SPONSORED COMMENTARY

THE LAST SMART BETA PAPER YOU'LL EVER (HAVE TO) READ

Institutional investors could be forgiven for rolling their eyes at yet another article on "smart beta." Indeed, the hype around this topic over the last few years has been intense. Smart-beta products seem to launch daily, webinars on the topic are offered weekly, and papers roll out monthly. Proponents of smart beta argue that it is the new cure-all. Replace your passive managers! (Solve the problems of cap-weighted indexes.) Replace your active managers! (Solve the problems of high fees.)

Adam Berger, CFA
Multi-Asset Strategist

Conor McCarthy, CFA
Director, Client Investment Solutions

We believe that smart beta will follow a path similar to other strategies that once promised to revolutionise portfolio management. What does this path look like? A handful of strategies will be great successes, enhancing investment outcomes for the pioneers who embrace them. A much wider range of me-too strategies, attempting to ride the coat-tails of the latest trend, will leave behind a trail of disappointed investors. But even if smart-beta products disappoint, eventually many of the core underlying ideas will have a lasting impact on the way institutional investors manage portfolios. This makes the concepts behind smart beta important – even for those who will never buy the products being hawked so aggressively today.

SMART BETA BASICS

The key insight of smart beta is that strategies built around factors such as value, momentum, carry and low volatility can offer attractive, sustainable expected returns that diversify the returns from a traditional portfolio driven by the performance of stock and bond markets.

Yet many smart beta approaches are constrained by being long-only, limited to equities and focused on a single factor. Such approaches may eventually outperform traditional cap-weighted indexes. But with only modest risk-adjusted excess returns (information ratios), they are likely to suffer short periods of sharp underperformance and protracted stretches of flat or negative excess returns. Hence, their long-term results net of transaction costs and fees are likely to disappoint – even if the latter are modest.

SMARTER THAN SMART BETA

Strategies that transcend the limitations of basic smart beta hold greater promise. For example, long/short approaches that seek to isolate specific factors without incurring market exposure have compelling diversification potential. Strategies outside equities, notably within fixed income, offer the possibility of outperforming widely followed indexes that often bear little relation to the goals of the investors who use them *(see "Beyond equities" sidebar)*. Lastly, approaches that combine multiple factors have strong potential to deliver better risk-adjusted returns than single-factor portfolios. We believe this potential is best realised in integrated approaches that combine multiple factors, where unintended risks can be mitigated by the manager at the portfolio level, rather than in an uncoordinated grab-bag of single-factor strategies.

Another major step in moving beyond basic smart beta is to acknowledge that any strategy deviating from a market-cap-weighted index is inherently active. This means investors should beware of "index-like" smart beta strategies that seem to dominate the space. Indexes are based on a clear set of construction rules that are transparent and static. But these are not desirable characteristics for active strategies. Transparent rules mean that others in the market can learn and take advantage of your positioning. Static rules mean that the investment process can't adapt to changing market conditions or crowded trades. (Although smart beta is sometimes compared to traditional quanti-

SOME KEY FACTORS

Beta	Implementation	Why can it work?
Value	Buy "cheap" assets	Mean-reversion; tendency of market to extrapolate bad news
Momentum	Buy assets with strong near-term performance	Market tendency to trend more often than not; investors are slow to process new information
Size	Buy assets with lower market capitalisation	Less established companies viewed as less desirable; investors overpay for large issuers
Volatility	Buy assets with low realised or expected volatility	Investors overpay for more volatile "lottery-like" investments
Quality	Buy assets with stable earnings, low operational or financial leverage	Power of compounding through a market cycle and avoiding large losses
Carry	Buy assets with high current income	Positive return if market conditions remain stable or little changed
Liquidity	Buy less-liquid investments	Investor preference for more liquid assets: market compensation for providing liquidity

tative equity or to the "enhanced index" strategies that gained popularity in the early 2000s, those approaches typically benefit from dynamic portfolio management by a team of specialists who continuously review and refine their models – and neither approach publicises its investment model for all to see.)

Investors who acknowledge that smart beta strategies are active approaches are more likely to focus on strategies that incorporate some degree of active skill, whether that comes from better or more differentiated factor definitions, implementation improvements in areas such as trading and transaction cost control, forward-looking insight or better portfolio construction through risk management or factor timing.

PUTTING SMART BETA CONCEPTS TO WORK

Amidst the cacophony of voices opining on smart beta, it's easy to forget that most investors pursuing the strategy are trying to accomplish one of three simple goals:

Enhance returns in a world of diminished expectations. The biggest bang for the smart beta "buck" may be in fixed income or commodities, where we believe traditional benchmarks are often misaligned with investor objectives.

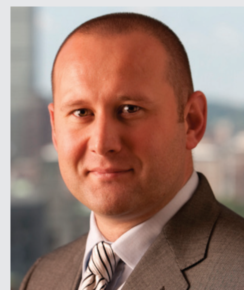
Improve transparency or reduce costs. Consider replacing or complementing relatively costly, opaque hedge-fund strategies with factor-driven alternative beta strategies that offer more efficient access to many of the key drivers of hedge-fund returns and differentiation.

Improve portfolio construction and risk management. Thoughtfully constructed low-volatility strategies – those that are conscious of sector risk and don't rely on unintuitive, over-engineered optimisations – may be useful. Or, investors can adapt the ideas underlying smart beta to improve their current active manager portfolios. This is where we think smart beta will ultimately have the biggest impact – that is, once managers stop launching products or writing papers (sorry!) and allow their clients to actually consider what the key ideas mean.

Because factors are important drivers and determinants of portfolio performance, investors should build portfolios that are well diversified across those factors. Moreover, since factors – like markets – tend to go through up and down cycles, investors can use factor analysis to add value through active rebalancing or strategy timing.

Our takeaway advice to investors is to look beyond smart beta. Stop reading papers, ignore most of the new products coming out, and focus on what these ideas mean for your portfolio and objectives. In today's challenging investment landscape, you might uncover a few nuggets of hope buried beneath the hype.

Mark Sullivan
Fixed Income Portfolio Manager



John Butler
Global Bond Strategist

BEYOND EQUITIES: IMPROVING MARKET EXPOSURES IN GLOBAL GOVERNMENT BONDS

Fixed income strategies influenced by the ideas of smart beta offer the potential to outperform indexes that – while frequently used – often bear little relation to the goals of the investors who use them. For example, traditional bond indexes are typically weighted by the size of debt issuance, with the most indebted countries representing the largest index exposures. And the duration of such indexes continues to lengthen, leading to an (uncompensated) increase in interest-rate risk. Because of such misalignments of bond-market indexes with investor goals, the development of improved fixed income market exposures is an area rich in promise for investors.

We seek to help investors realise this promise in several of our investment solutions. For example, our Global Strategic Sovereign approach goes beyond smart beta to do things a static, index-like portfolio can't do. GSS is an unlevered, benchmark-agnostic strategy that attempts to capture the traditional benefits of government bonds – diversification, liquidity, a hedge against low economic growth and disinflation – by reshaping market exposures through a discretionary investment process, enhanced diversification and a focus on downside risks.

- **Credit risk:** The GSS approach breaks out the analysis of credit risk into components. The process starts with data feeds into our proprietary Sovereign Risk Framework, which generates a sovereign credit score and corresponding rating for over 20 countries. We also tap the firm's broader research platform and our country specialists' knowledge to understand an issuer's short-term, cyclical dynamics. As a final step, we overlay these sovereign scores on top of current market pricing to assess valuations.

- **Interest-rate risk/duration management:** We use our strategists' global cycle research to gauge whether the strategy should be in return-seeking (longer duration) or capital-preservation (shorter duration) mode. Currently, we believe markets are in the early stages of a rising-interest-rate cycle which will likely be led by the US. Hence, we think it is prudent to lower duration in order to mitigate capital losses.

- **Currency risk:** The high degree of volatility expected from unhedged currency exposure is typically undesirable for government bond investors. Non-home currency exposure is therefore hedged back to the portfolio's base currency.

FOR INFORMATION, CONTACT:
Roger J. Spillere
Managing Director,
Global Relationship Group–EMEA
Telephone: +44-20-7126-6139
Email: rjspillere@wellington.com

To learn more about our research on this topic, visit: https://www.wellington.com/beyond_smart_beta

This material and/or its contents are current at the time of writing and may not be reproduced or distributed in whole or in part, for any purpose, without the express written consent of Wellington Management. This material is not intended to constitute investment advice or an offer to sell, or the solicitation of an offer to purchase shares or other securities. Investors should always obtain and read an up-to-date investment services description or prospectus before deciding whether to appoint an investment manager or to invest in a fund. Any views expressed herein are those of the author(s), are based on available information, and are subject to change without notice. Individual portfolio management teams may hold different views and may make different investment decisions for different clients. FOR INSTITUTIONAL INVESTORS ONLY

WELLINGTON MANAGEMENT®