In defense of smart beta

Keith Goddard | Capital Advisors | 10 June 2015 |

In a recent article, Why Smart Beta is Really Dumb, Michael Edesess encouraged investors to be skeptical of the growing number of factor-based investment strategies being marketed under the moniker of "smart beta". While I applaud Edesess's call for skepticism, I am compelled to play the role of public defender and cross-examine his accusations.

To set the stage for this mock trial, I will acknowledge that Edesess, representing the prosecution, has a strong case against my "client". Furthermore, within the privacy of attorney-client privilege, I am aware that smart beta is guilty of some of the charges against it - particularly, the charge of exaggerating its benefits and over-promising future results. Therefore, my strategy for this trial is to seek a plea bargain.

My client will agree to plead guilty to the charge of exaggerating its virtues in return for having all other charges against it dropped.

As the defending attorney, my first objective is to establish my client as an honorable character. The prosecution would like you to believe that smart beta is "all spin with no substance" - a scheme for charging higher fees. This is too harsh. There are numerous smart-beta strategies that offer real solutions for investors at a very reasonable cost.

For example, the defense submits as evidence dividend-weighted indexes. These factor-based strategies deliver efficient access to dividend income from a wide range of geographies and market cap slices. This innovation is particularly helpful today because central bankers seem to believe that bonds don't need to offer income to attract investor capital. The defense also submits factor-based indexes for fixed income as evidence of the defendant's character. These products help investors avoid over-weighting the most heavily indebted companies and/or countries in the fixed-income markets. This frequently occurs with traditional market-cap weighted indexes.

Please note, for the record, that neither of the examples above depends on a back-test study to define its purpose. Investors can easily understand the value proposition of a dividend-weighted stock index or a factor-based bond index without a slick presentation of back-tested data.

I bring this to the court's attention because the prosecution has accused my client of data mining without a theory. Indeed, the prosecution included the following quote from economist Fischer Black in the materials for this trial: "Lack of theory is a tipoff: watch out for data mining!"

In response to this charge, the defense hereby submits the theory of Rational Belief Equilibrium. The defense will demonstrate to the court that Rational Belief Equilibrium provides appropriate theoretical support for many of the empirical studies the prosecution claims are only "promiscuous data mining".

In the interest of time, here are the key points of the theory:

- Market prices are frequently wrong because investors cannot calculate the joint probability distribution of all possible future outcomes needed to determine the present value of an investment asset;
- All investors make mistakes, even the most intelligent and rational;
- Investor mistakes are often correlated because we share the same media, network in common social circles, employ similar valuation models and incorporate common biases into our processes for measuring value in the asset markets;
- The prevalence of correlated investor mistakes causes asset prices to overshoot their longer term average value in both directions from time to time;
- Overshooting asset prices reveal themselves in the historical record as bull and bear market cycles – booms and busts;
- Bull and bear market cycles exhibit a statistical property, serial correlation, or “memory";
- Systems that exhibit serial correlation are not entirely random; and,
- When a system is not entirely random, knowing something about the state of the system today can offer predictive value about the probable range of outcomes in the future.

Many of the smart-beta products my client offers seek to exploit overshooting prices in the asset markets. These products do this by systematically over-weighting specific market factors that demonstrate a correlation between measurable pre-conditions and subsequent outcomes in a given asset market.

The defense submits for evidence two specific examples of these factors – valuation and momentum. These two factors have been studied extensively for decades by professional investors and throughout academia. The prosecution would like you to believe the extensive literature on these two factors is mere data mining. My client objects because the studies that support value- and momentum-based strategies are fully compatible with a credible theory of how asset markets work in the first place (i.e. Rational Belief Equilibrium.)

To the extent that overshooting prices are a dependable characteristic of asset markets, as the theory of Rational Belief Equilibrium suggests, then there should be opportunities to exploit this characteristic through systematic trading rules. The empirical studies my client uses to identify these trading rules are simply an effort to validate theoretically grounded expectations with actual historical data. This is not a crime.

Unfortunately, my client cannot claim innocence for every charge against it. Like many profit maximising enterprises, my client failed to adequately supervise its marketing department, resulting in exaggerated claims of superiority for smart beta where no such superiority in fact exists. Upon deeper reflection, my client recognises that its tendency toward over-hyping its virtues begin with the moniker it uses to describe itself - smart beta. The word "smart" implies that other forms of beta-capture must be something less. My client is remorseful for this lapse in professional courtesy.

As I have demonstrated to the court, the virtue of smart beta is not about superiority over something else. Its virtue is diversification. Thanks to the efforts of my client, investors seeking income from the equity asset class have multiple low-cost vehicles at their disposal to achieve this objective. Passive investors in the global fixed income markets can reduce their exposure to the most heavily indebted credits within the primary bond market benchmarks. Investors who believe in the tendency for asset markets to overshoot can exploit this dynamic multiple ways. They can select products with a factor tilt toward value to exploit overshooting prices to the downside. For upside overshoots, there are multiple products with a factor tilt toward momentum. Creative investors can combine multiple factor based strategies into a comprehensive portfolio design.

In closing, your honor, my client stands before the court with an offer to the prosecution for a plea bargain. To the charge of over-hyping its virtues, my client pleads guilty. On all other counts, the plea is innocent. In return, my client respectfully requests a suspended sentence, a modest fine and six weeks of pro bono financial counseling as community service.

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