

Smart beta

How and where smart beta fits within your portfolio



In conversation:

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Governance and responsible investment

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Investing for the future

In a world of growing social inequalities, over-reliance on fossil fuels and growing demands from regulators, the issue of investing based on environmental, social and governance criteria has come to the fore.

As the United Nations Principles for Responsible Investment (UNPRI) celebrate their 10th anniversary, we take a look at the importance of ESG on the investment industry. Is it possible for trustees to manage the conflict between fulfilling fiduciary duty while taking moral considerations into account? Can the increased freedom DC members now have with their funds aid the growth of responsible investment? And what are the options for investors wishing to divest from fossil fuels?

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Smart beta, alternative indexation, factor indices, alternative beta, systematic beta. Call it what you will, smart beta remains a hot topic as investors debate its merits as a strategy, alongside just how new or smart it is.

As well as the multitude of labels, one of the difficulties for investors to get to grips with has been the multitude of choice. There are thousands of products and indices, primarily in equities, but increasingly in fixed income and multi-asset, all offering subtly different weighting schemes. It's no wonder much of the conversation has been around trying to define these terms, let alone invest in the strategies.

Cutting through the noise it's clear to see investors do like the concept. Research by Willis Towers Watson found its global clients allocated more than \$8bn to smart beta in 2015, taking total exposure to \$40bn – double the tally of 2012. Elsewhere, research conducted by FTSE Russell found 55% of investors in smart beta had an allocation of more than 10%. Just 12 months earlier, 40% of respondents had allocated 5% or less.

Investors are attracted by the promise of low-cost systematic exposure to factors such as size, value and momentum or low volatility indices which offer respite from the much-maligned pure passive approach of market capitalisation-weighted indices and the pure active universe. Executed correctly, smart beta strategies can earn investors a premium through these factor exposures and the portfolio rebalancing required to maintain them.

However, the term 'smart' also suggests that these strategies 'just work'. This is obviously not always the case and in an ever-busier marketplace, investors need to ensure they select the right products and understand why they are doing so.

Pádraig Floyd

contributing editor, *portfolio institutional*



Doing it all with beta

Passive investment continues to evolve, with smart beta and alternative beta at the forefront of that progression. How different are the two strategies and can they even be described as passive? *Pádraig Floyd* finds out.

The last five years has seen something of a revolution within defined contribution (DC) investment and, in particular, default funds.

A new breed of investment was in the ascendancy, with diversified growth funds (DGFs) offering trustees and employers access to low cost growth assets that were more diversified than the small number of funds they might be running.

That is, until the charge cap was introduced. The charge cap of 75 basis points (bps) for default funds has -already had a major impact on DC investments.

Many scheme have already wound down their exposure to certain DGFs, as they fear breaching the cap. This means 'dialling down' the investment strategy with an increase of passive investments, with or without some active management at some point of the process.

Though there is an increased use of passive in both the UK and Europe, this is a long way from a "wholesale shift", says Tim Huver, product manager at

Vanguard.

"There are active/passive combinations being used, sometimes for specific tilts or over weights. However, when we talk about the spectrum of beta, what we are seeing is a greying of that spectrum between passive and active."

And with good reason. Even before the charge cap was introduced, many schemes had already been increasing their passive allocations as part of their de-risking strategy. It was a similar tactic in areas where they felt they could not find active managers who could outperform or which were new to them.

ALTERNATIVE SOLUTIONS

Turning down the wick by moving towards a fully passive default may satisfy the charge cap, but it won't necessarily deliver members with sufficient growth to deliver them a meaningful income in retirement. So why don't DC funds look to hedge funds and other alternatives as a portion of their default funds?

Well, some probably do, but

while adding them may improve portfolio efficiency – the return for a measure of risk – they are sold on the basis of skill, and as a result attract a premium. They can't therefore make it under the charge cap.

Phil Irvine, director, PiRho Investment Consulting, says: "For skill based liquid strategies, a number of academics over the years have claimed that most of the return of hedge funds has come from their exposure to alternative risk beta."

These risk premia include:

- equity returns – small cap outperforms large cap, value outperforms growth, -momentum, quality;
- merger arbitrage – premium priced into the target stock until the deal completes;
- convertible bond arbitrage – buying mispriced convertible bonds and shorting equity exposure of the bond; and
- asset allocation – seek to 'back out' the -asset allocation of successful macro hedge funds.

"In a number of cases, the same



academics have ‘assisted’ the investment industry to replicate or reproduce hedge fund returns in a systematic manner, often using exchange traded, highly liquid derivatives,” says Irvine.

“The claimed advantages of these funds are transparency, liquidity, no capacity constraints, no manager specific risk and cheapness.”

This move to capture the beta within the risk factors active managers are exposed to has resulted in another investment revolution – what many call ‘smart beta’ products.

This could open the door for DC funds to be able to access low cost exposure to alternatives and effectively diversify their funds in a way that was simply out of the question before. Not only due to the costs, but because hedge funds were less transparent and offered insufficient liquidity.

This is a “paradigm shift” in the investment management industry, says Yazann Romahi, global head of quantitative strategies & research, multi-asset investment solutions at JP Morgan Asset Management.

“It’s about identifying

disaggregated returns from the the rest and seeing how much is idiosyncratic risk premium,” says Romahi. “Then you go about capturing it from alternative routes, by creating building blocks to access low-cost, transparent, daily liquid returns.”

It sounds simple, but of course it isn’t. The skill an active manager demonstrates is not straightforward and comes from how they blend and time the risk premia. This cannot be replicated in an index or other product; there are components of the return and risk premia

“ For skill-based liquid strategies, a number of academics over the years have claimed that most of the return of hedge funds has come from their exposure to alternative risk beta. ”

Phil Irvine, PiRho Investment Consulting

that are valuable in and of themselves, which is why hedge fund managers have exposure to that risk in the first place.

Much of the buzz has been about the application of ‘smart beta’, but Rohami is keen to differentiate between smart and alternative beta. He says the long-only nature of smart beta cannot possibly replicate the drivers of hedge funds’ strategy and ply them by investing directly in securities.

Drago Indjic, an independent consultant and former CIO of Sunningdale Capital, would tend to agree.

“By replicating any index of hedge funds, you are building a passive market equivalent for a universe that is actively managed by clever people, not captured by following smart betas that are indexing static formulas,” says Indjic.

“Most importantly, the reverse as well as long exposure alternative beta products are obtained as physical cross-asset, long/short replicating portfolios, not as synthetic index products.”

The confusion that exists between smart and

alternative beta strategies is understandable. Some of these approaches have been in use for more than a decade, but there was no unifying description and so they appeared to some as opaque as hedge funds – people simply didn’t get it.

But smart beta is not going to do the same for investors as alternative beta strategies will, says Indjic.

“Smart beta is not hedged enough and still nudges allocators to select single products rather than daily manage their portfolios,” says Indjic. He adds that all new betas are hedging instruments too, and he would far rather be able to take either long or reverse exposure in something that is not going to produce drawdown of more than a few percent than something with a huge potential drawdown.

“Remember, in the last last 15 years, equities have seen drawdowns of 40% to 50% on two occasions,” he says. “Why people are buying into them beats me.”

Even now, a number of large managers and pension funds

– F&C, Railpen and Hermes included – are only taking small steps in the smart beta arena to replace elements of traditional long-only equity and fixed income exposure, but not alternatives.

“It is very hard for them to think about alternative beta until they complete the evolution to smart beta,” says Indjic.

Romahi is bullish on the potential growth of alternative beta as he sees it as the single greatest factor to increase choice for investors, though he accepts many will jump to the conclusion that you can capture hedge fund returns in a passive manager.

This passive tag is likely to prove something of a red herring for many people, and is exercising some who take exception to its use in relation to smart – or alternative – beta.

“Once you move away from the market (beta) which is a consensus view towards factors or groups of factors, you have made an active decision and so that introduces an element of active management,” says Vanguard’s Huver. “The use of these terms create confusion.”

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“ It is very hard for [investors] to think about alternative beta until they complete the evolution to smart beta. ”

Drago Indjic, independent consultant

This isn't a spat between active or passive managers, either. Apart from the fact that a third of Vanguard's money is run actively, Rohami says beta offers more opportunities for active managers as well.

“At an overly-simplistic level, if everybody was buying the S&P 500, the 501st company would by definition be undervalued,” he says. “The big players in alternative beta are a mix of passive and active managers because there has been a focus on providing smart beta.”

The reason for the smart beta focus is easy – it is long-only and therefore something many asset owners are comfortable with, but because it is long-only, there is a lot more capacity than for a long/short strategy, he adds.

The price is always important,

never more so than with the DC charge cap imposed upon default funds. However, Indjic believes alternative beta can not only be competitive, but can also “produce exposure to hedge fund or CTA managed futures premia, long and reverse with very little synthetic and little counterparty risk”.

This makes sense from the perspective of cost/reward, with alternative beta being priced similar to exotic beta like emerging markets ETFs and other less common indices, though even the latter still attract fees of around 1%.

“Minimum variance index tracking would appear more protected than many other things that are long-only in the smart beta space,” adds Indjic, “but only in alternative beta can I see a clear sense of cross-

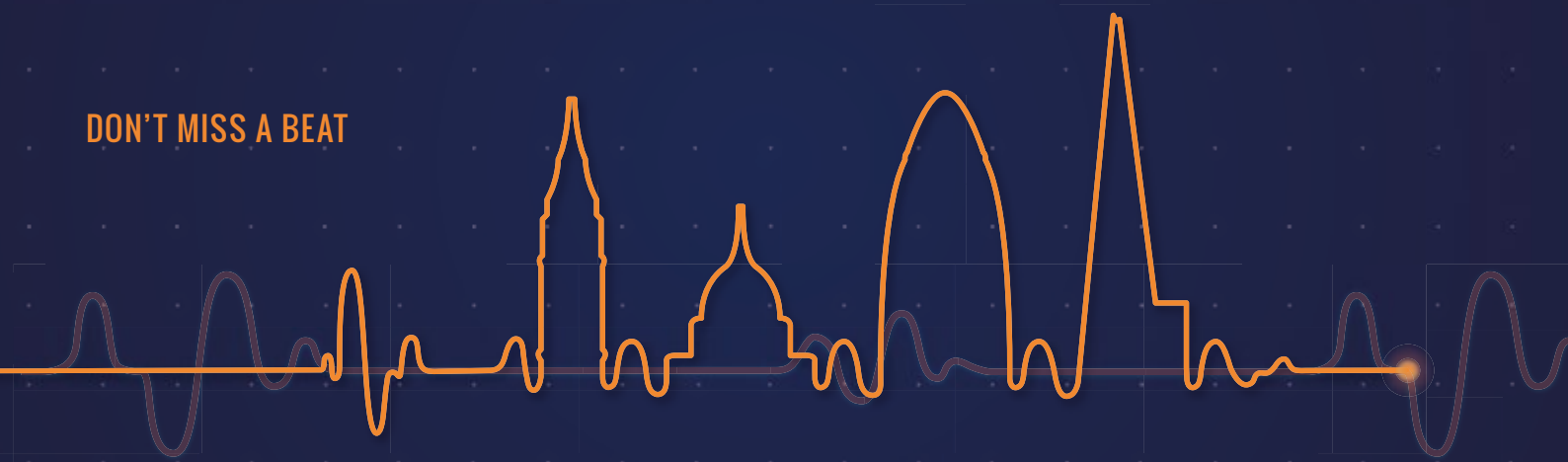
assets, hedging and active risk control – and all this can be packaged for 1% or less.”

While the marketing sounds attractive and the price is appealing, Irvine strikes a note of caution for investors who think they've found the goose that lays the golden egg.

While the thesis is “plausible”, their returns are simulated and “the actual performance history of such funds tends to be more limited and for the most part much less exciting,” he says.

“Investors thinking about making long-term decisions for their DC pots should treat such products with considerable caution and only invest after doing significantly more due diligence than they do with other asset classes they invest in and continue to monitor the funds after investment.”

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Clive Gilchrist

“One needs to take a step backwards and actually look at what it’s trying to deliver. Even if it does what it says, it won’t do it every year, let alone every quarter – it’s cyclical like other themes within investments.” Clive Gilchrist

Have smart beta strategies lived up to expectations? Perhaps we need to define what we mean by smart beta strategies because there seem to be almost as many as there are DGFs.

Jonathan White: If we avoid the term, we might call it investing in a systematic way. In a broader sense, it’s giving investors a range of choices to invest in a low cost systematic and transparent way so yes, I think it has in a broad definition lived up to expectations so far. There’s clearly a hype associated with the term and we should beware offering too many promises and ensure investment expectations are well set and well-designed. They’re delivering an important tool and we don’t lose sight of their function.

Clive Gilchrist: It is, in principle, a good idea, but one needs to take a step backwards and actually look at what it’s trying to deliver. Even if it does what it says, it won’t do it every year, let alone every quarter – it’s cyclical like other themes within investments. The problem I suspect is in the hands of the users, be they trustees or other investors who are not fully understanding what it is that they’re being asked to look at.

Simon Hill: That’s right. Even if the purveyors don’t set out to overpromise, many trustees hear an implicit promise, or read one. It is natural to try to make the claims for these stand up with some performance

data and the natural human response to extrapolate it. We're fairly clear in our view when we're talking to trustees about these kind of approaches what it is they're designed to achieve – it will be different in different cases. There's a difference between strategies that are essentially aimed at reducing equity risk or volatility – like reweighting from a capped weighted benchmark – and those which are explicitly pursuing factor returns. Different groups of trustees, different schemes at different times will need different types of approaches. But one of the major difficulties with any of these structured approaches is that people tend to believe they've found something that will outperform under more circumstances than is probably reasonable. They've not disappointed expectations so far, but they've not really been tested. We've not seen a major rotation in factors yet and not many of them have got very long life records either, so it's too early to say.

Nick Samuels: I'd agree if we define smart beta as the quite simple approaches used by ETFs or indices, but factor investing obviously has a much longer history. Most managers have robust and attractive track records over a meaningful period of time. But it's just too early to tell about smart beta because most of the products are pretty fresh.

The secondary – and major – benefit is that it's given the rest of the active asset management industry a bit of a shake-up. It's having to start to think about how to compete with smart beta, because in some ways it's come along and is eating its lunch. It's now very easy to compare a manager with a factor and suddenly those returns don't necessarily look quite as attractively as they used to and people on our side of the fence now have a better yard stick to judge active managers against. Active managers realise this and are starting to frame their investment process versus the smart beta alternative, which is great. Systematic approaches which look a little bit like smart beta are seeing their fees tumble, which is great for the environment.

White: I agree with everything said and many of these sound very healthy for investors. We are big believers in the benefits of smart beta and risk factor investing as it allows investors to deploy investments in a different way. We should recognise that this toolkit allows investors to better meet investment

goals. That might be a lower volatility profile, or because the investor has a certain type of pension scheme or insurance company and they can construct and tailor their allocation in a way which better meets my goals.

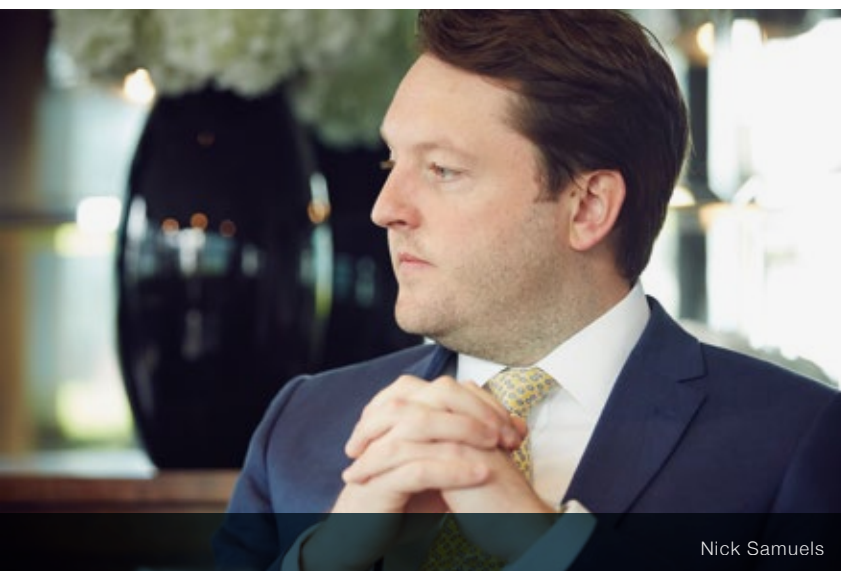
We mustn't lose sight of the hype in recent performance and should continue to work on expectation setting and transparency so people really understand what they're getting.

The rise of multi factor strategies is like the DGF space: the more popular it becomes, the more proliferation there is, making it tougher for advisers to differentiate on behalf of their clients.

Gilchrist: I don't think a typical investor understands what smart beta is, how it's composed or the fact that it's not static. People assume

that the index is achievable with no turnover and no cost. Actually index funds do a pretty good job of minimising the transaction cost – but it isn't zero. People looking at smart beta don't really understand what their comparator is. Mainstream pension funds don't use smart beta as much as I would have expected and part of that is a lack of appreciation.

Hill: They use them, but there's conservatism in the approach and some scepticism about it. There have



Nick Samuels

been lots of attempts that have turned to dust. The battlefield is littered with casualties and some trustees with longer memories might be scarred by their experiences. When they go wrong they tend to go spectacularly wrong. It's right that trustees are cautious about it. They tend to regard cap weighted index tracking as being almost literally a no-brainer – they don't think about it, so Clive's point is well made – and regard is as the starting point.

I don't have a problem if an active manager is managing a factor as long as it's cost effective and if as part of that they're also adding some stock selection skills or factor rotation – I think that is a form of active management. There's a danger multi-factor comes from a poorly-performing fund having a factor bolted on. Managers are very good at innovating and creating new things and trustees are by and large part-timers with people like Clive to help them, but I suspect even people like Clive find it hard to keep up with the pace of development.

Gilchrist: What concerns me is that rarely are these expectations also embedded with a timeframe which is thoroughly thought.

White: A horizon is incredibly important, particularly in this type of investment. These are longer term effects that people are investing in. There are five key factors in our opinion that have underlying fundamental links to corporate earnings. That's what investors are accessing in a more efficient way and they do it by investing in the market index.

There are risks associated with some of those approaches and being able to design a risk premia or factor-based approach around those risks, working with investors to understand the horizons that you need to benefit from and investing in these systematic approaches are the things that it is important the asset manager can do. It is about designing efficient ways of plugging these smart beta ideas that we believe index approaches lack in many areas.

Samuels: I find it difficult to see how the average trustee can choose which factors to select. I'm not sure they have the toolkit to start monitoring whatever it may be – value spreads, for example – and then decide that now is the time to go into value. But I don't think many consultants have that toolkit either. That's why multi factor is the natural evolution because you don't want to take that factor risk, but blend them together and it's much easier for the pension scheme to not worry about whether you need to be momentum or value as you've got everything in this multi factor framework.

Hill: But we're a long, long way ahead of where most trustees can reasonably expect to be. They're grappling with deficits, worrying where yields are going, what the next actuarial evaluation is going to be and will the sponsor still want to stump up money, etc. Hard as we professionals might try to guide them with this, there is a risk that we will end up being a bit too clever for our own good. For most trustees it's a level of detail they're really not into. They're much more worried about the bigger picture.

How do they go about selecting what's going to be the right product or products?

Hill: They rely heavily on consultants.

Gilchrist: True, but it's against the background of a significant decline in investment in equities anyway. Of course, for DC investment, typically people will just go into the default option, but one of our clients created a default option with a mixture of passive equities and diversified growth funds, with





Simon Hill

“There have been lots of attempts that have turned to dust. The battlefield is littered with casualties and some trustees might be scarred by their experiences. When they go wrong, they tend to go spectacularly wrong.” *Simon Hill*

passive split between conventional, index weighted and value index which is quite unusual.

Hill: As DC funds get bigger and trustees spend more time on them then we may well see more schemes – particularly among larger employers – using them.

Gilchrist: It will only be the larger ones because the smaller ones will probably end up in mastertrusts or in contract-based.

White: These are very long established well-observed factors, but a lot of them can be very well linked to the underlying corporate earnings. Quality has a very explicit link to the stability of future earnings. Even momentum has a link to future earnings growth. Building in and really understanding those fundamental links is important. It's one of the reasons we think these will persist in the future and are unlikely to erode away. What you're talking about is tapping into the DNA of what drives an equity in the long-run, which is earnings growth and the ability to continue to deliver that earnings growth. Ultimately it's a very fundamental idea. It's not magic.



Samuels: I don't disagree, but I think they're more driven by behavioural.

White: The behavioural concept comes from the fact that market cap captures behavioural effects through price and actually it's a very inefficient way to access corporate earnings. You've got price in the mix, you've got behaviour and behavioural biases. Behavioural biases are absolutely central to why cap weighted approaches are an ineffective way to efficiently tap into the real drivers of the market return, real drivers of equity beta. Whereas the factor approaches are a purer way to get hold of it.

Samuels: I don't think there's much link between value and corporate earnings, necessarily. Value tends to run before you start to see it in the companies themselves. You'll see stocks move and then at some point you can actually see it in the numbers and so personally I think it's driven much more by human behaviour and these factors exploit the behavioural biases of people.

Gilchrist: Does that suggest it can't be quant driven? It has to be driven by human behaviour predicting what will come out in the numbers?

Samuels: It's less about predicting and more about knowing humans always behave in a certain way and creating an approach that can leverage that at a certain point. It's all about the participants in the market and how they behave. It's been the same for a long time, so unless humans evolve far quicker than they have in the past it should carry on going.

Hill: There clearly are behaviour biases, but we're starting to get into quite murky waters when you go down that route, because on one hand there is a great deal of quantitative work establishing whether you have robust factors that stand scrutiny. Then you're also arguing there's the behavioural stuff that's much less susceptible to tests. There is often some backwards engineering – we observe a factor and think it must be because people do x. Following that logic, the more smart beta thinking develops, you must



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expect that behaviour to change – human behaviour learns – and will adjust in stock markets.

Samuels: Value has been around for 100 years and greed and fear have driven markets since markets were created. Value plays on fear and momentum plays on greed. If you’re exploiting quite a small anomaly, I agree it will probably get charged away and you need to come up with the next thing.

Hill: That’s a reasonable point. When you’re looking at different asset classes you’re looking at different time horizons and therefore different techniques work. The trouble is, these techniques work in principle, but those timeframes are varied because we now have tools available that create liquidity in markets that didn’t exist before.

White: That’s actually why in the long term we see better returns from all of these different approaches even though they can be very different. Momentum and value are very different but over the long term there is certainly evidence that they both have some similar attributes. That’s because they are better plugging themselves into fundamentals and corporate earnings in our view. Adaptation will be key. It doesn’t have to happen very quickly and that is why active management is in a better position; we can agree the concepts and work to build the best ideas. Index builders just launch a new index.

Hill: But the problem is that things have to go wrong very often before things evolve.



Jonathan White

“Behavioural biases are absolutely central to why cap weighted approaches are an ineffective way to efficiently tap into the real drivers of the market return. The factor approaches are a purer way to get hold of it.” Jonathan White

So is a behavioural response preventing people from investing because they won't look at it until it has fallen over once already?

Hill: I wouldn't go quite that far, but there is an element of that. There are relatively fewer approaches, but paradoxically cap weighted indexation is one of the things, for its flaws, that has delivered what people thought it should. It's delivered low cost equity returns.

White: I guess market cap did let investors down in the financial crisis. The entire focus was on tracking error and IR as your manager's key remit and then you end up losing 50% of your money. Was that the most suited investment to somebody who wished to lower their risk?

So this comes back to the healthy aspect that smart betas brought to the table, that you now have some tools by which you can, with more predictability than you could in the past for a market index, build an investment strategy that better meets your goals.

Gilchrist: That's right, because market cap indices have delivered what people expected. Well, they

would, because you're measuring them against themselves.

Hill: I don't think pension schemes are all that worried as they look forward about short term volatility. They got that message and equities are a smaller proportion of the asset mix, and increasingly we're looking at liabilities. That's not to say that anything involved in these developments is wrong, it's just that the trustee perspective is somewhat different.

What needs to change to make pension schemes look at smart beta differently?

Hill: To some extent, they need to be around for a long time. It's about simplicity as well and we need to be able to say the thing has worked. The trouble is, beauty is in the eye of the beholder.

White: A good investor would say they believe in these concepts, but ask if it is evolving and whether they need to change their views on it. There really aren't 200 factors out there – there's a handful of notions and we can see a link between those notions, fundamentals and ultimately corporate earnings.

We believe earnings quality is a risk premium, a factor through time because stable earnings tend to lead to long term stable earnings growth. Different people have different definitions of that what that is and it may and should evolve through time. We need to be continuously questioning whether we are plugging investors in to what drives equity returns.

Gilchrist: It suggests an area of equity market that superficially one might think lends itself to being a quant-driven, low cost-type product. But at the very least, you need a human, common-sense overlay and probably some sort of active manager involvement to ensure that the mechanistic approach doesn't lead you into trouble, whether it be the banks or declining industries or whatever.

Samuels: There are ways to correct for that – you blend value with some momentum. You're not buying declining industries, it's not going to have an effect on stock price momentum. You buy cheap areas and cheap areas that are improving. Blending factors together can help alleviate things like that and you don't necessarily need a human.

White: Blending is an incredibly important part of designing an investment approach that best meets an investor's needs. The point of blending is to design an approach that best meets investors' specific requirements. Having people involved in research, ongoing study, adapting the way in which we access

factors and risk premium, is absolutely critical. That doesn't mean it's going to be like an active manager changing the rules the whole time and constantly adapting. It does mean that monitoring, checking it's doing what it says on the tin and ongoing research is absolutely critical in this area.

Hill: I don't think we're disagreeing. You need to understand as well as you can why certain factors are doing what they're doing and to try and spot early enough if they're capturing certain other elements – biases – that you don't really want, but you need to understand what those are.

White: I couldn't agree with you more. These factors don't come without risk and you can take steps to potentially control these invest-

ments. Value can get you exposure to distress and extreme risks you probably don't want, but you can still capture the value effect and can take care of some of the undesirable pieces of the value effect.

Implementing in a way that's practical and makes sense can also involve humans. If you turn them over too much, you're paying costs and you own too many lines, your investors pay for that. Your investors pay



Clive Gilchrist

in terms of custodial costs, etc, so not having uneconomically small positions in your portfolio is important. These sound like small things, but they add up and matter in achieving best execution. That requires humans to think these things through.

Let's move on to ESG, which increasingly seems to be a combination of behavioural and rational, whereas in the past it's been seen more or less as behavioural. How does that fit within the smart beta framework?

Gilchrist: I think it absolutely fits because we've talked about quality of earnings and ESG is increasingly about longer term economic realities that arguably should be built into investment processes anyway. I see that coming through with the way people evaluate longer term quality of earnings.

Samuels: My worry with ESG in the smart beta framework is the data quality. We've looked at a number of different ESG data providers and they can have polar opposite views on the same stock. So in order to incorporate ESG into a smart beta framework, you need to decide which data provider is the one to go with. As for the definition, as an industry we haven't nailed that down yet.

Part of the problem lies in having three very discrete approaches to investment which historically have been at odds with each other. How do we drive that to be more closely aligned to things like quality?

Samuels: From a data point of view, that's difficult. An active manager looking into the ESG risk of the stock market can pretty much cover that off.

Hill: Investors will have different views about it, which is part of the problem. Then there is so much judgement involved. The debate is moving on ESG as in the first place it is about principles, but it has progressed increasingly. Now it's less about what is morally or ethically right or wrong and what will damage shareholder returns in the long run. That's an investment judgement like any other and that's the role of an active manager as it's very difficult to capture that in a rules-based environment, except in the most simplistic way.

White: ESG data sets are evolving and coalescing around certain standards. Our perspective is that the characteristics that you capture through financial analysis and the information you can get from ESG is very uncorrelated. There's not a positive or negative correlation – it's just uncorrelated. That's really useful because that means we've got a broad investment set – like a typical factor-based approach should – deployed across a large number of names. We find you can include ESG criteria very successfully in a factor or smart beta approach without actually interfering too much or very little with the characteristics that you want to capture. You can still capture a low volatility or value approach, but you have a broad data set to apply it to and a broad set of ESG information. So the low correlation between these two features makes it actually very applicable to integrate into a smart beta approach.

Hill: Intuition suggests that is probably true and as you create a portfolio out of those two data sets it's probably as equally a good portfolio as the non-ESG one you're creating. It comes back to the quality of the data again, but it might be uncorrelated because the data is rubbish.



Jonathan White



Nick Samuels

“In order to incorporate ESG into a smart beta framework, you need to decide which data provider is the one to go with. As for the definition, as an industry we haven’t nailed that down yet.” Nick Samuels

White: There have been huge improvements in the quality of that data around carbon and water intensity. If you want your investment to not have as large an impact on water intensity or carbon, you can construct a portfolio that accesses the investment ideas that underpin factor-based investing while avoiding the coal intensive firms and emphasising gas utilities, for example.

Our view is that including ESG criteria doesn’t interfere with the investment outcome. There’s no evidence that it improves the investment outcome at this point, but certainly we think it doesn’t detract from the investment attributes. So long as it’s built on the broad dataset broadly applied.

Hill: I don’t have any fundamental difficulty with your principle but I don’t think it will work because you’re just picking up another factor in effect.

Gilchrist: If it doesn’t detract value but ultimately people feel more comfortable with it and may add a bit of value, then actually that is performing.

Hill: I agree, but something which increases the friction in achieving shareholder return presents an



Simon Hill

“ESG is now more about what will damage shareholder returns in the long run. That’s an investment judgement and is very difficult to capture in a rules-based environment, except in the most simplistic way.” *Simon Hill*

additional risk to shareholder return and it may well be environmental factors. I’m struggling to do it on a quantitative basis because I think the data is too poor quality – even if you’re looking at things like returns data – it’s very difficult to make that case. This is not a new problem for the investment industry.

White: Having people who are involved in studying companies in detail to compliment the data you can purchase on the ESG scores is an absolutely critical importance to any sort of ESG framework. It’s part of the role of an asset manager to do that, and the asset owner as well.

Can smart beta continue to deliver or not be damaged by returns should it become more popular?

Samuels: You get bubbles in lots of areas, they pop and a mean reversion kicks in. I’m sure the same thing will happen with various smart beta factors if the popularity continues. At some point it won’t work for a while and then it will work again because people are back out of it and the popularity has gone, but I don’t think it will be anything to particularly worry about.

Hill: People are interested in finding sources of greater return in an equity bull market which is not generating very great return. Whether that great return is positive or negative then I think interest in the smart beta approach is spreading and the small stuff in a sense will disappear. People will just ride the wave. But I do worry that every good idea contains seeds of its own failure. I think trustees are aware of this and

we just have to be mindful of that.

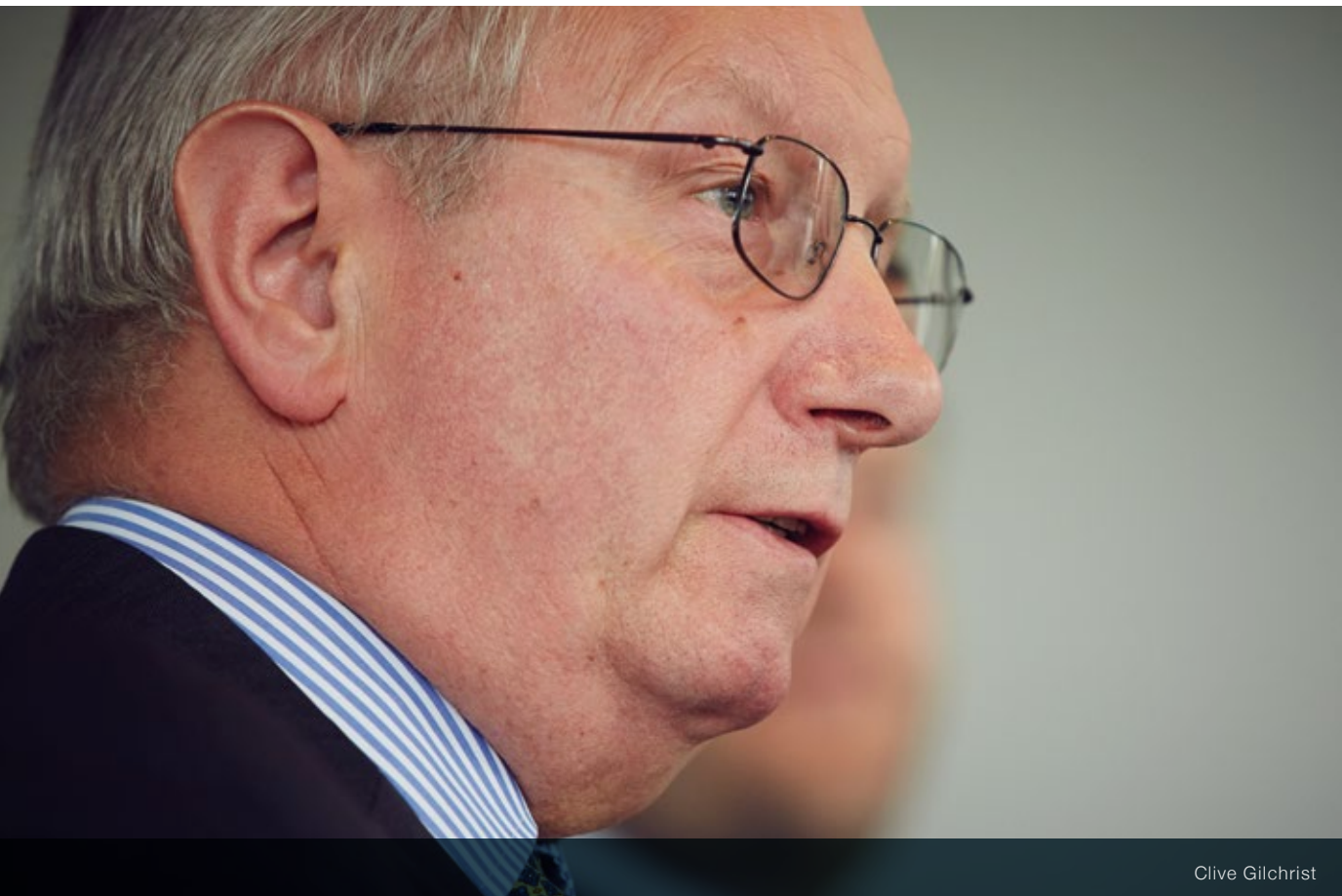
Samuels: Just don't put all your eggs in the smart beta basket.

White: I do agree with all of you around the near term notions that there's going to be elements of certain pieces of factor investing, smart beta investing that are going to become popular and even flow through time. I don't think that necessarily means the long term notions that underpin why these are a good investment idea in the long term with the right horizon are in any way diminished and in any way should evaporate.

I keep coming back to this, these are better at convincing investors of why they should invest in an equity, the earnings, the fundamentals that underpin them. In the long term if these notions grow and grow and grow and everyone invests in a factor-based approach there's different – we've talked about value, momentum, quality – there's no strong reason why all investors will coalesce around the same idea. Therefore, because everybody has different requirements and needs from their investments, I think it's something that's certainly here to say.

Hill: The piece that will mature is a more detailed understanding of how equities work and what covariances there are within equity markets. You need to apply judgement to that. To understand that and to understand beta better is clearly a benefit.

White: We mustn't lose focus on the fact that hyperbole does sometimes revolve around the asset class and it's important to keep all these disciplines. I guess that's our job – all of us in this room – to keep at it.



Clive Gilchrist

Blending equity risk premia to target better investment outcomes

By Rob Barrett, Director, UK Institutional



UK pension schemes seeking to address the dual challenges of achieving cost savings while improving the risk-return profiles of their equity holdings are increasingly turning to smart beta approaches.

Smart beta strategies are structured to capture various risk premia such as value, momentum, quality or low volatility.

Since each risk premium has a different long-term risk and return outcome, pension schemes can use well-designed smart beta strategies to access them and align their equity investments with their target outcome.

The rationale for smart beta investing

The traditional way of investing in equities has been through market cap weighted indices. This has also been the default approach for measuring the risk and returns that equities offer. However, the key failing of a market cap weighted approach is that prices determine a stocks' weight in the index and stock prices are often not rational due to a difference in information, circumstances and objectives. The most influential factor is that investors are subject to behavioural flaws, such as fear and greed, loss aversion and herding.

It is these inefficiencies that many believe explain the existence of the various risk premia such as value, momentum and more recently low volatility and quality (see performance against the market in Table 1).

All four risk premia have delivered superior historical long-term returns compared to the market cap index. Momentum and value have demonstrated the highest rates of return, but with the highest levels of volatility or total risk. Low volatility and quality exhibit lower levels volatility with somewhat lower levels of excess return.

Table 1: Risk Premia and Example Blends: Return and Volatility Summary

Global Developed Markets	Return	Volatility	Return to Risk Ratio	Tracking Error	Maximum 3-year drawdown
Low Volatility	8.0 %	12.4 %	0.65	5.9 %	-30 %
Quality	9.2 %	14.8 %	0.62	3.5 %	-34 %
Value	9.7 %	16.4 %	0.59	4.1 %	-46 %
Momentum	9.7 %	16.8 %	0.58	6.3 %	-41 %
Example Blends					
Low Volatility, Value, Momentum	9.2 %	14.6 %	0.63	3.0 %	-39 %
Low Volatility, Quality	8.7 %	13.3 %	0.65	3.9 %	-32 %
Overall Market	7.7 %	15.6 %	0.50	0.0 %	-40 %

Source: AXA Investment Managers, Rosenberg Equities. Data presented are annualised from January 1990 to June 2015.

It is our view that these premia offer long-term superior performance because they avoid investor behavioural flaws. Instead, they provide a better connection with the fundamental characteristics of companies that ultimately drive a stock's risk and return – corporate earnings.

The investment ideas underpinning risk premia are not new, but pension schemes can now access these premia in a more direct, transparent and efficient way using well-designed smart beta strategies.

Blending risk premia to reduce dependency on a single source of return

The returns shown in Table 1 are annualised averages over the last 25 years. Over shorter time horizons an individual risk premium may suffer from periods during which it is not in favour.

Long periods of weakness may not suit the objectives of a pension scheme. While pension schemes are long-term investors, downside volatility can lead to declining funding levels, which in turn can lead to increased contributions. This could apply equally for defined contribution members, especially just before the decumulation phase.

Instead of relying on the long-term risk and return characteristics of a single risk premium, pension

schemes might look for a blended solution. By blending risk premia, investors can reduce dependency on one source of return and further manage and target the risk and return outcomes offered through smart beta investing.

Finding the right blend

A useful framework for analysing performance patterns is to look at each risk premium's behaviour in the context of the corporate earnings cycle, which we split into four stages:

- i. **Earnings expansion > early cycle – bull market:** Earnings are growing rapidly and equity market prices are rising.
- ii. **Earnings expansion > mid/late cycle – bull market:** Earnings are growing but the rate of change is steady or slowing. Equity market prices are rising.
- iii. **Earnings recession – bear market:** Earnings are in recession (falling by 20% or more) and equity market prices are falling.
- iv. **Recovery market:** Earnings are in recession (falling by 20% or more) but equity market prices are rising in anticipation of recovery.

Since 1990 we have experienced three full earnings cycles and we can draw two conclusions from these periods:

1. There is some observable consistency in the historical behaviour of individual risk premia at different stages of the earnings cycle, and
2. No single risk premium performs well at all stages of the cycle. A smart beta investor may therefore benefit from blending more than one risk premium to take advantage of the different performance patterns and to reduce the possibility of a protracted period of underperformance.

When considering a blended smart beta approach, a pension scheme should ensure the selected blend is consistent with its long-term objectives. For example, a pension scheme that wants to minimise drawdown when markets are distressed might not see any benefit from investing in a blended premia strategy that has too much exposure to value and momentum. While such a blend can be expected to reduce the overall tracking error when markets are rising, it will also increase overall volatility and is not expected to reduce the drawdown when markets fall.

However some risk premia are more natural complements to each other in terms of overall risk profile while potentially improving the pattern of returns.

For example, both the quality and low volatility premia exhibit defensive behaviour in bear markets (see Table 1). When blended, these two complementary strategies offer attractive down market performance. Blending them may also boost overall returns and help reduce the risk of a long period of underperformance as the quality premium is expected to outperform during periods of earnings expansion, notably the mid to latter stage.

The reason quality has the twin attributes of defensiveness during recession and solid performance as the earnings cycle matures is because it benefits from a fundamental link to corporate earnings growth stability and balance sheet strength.

During a recession, quality is less exposed to balance sheet distress and earnings drawdown than the market. Its importance grows in the latter stages of earnings expansion because it offers exposure to earnings growth which becomes harder for companies to achieve and therefore for investors to capture.

A smart beta approach that blends low volatility and quality may suit pension schemes with an objective to improve long-term equity returns, reduce volatility and drawdown risks and wish to avoid long periods of cyclical underperformance, which a focus on low volatility alone may provide.

Individual risk premia demonstrate different performance patterns over the earnings cycle with long-term risk and return characteristics that may result in long periods of underperformance.

Pension schemes should not rely on a single risk premium to align their long-term equity investments with their overall investment goals, but consider adopting a smart beta solution that blends risk premia.

By carefully selecting and blending risk premia, pension schemes can better manage risk and target their desired long-term outcomes in a cost effective and efficient manner.

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The next roundtable is on credit and will be held on Friday 29 July.

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