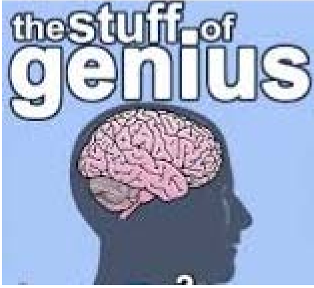

Smart Betas Brain Drain Active Managers while Smarter Betas Empower Them

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Knowledge speaks, wisdom listens Jimi Hendrix

Fundamentally-weighted indexes were introduced by Robert Arnott in 2004, and have come to be known as smart beta indexes because they are professed to outperform the market, as represented by traditional capitalization-weighted indexes. Hundreds of $Billions have flowed into smart betas, but some of that money would be better placed in new improved smarter beta indexes. Smarter beta indexes can beat the market too, plus smarter betas complete active managers, rounding out investment portfolios. Smarter betas are designed for active-passive investors rather than all passive. You need to determine how smart your beta should be.

Fundamental (smart beta) weights typically tilt toward value and smaller companies relative to their cap-weighted counterpart, because this tilt has a history of performing better, so it may be smart. The future will tell us how smart this actually is. Fundamental indexes are created for broad markets, like the U.S. or Europe; they are total market indexes.

Even Smarter Betas

Because smart beta indexes encompass entire markets, they are not intended to be used in conjunction with active managers. If smart beta indexes are combined with active managers they dilute active manager decisions by adding stocks active managers don't want to hold. Furthermore, they tilt the entire portfolio toward smaller company value, potentially undermining portfolio structure, especially growth allocations. Smart beta indexes play a specific role that does not involve active managers.

By contrast, smarter beta indexes complement active managers by serving as smarter core in core-satellite portfolio constructs -- it's even smarter than smart beta in this situation.

The smarter beta index is created by identifying the stocks that lie in between value and growth – the stuff in the middle – and by allocating to them using fundamental weights rather than capitalization. The stocks in the middle are organized into economic sectors like technology and utilities, and assets are allocated to these groups at market weights. This eliminates sector bets. Then within sector groups, each stock receives an equal allocation, which is fundamental weighting.

The benefits of smarter beta indexes are enhanced diversification and higher returns, which seems too good to be true, so here's how these benefits are produced. Diversification is enhanced by adding stocks that active managers usually don't hold because they don't fit value or growth mandates; these are good companies that are simply overlooked. Higher returns are generated by replacing an existing core with the smarter beta core because smarter beta core does not dilute active managers. This higher return expectation is based on the belief that the active managers actually add value, which seems right since they wouldn't be hired if that wasn't the belief.

Conclusion

Sometimes a good idea has its limitations. When it comes to betas, you need to choose the smartness of your beta carefully. Standard smart betas don't play well with active managers. New improved smarter betas are much friendlier playmates. Or put another way, if your investments are entirely passive, smart beta indexes may be for you. But if you use active management, you need a smarter beta index.