Some days it feels as though you can’t open a copy of your favorite financial journal without hearing some mention of “smart beta” or one of the many other names it goes by. Personally, I am not a fan of the term smart beta but use it in this article for simplicity. While the benefits have been touted exhaustively (e.g. lower costs, compelling historical performance, and transparency), the majority of investors I come across continue to ask the question—“How do I know if smart beta is right for me?” Rather, let me turn the question around and argue that the more relevant question is, “Am I right for smart beta?” This I believe is a more useful way of framing the problem.

First off, let’s begin with a broad definition of smart beta. Here, I take it to mean any rules-based process for creating non-market cap weighted portfolios. Smart beta strategies should be managed as index funds and fully transparent, thus retaining the usual benefits of passive management such as transparency, objectivity, and low costs. Managers charging active fees for proprietary strategies that utilize smart beta concepts are not smart beta managers, just traditional quant managers!

This definition of smart beta may seem like just an extension of passive investing. However, smart beta also shares an aspect with active management in that it entails an active decision by the investor to hold certain types of stocks based on investment judgment and beliefs. The decision to over-emphasize securities with certain attributes like low valuation or low cap size should be made on the basis of an investment thesis—either because one believes it is a source of systematic risk or because it is a mispricing anomaly that can’t easily be arbitraged away. Smart beta may not be active management but it does involve active decision-making and the risks such decisions entail.

Thus, whether an investor is right for smart beta strategies depends on two criteria. First, the investor should have an investment thesis and a conviction about the underlying sources of return that smart beta strategy is designed to capture. If it is low valuation, for instance, the investor should have an answer to the question, “Why do value stocks outperform over the long run?” Second, the investor should have an investment horizon long enough to withstand any short-term periods of underperformance that can and will inevitably occur. Smart beta strategies certainly have underperformed asset class benchmarks in some periods because the underlying investment exposures have not always been in favor.

If this way of thinking seems eerily similar to asset allocation, it is no accident. There are strong parallels with the decision to invest in equities, bonds, real estate, currencies, etc. In the same way investors must assess their investment theses, objectives, constraints and horizons when allocating across asset classes, the same process should be applied to smart beta. And, just as they have to form expectations about asset classes—or at least have a belief they will generate returns relative to some benchmark—investors need to do the same for smart beta strategies. Moreover, asset classes too can go out of favor. Investors have long learned that short-term risk is unavoidable in any single asset class.

Why is there ongoing confusion surrounding smart beta? The confusion stems in part from the fact that smart beta is not just
an asset allocation decision but also a way of getting exposure to a particular asset class. Imagine an equity CIO who has made a decision to allocate a certain amount of capital to international developed equities. That CIO has the choice of employing a traditional passive market cap weighted portfolio, an active portfolio, and now, a smart beta portfolio.

Before there was smart beta, the CIO had to decide whether he or she believed active managers could add value after accounting for fees. If yes, the CIO would select an active manager. If not, he or she would select a passive manager to track the broad benchmark.

Today, smart beta provides a third way to get exposure to a particular segment of the market. The decision for the equity CIO is no longer as simple as deciding whether active management can add value. Now, it must be determined whether smart beta is a better fit for the institution relative to both the existing active and traditional passive options from a cost perspective and a performance perspective. Moreover, as I’ve just argued, ideally the CIO, with the investment board’s backing, would also have formed a coherent set of investment beliefs surrounding that smart beta strategy. A daunting task for anyone!

We can view smart beta then as a hybrid of both an implementation/manager-selection decision and an asset allocation decision. This uniqueness may explain why smart beta has not been adopted as rapidly as it should, given its compelling benefits. The third and final pre-requisite for smart beta investing then is whether the investor is willing to think beyond the traditional framework of asset allocation and manager selection.

Our discussion highlights the importance of each investor asking the question, “Am I right for smart beta?” rather than “Is smart beta right for me?” There is an old adage “If we can’t be honest with ourselves, who can we be honest with?” The more honest investors can be about their ability to form the necessary set of investment beliefs, set an appropriate horizon, and think outside the standard framework for investing, the better they can answer this question. While these challenges are not trivial, the potential benefits of smart beta to investors could be significant.

While I have put the onus in the article on the investor, we researchers in the smart beta space can clearly do more in providing clarity around the topic. We should strive to provide more information and guidance around what drives the performance of different smart beta strategies and what the real risks are. We should think about how smart beta strategies should be integrated into existing portfolios and what criteria could be used to evaluate them relative to existing investments.

There are also important implementation issues being addressed, such as how to construct portfolios of multiple smart betas (taking advantage of diversification in a similar way to asset class allocation), how to benchmark such strategies and how to manage the risk of these strategies. And of course, similar to asset class allocation, there is great curiosity around how to tactically time the different factor strategies. All of these open questions promise that this will be an exciting area of research for some time to come.