Fama and Kenneth French introduced their three-factor model. Between cap-weighted performance (i.e., the market factor), and small-cap and value factors, the authors found they could account for more than 90% of a diversified stock portfolio's performance. A spate of other papers published during the '90s linked low volatility to long-term outperformance and recognized stocks' tendency to maintain past performance—that is, the momentum factor. Still, more than a decade passed between the introduction of the three-factor model and an investible vehicle to take advantage of it.

California-based Research Associates rolled out arguably the first smart beta products in 2005. These indexes—weighted by corporate fundamentals including income, book value, revenue, sales, dividends, and employment—got off to a slow start, according to equity research head Vitali Kalesnik. “We were all alone in the market, trying single-handedly to push for a strategy that was a little bit strange,” he recounts. “Investors don't know how to classify it: Is it active? Is it passive? The financial community is conservative, and for a good reason: It helps investors stay alive. So before the products had a category, selling was difficult.” A few years ago, Towers Watson came up with a name for these nontraditional indexing methods that was as scorned as it was sticky: smart beta.

And for the first time, asset owners began taking more than an academic interest. Low-volatility products emerged at the forefront of smart beta uptake (more on that later). From the end of 2011 through the close of 2013, the 86 strategies in eVestment's low-volatility database swelled from \$22.5 billion in institutional capital under management to \$71 billion. Last year alone, Towers Watson's consulting clients doubled their smart beta investments to \$11 billion worldwide. State Street Global Advisors (SSgA), another major player, recently surveyed 300 institutional investors and found 65% either had allocated or planned to, and just 17% were skeptical of the strategy. UPS may have been in the vanguard, but its peers are catching on.

Smart beta, like outsourced-CIO (OCIO) services, represents a rare and promising area of potential growth for asset management outfits. But perhaps unlike OCIO, substantial research exists suggesting smart beta may be a good deal for asset owners, as well.

Indeed, the world's second largest institutional asset owner contributes substantially to smart beta literature, as well as to risk factor investing more broadly. A 2013 study by two Norges Bank Investment Management analysts back-tested smart beta strategies against a market cap-weighted FTSE global index. The

standard index returned an annualized 4.57% from 1999 through 2012, while an equally-weighted portfolio gained 9.06%, the momentum strategy added 8.92%, an equal-risk index climbed 8.33%, and the fundamentally-weighted strategy earned 7.63%. It's worth noting that these experimental figures do not account for fees: Based on figures from users and providers, cap-weighted indexes cost one or two basis points, while a large institution can expect to pay around 10 basis points on a customized alternative blend. UPS pegged its cost at between six and nine basis points, whereas its active management spend ranges from 40 to 45 basis points for very liquid domestic strategies, and upwards of 100 in less liquid markets.

“Costs have come down a lot over the past five years,” says Felix Goltz, head of applied research at the EDHEC-Risk Institute, a smart beta think tank and index developer. “That said, providers don't offer much information publicly, and the costs will differ among investors. Licensing costs for smart beta indexes should be no more expensive than cap-weighted. With increasing competition, costs have clearly dropped over time.”

Aside from licensing an index from the likes of EDHEC or customizing one, investors can also access smart beta through exchange-traded funds (ETFs). Expect to pay more in fees—although ETF providers also take care of implementation, which index firms leave up to investors. BlackRock's US microcap ETF charges 72 basis points, for instance, whereas value-tilted emerging markets exposure costs 49 basis points via iShares/MSCI. But Haque's critique of off-the-shelf smart beta indexes applies to ETFs, too. With the latter ETF, financials account for 30%, and nearly 70% of its market exposure is from Asia.

In Goltz' experience, custom indexing makes sense for institutions, like UPS, that seek smart beta exposure within specific parameters. “If the institution has a certain liquidity requirement, sector exclusions, or environmental, social, and governance screens, a standard product may not be relevant,” he says. “For example, a corporate pension plan sponsored by a major oil company would likely prefer to avoid over-concentration in that area.”

As Haque and UPS CIO Brian Pellegrino see it, specific parameters are exactly what an asset owner *should* have in mind when shopping for smart beta vehicles. “As a result of Syed's work, I am a big believer in the custom beta exposures,” Pellegrino says, with no small amount of pride. “But you have to be willing to do the work in determining how it fits in the overall portfolio. It's a tool—if you understand it, and understand what's available, it can be useful.”

The question for asset owners is, for how long?

Ask the strategy's two main actors—risk researchers and asset management executives—about smart beta's potential Achilles heel, and you will hear two distinct answers. (One will be much longer.) How both parties depict the scalability of alternative beta tells the story of the tactic: Where it came from, what it offers, why asset owners have only just begun to pay attention, and how providers are finally convincing them to do so.

“When I started my first quantitative portfolio in 1995 or 1996,



I asked our quant that same question back then: Why won't value just get arbitrated away as everyone realizes it's a compensated risk factor?" recounts Matt Peron, Northern Trust's managing director of global equity. "And she very confidently said, 'We're a long way away from that because of the behavioral biases people have.'" He and his team also caution clients to be very selective in terms of what risk premia they're trying to capture. "We believe in value and quality—although a lot of people do quality in a way that we don't think is well-grounded," Peron continued. "Some will just build a smart beta product by doing a screen: We think those products are based on weak engineering. The deficiencies in their approach will be clear... The weaker players will go to the wayside."

Lynn Blake, CIO of global equity beta for SSgA, and Rolf Agather, Russell Investments' head of index development, both say the capacity question is best answered by clients. To Blake, conviction in a smart beta investment thesis entails a belief about why a certain tilt (or tilts) will be rewarded. "Why do I think that these will continue and not get arbitrated away? You really need to have answered that to continue with the investment," she says. Agather puts it more bluntly: "Buyer beware. Investors have to believe in the rationale behind the product, and in some reason why the premia will persist." He points out that Russell provides investors with a specific exposure through their factor-tilted indexes, not a guarantee of outperformance. "I don't know how many providers are making that clear," he adds.

Many in the field suggest that some asset management giants' reluctance to delve into factor-tilted products played a role in smart beta's long delay to market. Firms whose bread and butter was active equity management had little incentive to push lower-cost alternatives. All the big names have entered the game by now, and some have indeed emerged as leaders. Still, it's telling that Research Affiliates—a three-year-old boutique based out of Newport Beach—beat all the big players to the punch in rolling out alternative index products to US markets.

Where corporate asset managers seem to sidestep the possible capacity constraints of smart beta, risk and indexing specialists couldn't be more focused. Kevin Shea, CEO of Disciplined Alpha—a Boston-based shop with a strong research emphasis—foresees implementation issues past about \$300 million in the US microcap space, and in the mid-billions for a value strategy. "When assets flow into value smart beta, this causes cheap stocks to get bid up in price and, by definition, are then no longer cheap. You can, however, run tens of billions in an equal-weighted index fund," Shea acknowledges. "But there is no strategy that enough assets can't destroy."

A US expert in the field, Vijay Vaidyanathan, has been a sounding board for UPS' Haque since he first began exploring the strategy. While serving as president of EDHEC-Risk indices and benchmarks for North America, Vaidyanathan helped build UPS a custom large-cap index. "We started a conversation about whether an emerging markets small-cap index would even work," he says. "You get into capacity constraints so quickly." One of the advan-

tages of a cap-weighted portfolio, the finance PhD points out, is that "if you have exposure to a teeny-tiny company, it's likewise teeny-tiny." Vaidyanathan felt hamstrung in his role as an index provider, unable to act as a proper advisor, which he believes the market needed. So last spring, he and a partner launched Optimal Asset Management, a fund advisory focused on alternative beta. One of their first contracts: Crafting a custom small-cap emerging markets index for UPS.

"We took the universe of relevant stocks and constructed a maximum Sharpe ratio portfolio. After that, we added a minimum volatility screen—but then the capacity problem gets worse." Haque and Vaidyanathan added more screens, filtering to achieve a certain percentage of stocks tradable in two days, for example. The final index includes 800 securities (with only modest exposure to financials, one assumes). "It's the archetypical blend: minimum volatility with a return-seeking aspect," Vaidyanathan notes with a smile. UPS' implementer managed to construct a portfolio nearly identical to the model provided, and returns have likewise mirrored expectations. "Syed and Brian are more engaged than most," the advisor says. "They've executed the smart beta program just like the textbook tells you."

If institutional smart beta investing had a textbook, it would surely open and close with a lecture on governance. Corporate asset managers and risk geeks alike stress this factor in successful implementation. "Institutions will appear to have the necessary incredibly long-term view, but often they don't," says Russell's Agather. "They have boards, perception risk, and cap-weighted benchmarks. These strategies can underperform for years before turning up factor premia. If you held value in the '90s, you looked stupid." The UPS CIO sounds a similar warning note: "The caution for our peer group is that we run a benchmark-agnostic portfolio—absolute return. So if your measure of success is beating a large cap-weighted index, sometimes it's going to work for you, and sometimes against."

One technique for making smart beta more benchmark-friendly is just gaining traction, but shows promise for motivated institutions: holding a basket of products with different factor tilts diversifying performance risk, as each tends to thrive and fail in different environments. MSCI has recently rolled out a suite of indexes intended for mix-and-matching, and SSgA is likewise promoting the strategy.

A looming threat over a group of first-movers may be the ultimate advertisement for diversified baskets—or smart beta's downfall. Low-volatility products attracted tens of billions in capital over the last few years, inflating asset prices and prompting whispers of the "b-word". "Min-vol has gotten expensive," says Vaidyanathan. "It's been so popular, and the speculation is that prices have been bid up. For many people, smart beta equals minimum volatility. I fear that they will be disappointed and give up on it entirely, sticking to just cap-weighted passive and active management in the future. But it's like music. You are doing yourself a disservice if you believe there are only two kinds: classical and rock 'n' roll." ■