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Commentary: Demystifying smart and alternative beta

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The proliferation of quantitative strategies indicates investors increasingly recognize the benefits of using data and technology and applying a scientific investment approach to generate returns. Advancement of this kind led to the emergence of a "new" beta category and means the investment universe no longer divides neatly into funds that seek alpha or beta. Similarly, the nomenclature used to define the strategies has become indefinite. Unfortunately, the blurring of strategies and terms has led to confusion and frequent conflation of two distinct strategies: smart beta and alternative beta.

It is critically important the investment community better understands the difference between smart beta and alternative beta because they aim to deliver markedly distinctive risk-and-return profiles and, accordingly, serve different purposes in an investment portfolio.

This article clarifies the two categories with respect to investment objectives, implementation and fees. The comparative analysis focuses on equity-based strategies, but the arguments presented are asset class agnostic. Ultimately, this comparison intends to help investors make well-informed investment decisions.

Investment objectives

Smart beta and alternative beta strategies exploit a similar set of factors, often behavioral return anomalies such as value or momentum, but use them to generate entirely different return streams.

Smart beta strategies are generally designed to provide exposure to equities with a higher Sharpe ratio — that is, a better risk-adjusted return — than conventional, market capitalization weighted indexes. It attempts to achieve this by constructing portfolios based on factors that have empirically shown higher Sharpe ratios than those using market capitalization. Ultimately though, performance of many smart beta strategies closely correlates with equity markets, and thus much of their risk and return is driven by the market. Figure 1 shows the result based on a set of popular funds.

Alternative beta strategies, in contrast, are designed to exhibit almost no correlation to equity markets to provide a "pure" exposure to the factor they are attempting to exploit. They should have little to no beta exposure to equity markets and, ideally, target a specific level of volatility that is independent of the volatility of equity markets. As such, their expected Sharpe ratio should be higher than that of the market.

The strategies' distinct objectives mean they tend to fall into different allocation buckets within an investor's portfolio. Smart beta strategies behave like an equity investment and typically fall under the long-only, growth portion of a portfolio. Alternative beta strategies, in contrast, are largely uncorrelated to equities, so they are often viewed as an absolute-return strategy and a diversifier within a portfolio.

Figure 1

Correlation, beta and risk exposure to the S&P 500

Calculated using weekly data, for a selection of Smart Beta funds. Risk exposure is calculated as the fraction of variance explained by the S&P 500. Analysis does not take into account distributions.

Strategy	Starting date	Correlation to S&P 500	Beta to S&P 500	Portion of risk (variance) explained by the S&P 500
iShares MSCI USA Momentum Factor ETF	Jan. 2012	91%	0.98	82%
iShares MSCI USA Minimum Volatility ETF	Jan. 2010	90%	0.72	81%
Russell 1000 Growth Index	Jan. 2000	96%	1.04	92%
iShares MSCI USA Quality Factor ETF	Jan. 2012	98%	0.99	95%
DoubleLine Shiller Enhanced CAPE	Jan. 2012	96%	0.97	92%
iShares MSCI USA Size Factor ETF	Jan. 2012	89%	0.82	80%
iShares Select Dividend ETF	Jan 2002	96%	0.91	93%
iShares Core High Dividend ETF	Jan. 2010	86%	0.68	73%
iShares Core Dividend Growth ETF	Jan. 2013	97%	0.92	94%
iShares MSCI USA Value Factor ETF	Jan. 2013	92%	1.03	84%
Russell 1000 Value Index	Jan. 2000	96%	0.98	93%
PIMCO RAE Fundamental Plus	Jan. 2004	82%	1.17	68%
Average		**92%**	**0.93**	**86%**

Source: "3 Things to Know About Smart-Beta Funds," Wall Street Journal, October 4, 2015

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Implementation

Smart and alternative beta strategies differ in their implementation.

Generally speaking, smart beta strategies are constructed as long-only portfolios meant to provide exposure to equities by following indexes constructed by weighting that is different from those weighted by market cap. They buy stocks and avoid derivatives and other financial instruments with embedded leverage. Some of the more sophisticated smart beta strategies will attempt to neutralize sector biases that can be associated with certain market phenomena, such as the low volatility factor that tends to overweight utilities. Like traditional market capitalization indexes, smart beta strategies are often rebalanced based on a fixed, periodic basis, so in between rebalancing dates, exposures to market factors can vary.

Alternative beta strategies are constructed as long/short portfolios to have minimal beta exposure to equities, meaning leverage is typically used to meet return and risk targets. As such, alternative beta strategies will not only buy stocks, but also derivatives and other financial instruments with embedded leverage. Implementing a long/short portfolio means shorting equities, which requires experience with prime brokerage agreements, margin requirements, financing costs, and an understanding of true levels of short interest and availability. Alternative beta strategies often have a higher turnover because they typically target a constant risk and often reassess both signals and risks daily, based on the market environment.

Fees

Smart beta strategies are ostensibly cheaper than alternative beta strategies. However, a comparison of fees without consideration for the desired outcome for each strategy is overly simplistic.

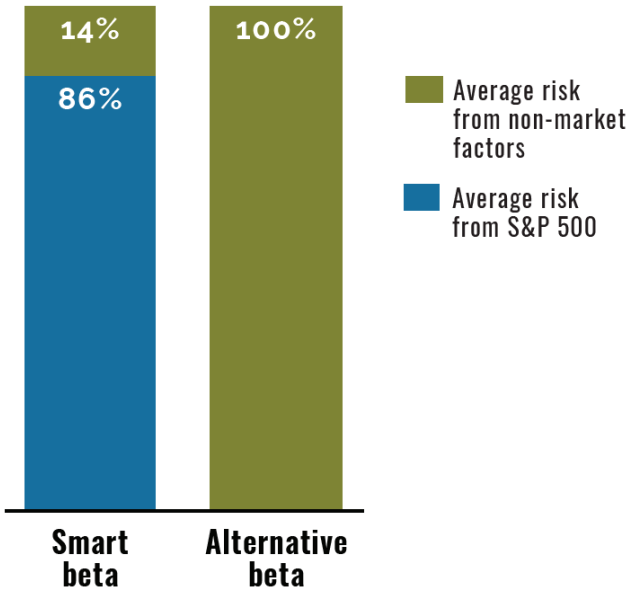
Most of the risk and return for smart beta strategies comes from equity markets, in our example the S&P 500. The "active risk" component, that is, the risk from the smart beta component, is much smaller.

Bear in mind, in today's marketplace of financial products, investors can source passive exposure to the market risk through low-cost index funds and exchange-traded funds for basis points. Figure 2 shows that, based on our previous sample of smart beta funds, 86% of the risk is explained by the market or S&P 500 and only 14% is explained by the active bet on certain factors. In contrast, nearly all of the risk for typical alternative beta strategies should be derived from non-market factors. Once the fees are normalized by the amount of risk from non-market factors, they appear to be more comparable for smart and alternative beta strategies.

Conclusion

Smart beta strategies seek to provide a higher Sharpe ratio than traditional, market-capitalization indexes. In contrast, alternative beta strategies are absolute-return strategies, historically used by hedge funds to provide diversification. Their different investment objectives and implementation requires a different skill set from the investment manager.

Figure 2 Risk decomposition for smart beta and alternative beta



Source: CFM

Although smart beta strategies appear to be cheaper, investors would be wise to examine fees in the context of the risk exposure and return profile they are seeking. We would argue that when the fee is normalized by the amount of risk from the smart beta component, the costs of the two strategies are comparable.

As institutions continue to invest in quantitative strategies and examine the merits of smart and alternative beta, it is our hope that investors will better understand the two strategies, what they aim to deliver, how they fit within a portfolio's construction, and, ultimately, make more informed investment decisions.

Philippe Jordan is the New York-based president of Capital Fund Management. This article represents the views of the author. It was submitted and edited under Pensions & Investments guidelines, but is not a product of P&I's editorial team.