Dumb happens.

Fundamental Indexes Claim to be Smart Beta, but Some are Dumb.

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Kudos to Rob Arnott for coining the phrase "Smart Beta." Everyone wants to be smart. Indexes that use fundamental weightings, rather than capitalization weightings, are deemed to be smart by Mr. Arnott because they are predicted to perform better. For the first time ever, we have indexes that are designed to outperform. All other indexes are designed to match the performance of an entire market or a market segment.

Fundamental (smart beta) weights typically tilt toward value and smaller companies relative to their cap-weighted counterparts, and this tilt has a track record of performing better, so it may indeed be smart. Fundamental indexes are usually created for broad markets, like the U.S. or Europe, but PowerShares recently introduced fundamental style indexes called "Fundamental Pure Style Indexes", or FPS.
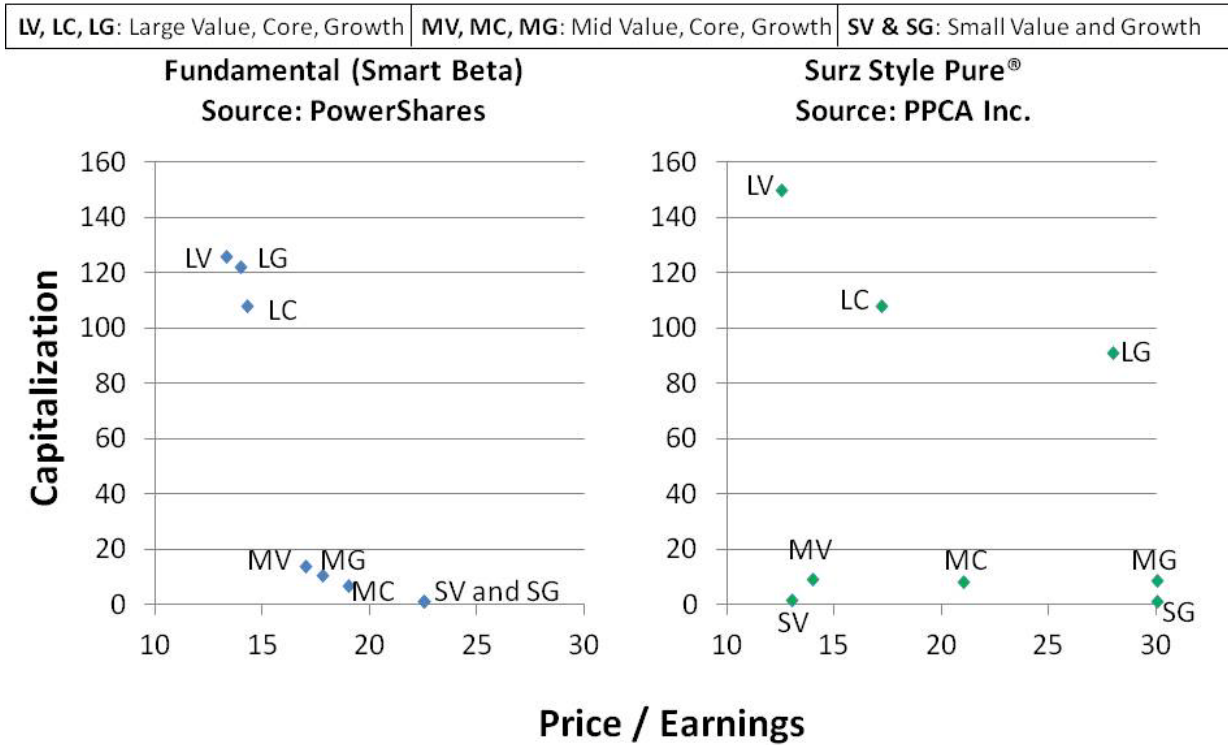
Smart

FPS indexes are indeed smart on one important count. They are mutually exclusive and exhaustive, mirroring the familiar 3 X 3 structure of the Morningstar style indexes, which are derived from the Surz Style Pure® indexes I developed in the 1980s. Mutually exclusive and exhaustive is smart for both returns-based and holdings-based style analyses, and also for portfolio construction. They make good building blocks. There are only three such families of style indexes: FPS, Morningstar and Surz.

Not so Smart

Style indexes are used in portfolios as completeness funds and to make style bets, like style rotation approaches. They are used in tandem with other investments, like active managers, to add value. As such, you'd prefer your indexes to be different from one another. Therein lies the flaw in FPS. The FPS indexes are tilted toward value, so they are more clustered than Surz Style Pure indexes, as shown in the following exhibit. Also, FPS core is not in between value and growth, which is puzzling.

Style Index Comparisons
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| **LV, LC, LG**: Large Value, Core, Growth | **MV, MC, MG**: Mid Value, Core, Growth | **SV & SG**: Small Value and Growth |

Fundamental (Smart Beta)
Source: PowerShares

Surz Style Pure®
Source: PPCA Inc.

FPS might beat my indexes on occasion, but they don't provide the benefits that most expect from style indexes, namely completeness or style concentration. The fact is that the FPS value-core-growth indexes are almost identical. The value tilt pushes them all to the left, toward value.

Conclusion
Sometimes a good idea has its limitations. Extending fundamental weightings to style indexes is not a good idea. Value-tilted growth is not that smart.