Smart Beta Implementation Strategies

As reported by 50 asset owners with smart beta allocations

Last year, Russell Indexes published the results of a survey (Smart Beta: A deeper look at asset owner perceptions) about the perceptions and adoption of smart beta among nearly 200 institutional asset owners in Europe and North America. **More recently, a new report was published containing additional insights into how smart beta is being implemented, focusing on the survey responses of over 50 asset owners that currently have smart beta allocations (Smart Beta: asset owner implementation strategies).**

The broad concept of smart beta has become a ubiquitous topic in recent years in the media and among investment practitioners. However, it's important to remember that 'smart beta' does not denote a single investment strategy, but rather several distinct strategies. Each strategy has a unique objective and set of characteristics that enable investors to more precisely construct their portfolios as they seek specific outcomes, such as return enhancement, risk reduction, income generation or improved portfolio diversification. Among these strategies are weighting by company fundamentals as well as various factor strategies such as low volatility, momentum, quality and value.

The range of individual strategies within the broad smart beta category is underscored within the follow-up to the original survey. A key finding is that the majority of asset owners who have adopted smart beta are using more than one strategy, with a third including more than three in their portfolios. Fundamental weighting and low volatility were cited as the two most-used smart beta strategies. However, many investors are using fundamental weighting and low volatility in combination with each other, as well as with other strategies. **The increasing combination of smart beta strategies within portfolios highlights the need for continued education, for better understanding not only of how strategies are likely to behave individually, but also of how they are likely to interact with each other over time.**

As might be expected, the survey also found that the largest allocations to smart beta tend to be among asset owners who are using more than one strategy, as well as among those with the greatest numbers of assets under management. Additionally, respondents used different vehicles to implement smart beta strategies in strategic and tactical applications. Respondents preferred separate accounts, mutual funds and collective investment trusts for strategic use, and exchange traded funds (ETFs) and derivatives for tactical use. **A key question is whether the growing adoption of smart beta will continue to drive increased ETF usage among institutional investors.** At present, regardless of their choice of investment vehicle, survey respondents clearly indicated that they use smart beta strategies as part of both active and passive allocations in their portfolios.

SUMMARY OF KEY THEMES

The majority of asset owners who have adopted smart beta are using more than one strategy.

- Low volatility and fundamental are the most popular among asset owners who are currently using two or more smart beta strategies, used by 67% and 56% of respondents respectively.
- Both low volatility and fundamental strategies are used by more than a third of asset owners who are employing two or more smart beta strategies.

Similarities exist among asset owners making the largest investments in smart beta.

- Larger allocations are more common among asset owners using more than one smart beta strategy.
- Corporate asset owners and asset owners with AUM over $1 billion are also more likely to have larger smart beta allocations.

Asset owners prefer different vehicle types for strategic versus tactical implementation.

- Respondents preferred separate accounts, mutual funds and collective investment trusts for strategic use.
- For tactical implementation of smart beta, ETFs and derivatives are the top choices in North America and mutual funds are the number one choice in Europe.

Asset owners do not have consensus on whether smart beta replaces allocations for active or passive management.

- European asset owners with smart beta allocations are more likely to view smart beta as a replacement for passive management than North American asset owners with smart beta allocations.
- Asset owners who have already made smart beta allocations are more likely to view smart beta as a replacement for passive management than those asset owners who are still evaluating smart beta.

The majority of asset owners who have adopted smart beta are using more than one strategy.

Nearly 60% of asset owners using smart beta are using more than one strategy, with fundamental and low volatility strategies being the most common.

Similarities exist among asset owners making the largest investments in smart beta.

Corporate asset owners and asset owners with AUM over $1 billion are more likely to have a larger smart beta allocation. Larger allocations to smart beta are more common among asset owners using more than one smart beta strategy. Forty-two percent of asset owners currently using two (or more) smart beta strategies allocate more than 15% of their portfolio to smart beta. Asset owners using a single smart beta strategy are likely to allocate less than 10% of their portfolio to the strategy.

Asset owners prefer different vehicle types for strategic versus tactical implementation.

Eighty-two percent of asset owners are using external asset managers for strategic smart beta implementation. For the strategic implementation of smart beta, separate accounts and mutual funds are preferred in Europe. Separate accounts and collective investment trusts are preferred in North America. There was essentially no interest in using ETFs for the strategic implementation of smart beta in either region. Approximately 18% of asset owners are managing smart beta assets internally.

For the tactical implementation of smart beta, mutual funds are the number one choice in Europe and ETFs and derivatives are the top choices in North America. Separate accounts and internally managed funds are preferred by less than 11% of respondents for tactical implementation of smart beta.

Asset owners do not have consensus on whether smart beta replaces allocations for active or passive management.

European asset owners with smart beta allocations are more likely to view smart beta as a replacement for passive management than North American asset owners with smart beta allocations. Among asset owners in Europe with smart beta allocations, 44% view smart beta as an allocation for passive management – while only 15% view smart beta as an allocation for active management.

Asset owners with existing smart beta allocations are more likely to view smart beta as a replacement for passive management than asset owners who are still in the evaluation phase; 39% and 13% respectively. In both groups, around 20% viewed smart beta as an allocation for active management.

The follow-up analysis published in 'Smart Beta: Asset owner implementation strategies' further demonstrates asset owners' growing interest in, and adoption of, smart beta. It also provides helpful insights for investors who are considering including these strategies within their portfolios. Russell's second annual institutional smart beta survey is expected to be published in 2015.

For more information about Russell's smart beta indices or to view the original survey and follow-up report, visit ***www.smartbetaindices.com****.*

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