INVESTMENT

# A smart move

**Sandra Haurant explores why European pension schemes are increasingly turning to smart beta investment**

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Smart beta, also referred to as factor investing, is a term that covers a range of investment strategies. Instead of making investment decisions based on the way in which separate asset classes or individual securities behave, a smart beta strategy takes into account the underlying factors that might affect performance.

"Factor investing is most commonplace in equity portfolios, but does not need to limit itself to equity investment," explains Aon Hewitt senior partner and EMEA head of investment John Belgrove. "Although there are arguably hundreds of variants, the most popular factors remain focused towards value and minimum volatility followed by momentum, quality and size. Our preference is to diversify across multiple factors."

## Gaining ground

Smart beta, once quite a niche area, has been gaining ground since the financial crisis in 2007-2008, when the importance of controlling risk became alarmingly clear. In the decade that has passed, the approach has edged its way into the mainstream. According to FTSE Russell's fourth annual global smart beta survey, published in May 2017, the percentage of asset owners reporting an existing smart beta allocation has reached 46 per cent, up from 36 per cent in the previous year, a rise which sees the continuation of a three-year trend.

Europe continues to be particularly enthusiastic in its adoption of smart beta; some 60 per cent of asset owners said they had an allocation, with the sharpest increase found among asset owners with between $1 billion and $10 billion assets under management. FTSE Russell managing director of North America research Rolf Agather says: "Our fourth annual smart beta survey demonstrates asset owners have readily adopted smart beta indexes and continue to evolve their strategies based on these indexes. Asset owners and consultants continue to increase their understanding of smart beta and are now harnessing the full spectrum of smart beta tools available."

One reason interest in smart beta continues to gather momentum is that it offers something different to 'traditional' actively-managed funds, and yet something quite apart from passive index trackers too. "These funds are marketed with the advantage that one can access out-performance of an index over the longer term in a very systematic way with lower fees than an active manager," says PiRho managing director Phil Irvine.

Instead of trying to beat a given index, smart beta aims to bring about a diversification that will reduce correlation, so that, simply put, when one area goes down, another will go up. Irvine says: "The majority of low tracking error, active funds have struggled to beat or match the index. However, given very low bond yields and low expected returns, then there is demand to access higher returns at low fees. Smart beta seems to be a solution here."

## Passive or active?

Smart beta, unlike classic actively-managed funds, is largely process based. And yet, says Irvine, these funds are not exactly passive either: "This area is often marketed as a bridge between active and passive. My own view is that all smart beta funds have a large degree of individual manager input in how the strategies are actually implemented in the first place. That is there is a lot of 'active' skill in setting up the smart beta fund in the first place."

Belgrove adds that the "process-driven nature" of factor-based products may lead people to the conclusion that smart beta makes them somewhere between passive and active. However, he says: "All factor investing is active investing. Factor investing versus passive investing is not an 'either/or' decision, in our view."

Indeed, Principal Global Investors managing director, equity portfolio manager Mark Nebelung says emphatically that, in his opinion, smart beta should not be seen as a bridge between active and passive strategies. "It is merely the unbundling of traditional active quantitative investment management," he says. "What that provides asset owners is transparency, the ability to more tactically manage their risk premia exposure, and to do this all at lower fees than what they would have paid an active quantitative manager providing a bundled solution."

A smart beta strategy, after all, involves a less hands-on approach than a traditional active strategy, and this has clear advantages when it comes to cost. "Smart beta is less complex than full-on active management, and therefore cheaper to implement and cheaper from a management fee point of view, though not as cheap as plain-vanilla passive management," says Candriam global head of financial engineering Kristof Woutters.

But while smart beta appears to offer some value for money solutions to problems frequently faced by pension funds, there are, of course, challenges.

## Challenges

AQR Capital Management Europe principal Christopher Palazzolo says: "Unfortunately, not all smart beta strategies are 'created equal,' and the devil is in the detail. Like most investment strategies, there are many decisions that a manager must make in terms of how to define, weight, measure, rebalance and trade a portfolio."

"Collectively, we may label these decisions 'implementation', and there can be either improvements or degradations made to the portfolio in implementation. Therefore, there is a significant responsibility thrust upon smart beta investors to perform adequate due diligence in the space to better understand these implementation details and how they may vary across products."

**_[SMART BETA]_ OFFERS SOMETHING DIFFERENT TO 'TRADITIONAL' ACTIVELY-MANAGED FUNDS, AND YET SOMETHING QUITE APART FROM PASSIVE INDEX TRACKERS TOO**

What's more, Belgrove adds: "The primary challenges relate to performance depending on market conditions. Value for example, although having a strong long-term case of delivering better returns can 'underperform' relative to cap-weighted both substantially and for very long periods of time, which will test most governance structures and decision takers."

A factor has the potential to both outperform or underperform the market, and this in itself can be a challenge. Just as selecting the right stock or the right index is crucial to performance, so it selecting a factor that will deliver.

Increasingly, says Belgrove, investors face the agony of choice in this area. There are more and more options available, and selecting the best of the bunch is becoming increasingly difficult. "The sheer proliferation of products can overwhelm investors and make it hard to differentiate between academically, robustly researched and implemented products versus opportunistic data-mined products jumping on a bandwagon of client interest."

There is, then, pressure on pension funds to ensure they are make the right decisions in what is shifting from a niche to a crowded marketplace. Even so, the smart beta approach does appear to be taking hold as a more or less mainstream strategy, with the trend for take up firmly moving upwards. It is no longer an approach reserved for the few.

Belgrove says: "*[Smart beta funds]* are more mainstream now, but we think are likely to grow further to become core in time. We think factor strategies based on robust academic research will provide better outcomes for investors than cap-weighted passive strategies at a cost that will appeal to investors."

However, Belgrove believes the caveat to this is that investors will have to take a very long-term approach.

There is also significant scope for development in areas outside equities, says Palazzolo. "These strategies have been associated largely with the long-only equity space, but factor investing certainly does not apply only to equity," he explains.

"AQR has written extensively on the multi-asset application of factors across asset classes, and has been putting these premia into practice in various ways in a long-short and long-only context across equities, government fixed income, corporate bonds, commodities, currencies and interest rates for nearly two decades."

This is, then, an area of investment that continues to gather pace and has plenty of space in which to evolve and grow. There are certainly challenges, but investors are increasingly interested in seeing just how smart smart beta can be. As Belgrove says: "Factor-based investing has seen tremendous growth in recent years, but we think this is only part of a longer-term continuing trend." ■