Q&A WITH QMA

How Smart is Smart Beta?

April 2018

AUTHOR

Stacie Mintz
Managing Director and Portfolio Manager
QMA's Quantitative Equity Team

ABOUT QMA

Serving investors since 1975, QMA targets superior risk-adjusted returns by combining research-driven quantitative investment processes built on economic and behavioral foundations with judgment from experienced market practitioners. Ultimately, each portfolio is constructed to meet the individual financial needs of the client. An independent boutique backed by the capabilities of one of the world's largest asset managers, QMA is the quantitative equity and global multi-asset solutions business of PGIM, the global investment management businesses of Prudential Financial, Inc. As of 3/31/2018, we manage approximately $128 billion in assets for a wide range of global clients.

FOR MORE INFORMATION

To learn more about QMA's quantitative equity capabilities, please contact Gavin Smith at gavin.smith@qmallc.com or 973.367.4569.

QMA a PGIM company

The rapid growth of smart beta strategies in recent years has provided our clients with a powerful new tool in their search for better returns, but it has also sowed quite a bit of confusion. Here, ***Stacie Mintz****, portfolio manager for the Quantitative Equity team, answers the questions on many of our clients' minds.*

How do you define smart beta?

Smart beta is a rules-based way to gain access to certain exposures believed to drive investment returns. It typically offers exposure to common factors – such as value, growth, quality, momentum, volatility and size – that have been identified as potential sources of incremental expected returns beyond the traditional equity risk premium.

The way these smart beta portfolios are built is usually straightforward and relatively transparent. In a price momentum exchange-traded fund (ETF), for example, it can be as simple as calculating momentum over the trailing year for the largest 1,000 stocks in the US, picking the top third, and combining them in a particular weighting scheme. Then, for the next six months that's your portfolio.

Portfolios are not necessarily cap-weighted. They may be equal-weighted or weighted on some other metric such as dividend yield or revenue growth. (In fact, such weighting differences have often been the primary driver of their "outperformance.") They also tend to be rebalanced on a predetermined schedule, typically quarterly or semi-annually, which is spelled out in the description of the smart beta product.

How does that compare to what you do in many of your strategies at QMA?

It's really a spectrum: At one end are the simplest smart beta products with exposure to a single factor targeting a particular investment universe. These strategies sometimes take large unintended bets relative to the applicable benchmark. In the middle are approaches involving a few different factors, usually combining the holdings of several single-factor exposures, again targeting a particular universe. Like the simpler products, these approaches often take large unintended market bets.

At the other end of the spectrum is what we do as an active quantitative manager. That is, we use factors at the individual stock level, in more nuanced combinations, to

construct portfolios that are carefully managed to – and have the goal of consistently outperforming – a targeted benchmark.

Part of this more nuanced exposure involves using factors differently for different types of stocks, or for different sectors or countries around the world. Or we may change the weight of those factors as we move through time depending on how expensive we think they are.

We also tend to focus more on alternative sources of data and on how all of these types of factors work together in a strategy. An example of this alternative type of signal is one we just added to our US Core strategy. It looks at the earnings call transcripts for companies on a quarterly basis and uses software to read the text and score the call for changes in tone that complement our traditional growth factor. This kind of signal, based on unstructured data and text recognition, is the kind of factor exposure you'd be hard-pressed to find in a smart beta strategy.

In addition, when building a portfolio, we don't just focus on the factors we want to target but on mitigating other risks. If you invest in a momentum smart beta ETF, you may have a very heavy overweight to whatever industry or sector did well the prior year. In accepting that momentum exposure, you're also accepting the risk that comes with it. We consciously minimize any unintended exposures as part of our effort to consistently outperform. We also do not rebalance on a predetermined schedule. Instead, we are more flexible and opportunistic in how we maximize the alpha potential of our portfolios. That way we can minimize our trading costs at the same time. Lastly, we place a premium on research, so all of these processes tend to evolve over time.

What about cost? Isn't smart beta cheaper?

Yes, generally it is, especially at the simplest end of the spectrum, particularly regarding fees. But there is also a surprisingly large dispersion of fees across smart beta ETFs.

However, there may be other costs associated with smart beta. For example, active quantitative managers pay a lot of attention to trading costs. So we are constantly focused on how much of each stock we are buying and selling and in which part of the market cap spectrum since the associated trading costs affect the total return of the fund.

With smart beta, controlling trading costs can be more difficult. If a fund is not cap-weighted, more trading will generally be required at rebalancing because with a cap-weighted strategy more of the positions tend to move up or down more in the direction of the market. Because that rebalancing occurs on a predetermined and publicly available schedule, there can also be a tendency for abnormal price movements before and after the rebalances.

We've actually done some research on this. What seems to be happening is that because these strategies are so transparent, some people are taking advantage of knowing what the funds are about to buy and sell, and are front-running these trades. So, even though the fee may be low, investors may not be getting the best prices for the stocks in the portfolio.

So, is smart beta smart?

It can be, *if* you know how to use it and know what the risks and real costs are. Smart beta can be a good low-cost way to get a desired factor exposure into your portfolio. If you're a plan sponsor looking to quickly increase your exposure to value, a low-cost ETF that targets "cheap" stocks can be an effective way to accomplish that objective. Or maybe you've built a portfolio of managers you're happy with, but in doing a top-down evaluation you realize you are uncomfortable that your aggregate exposure to momentum is negative. In this case, you can tactically buy a momentum ETF as a completion strategy without upsetting the balance of your roster or going through an intensive manager search. In each of these instances, smart beta can be a smart way to act on the investor's own market intelligence and convictions.

But I think one of the most interesting uses of smart beta may be as a new reference point for what we as active managers do. Active managers are used to comparing their performance against indexes like the S&P 500 or Russell 2000® Value Index. But now a lot of investors are asking, "Can I replicate my current manager's alpha and beta using these ETFs at a lower cost?"

In doing this analysis, it is important to realize that the exposures offered by smart beta may be quite different than you think they are, especially when you are using them in combination with traditional beta exposures. Large sector or size bets will often be the biggest drivers of relative performance, especially versus an active manager that targets attractive factor exposures while minimizing such untargeted and unintended bets. Even so, if in comparing an active manager to a smart beta portfolio, investors see that all the active manager is doing is delivering its "alpha" through simple factor tilts that can be easily and cost effectively replicated and managed, then they are right — they may be better off with some mix of smart beta and the market index.

On the other hand, if the manager can show that the alpha he/she is delivering provides better performance and risk management than simple factor tilts even *after* any difference in fees, then the case for active management is even more powerful. In this context, smart beta, if used carefully, becomes a powerful new frame of reference for helping clients determine the success of the active strategy.

In summary, smart beta strategies can provide valuable options to satisfy a variety of investment requirements. However, investors ought to properly understand exactly what these products offer in order to truly recognize both their benefits and their limitations. Smart beta investors need skills to succeed. By choosing to make their own investment decisions, they are taking on performance risk that renders them increasingly accountable. Active quant managers offer more complex investment solutions, with a higher potential for alpha on a more consistent basis, *and* they take full accountability for performance relative to the index benchmark. Ultimately, smart beta and active quant strategies present different factor-investing options, which potentially solve different problems for different investor needs.