One size does not fit all

Smart beta explained

Smart beta is not a single strategy – it is a variety of custom-made options for investors to choose from. And transparency and education are paramount in identifying the right smart beta approaches, says ETFs expert WisdomTree

The exchange-traded funds (ETFs) industry has continued to gain momentum in Europe with no signs of abating any time soon. And, with this type of positive growth, the next 'big thing' is always just around the corner. That, right now at least, is smart beta, which represents around 20% of the almost $3 trillion global ETF market[1]. But, for those trying to invest in smart beta, let us take a step back to see what it actually means.

First of all, it is important that investors realise that smart beta is not a single strategy, but an all-encompassing term to describe a multitude of strategies ranging from the very simple to the very complex. Second, smart beta strategies are rules-based. They aim to achieve better risk-adjusted returns but in a systematic way. The difference between the smart beta types includes the ways in which each will select and weight specific securities or investment objectives.

Some of the smart beta strategies we believe to be attracting attention are presented here in table A.

A The range of smart beta strategies

Smart beta strategy	Description
Fundamentally weighted indexes	Components are selected to provide broad exposure to an equity market, but companies are weighted by a fundamental factor such as aggregate dividends or earnings rather than market capitalisation
Equal-weighted indexes	Components are based on established indexes like the S&P 500, but are equally weighted so that all components have identical weights when rebalanced
Factor-based indexes	Components are selected and weighted, based on one or more fundamental factors
Low-volatility indexes	Components are selected because they have exhibited lower volatility than the overall stock market and/or are weighted based on their historic volatility

Within these strategies a multitude of different products is offered, ranging from those weighting by a single factor, such as dividends, to those skewed towards multiple factors within a single ETF. Added to this is the discussion about what drives returns. For example, there has been some research pointing to smart beta strategies performing well only because money has flowed into them. In other words, investor enthusiasm has driven returns by bidding up valuations. We find this unlikely given the short history of smart beta and the relatively small scale of investment.

This may be applicable to more traditional market capitalisation-weighted indexes that assign more weight to a stock as its price rises. On the other hand, we weight the companies in our fundamental ETFs by their annual cash dividends in a proprietary methodology called the Dividend Stream®[2].

We believe that dividends offer an attractive objective measure of a company's health, value and balance-sheet strength and, therefore, this weighting serves as the foundation for most of our ETFs in Europe. And, because stocks owned by smart beta strategies could become overvalued or no longer representative of the factor(s) under consideration, we also rebalance to a measure of fundamental value annually.

Different strokes for different folks

Ultimately, transparency and education will be key to the future success of the smart beta sector. Therefore, those investing in ETFs need to take a closer look at the providers' smart beta strategy: what the approach is, what it invests in, whether it complements what they already own, and what type of exposure it gives.

It can certainly be challenging to distinguish all that is out there. When it comes to identifying truly smart beta strategies, we think investors should seek the following:

- A rules-based, repeatable methodology that offers broad, representative exposure to an asset class.
- Alternative weighting methods that allow for ample investment capacity.
- High correlations to established benchmarks.
- An established track record on a total return and risk-adjusted basis.
- Regular rebalancing.

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[1] *Bloomberg.*
[2] *The Dividend Stream is the sum of the cash dividends of all the constituents in the index. A company's weight in the index is defined by its cash dividend as a proportion of the Dividend Stream.*