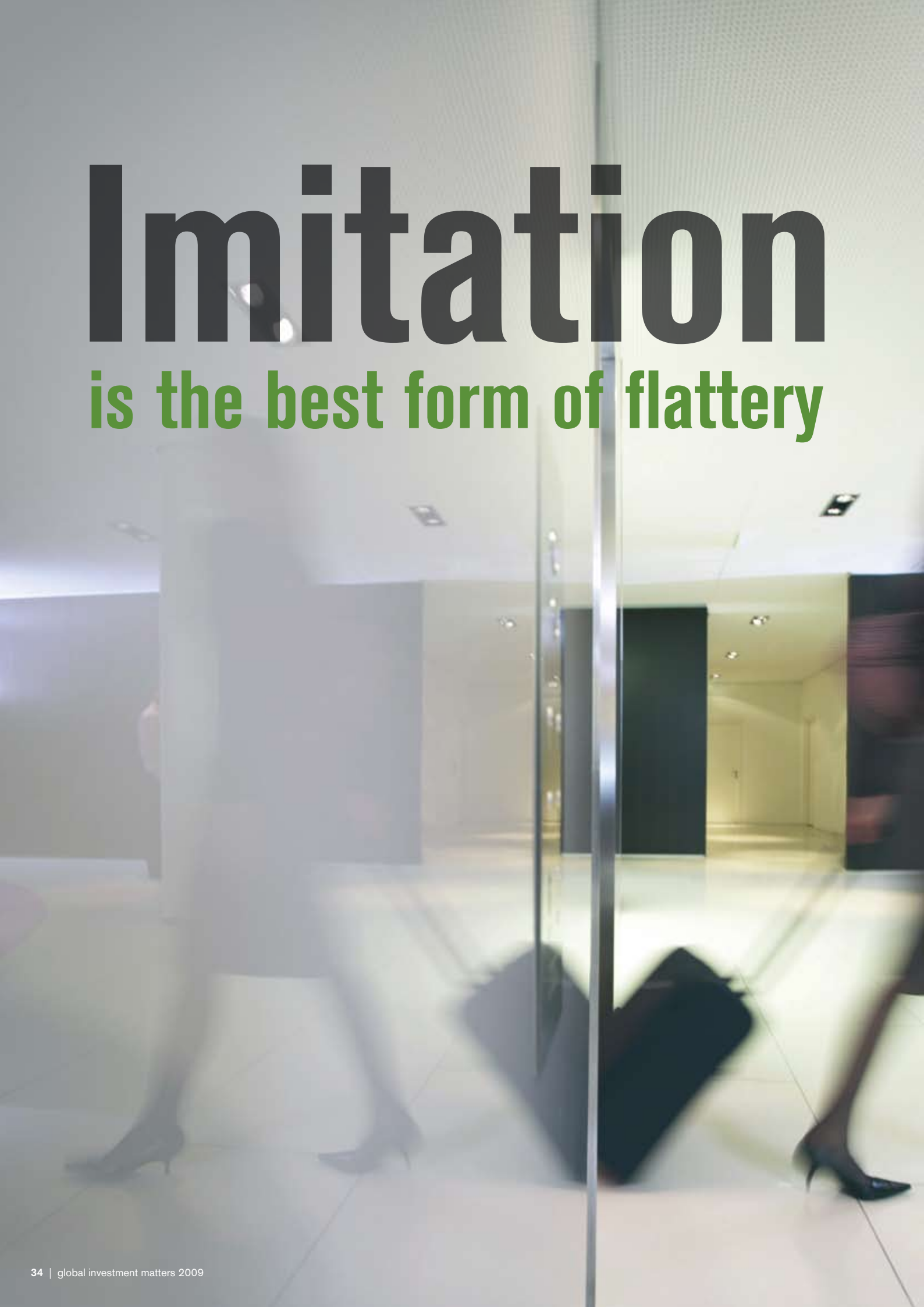


Imitation

is the best form of flattery





In a world characterised by an increasingly difficult investment landscape and greater specialisation in asset management, fund management fees have continued to rise. So called **'smart beta'** strategies provide a potentially more cost-effective route to capturing investment returns, providing an important 'control lever' in creating value and reducing cost drag. The initial focus of the smart beta concept was in the equity area, with the emergence of non-capitalisation-weighted strategies, but opportunities are now developing in other asset classes as investors turn towards more cost-effective solutions.

One can take advantage of shifting investment trends and opportunities by seeking specialised smart beta products designed to capture medium-term asset allocation possibilities. In addition, opportunities arise to exploit what used to be considered alpha strategies in more systematic, scalable ways.

This greater range of alternative betas first emerged with the production of indices that do not use market prices, starting with so-called Fundamental Indexation¹, and wealth-weighted indices. A wider range of new betas is now becoming available and with them an opportunity for increased diversification.

Using these smart beta strategies can also reduce the governance budget required to access what have hitherto been regarded as active inputs, they also offer the potential for implementation at substantially lower management fees. In this process, governance is more skewed towards evaluating product design rather than fund manager selection. Furthermore, by integrating manager skill into a more mechanistic passive approach, a smart beta investment can improve risk budget efficiency and provide a greater diversity of risk sources.



What is wrong with traditional equity indices?

To recap on previous papers, traditional market capitalisation-based indices tend to overweight overvalued securities and underweight undervalued securities. If those valuations revert to the mean, the capitalisation-weighted index will suffer a performance drag relative to some of these new alternatives. Smart beta techniques replicate investment strategies that have tended to outperform capitalisation-weighted indices over the long term, but need to be based on investment beliefs rather than just on extensive data-mining.

The aim of an equity smart beta is to retain many of the characteristics of capitalisation-weighted indices, such as low turnover, low cost and liquidity, while generating returns above those indices. Smart betas should offer better value fee propositions than traditional active management.

Expanding the scope of smart betas

Smart betas can also be extended to other asset classes (for example credit) and strategies which allow investors to take a view on macro issues. The latter is a different approach from equity smart betas. For example, emerging markets-based strategies provide interesting investment opportunities for western capital, particularly for investors with long investment horizons who can tolerate higher volatility. The value proposition is that relatively strong economic growth in emerging markets, ongoing infrastructure development and the associated emergence of a local middle class with greater spending power will continue. In China, India and elsewhere, we think the drivers behind this wealth creation are set to remain strong.

Figure 1 | Groups of betas available

Type	Example Strategies
Market capitalisation-weighted indices	
Programming inputs in active strategies	Value, growth, dividend, momentum
Replicating alternatives return patterns	Common hedge fund strategies
Exotic or 'hard to manage' betas	Catastrophe bonds
Exposure to different return drivers	Illiquidity, insurance premium
Macro themes	Emerging market growth

One investable beta is a basket of emerging market currencies, where the investments are designed to take advantage of carry trade opportunities and value premium relative to developed market currencies.

Direct equity approaches are also becoming more feasible, but it should be noted that index construction for some markets is in its infancy. For example, given the impracticalities of investing directly in the stock markets of many emerging economies, a developed market equity tilt strategy could be managed in a rules-based manner focusing on developed market companies with high sales or income from emerging countries. Beyond equity tilts, commodity strategies may also take advantage of this economic growth through increased energy and raw material consumption.

Hedge fund beta/replication

Hedge funds have typically charged high fees and dictated lock-up periods. Replicating strategies such as carry (buying high yielding assets and selling low yielding assets) and volatility plays can be implemented more cost effectively and with greater freedom using liquid derivatives and index strategies. Return replication finds a combination of these easily investable assets to produce similar return profiles to those of hedge funds.

¹ Fundamental Indexation (a form of market-value-indifferent indexing) is the patent-pending proprietary intellectual property and registered trademark of Research Affiliates LLC.