FINDING THE WAY THROUGH THE SMART BETA MAZE

Navigating the Smart Beta Maze

The hunt for yield is leading sophisticated factor investing to gain increasing interest with institutional investors

BY RICHARD MORROW

THE RISE OF asset valuations across the world and a corresponding increase in risk has many asset owners concerned. Part of their reaction has been to diversify into a broader array of assets. Another response has been to embrace different ways of investing into mainstream assets.

This has helped underpin the credentials of factor, or smart beta, investing. Essentially a way of creating portfolios using measurements other than market capitalisation, smart beta strategies can help investors build exposure to equities (and other asset classes) depending upon how they see the market changing. If they want to be more defensive, they can opt for factors that focus on this. Return-chasing investors can plump for factors that prioritise returns but also greater risk.

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AsianInvestor asked several smart beta experts how this area has evolved, and how much further it has to go in Asia.

Paul Colwell, Chairman of portfolio advisory group, Willis Towers Watson
Ben Garland, Director, senior investment strategist for factor based investing unit, BlackRock
Jonathan Shead, Head of portfolio strategists, Asia Pacific, State Street Global Advisors
Christopher Vass, Senior product manager, FTSE Russell
Richard Morrow, Editor, *AsianInvestor* (moderator)

Q. How much has institutional investor engagement with smart beta evolved over the last couple of years?
Colwell: There has been a high degree of media interest in this space, which is quite useful, but it has mostly looked at global and broader regional investment trends. When I speak to people in this region they want to understand more about how these trends are going on and how they can apply these trends into their own investment portfolios.

Secondly, advisers like us are looking to help our client base improve their investment portfolios and diversify. That's been a key area for us, and that pushes us into the alternative investment space, particularly alternative smart betas, as well as the more traditional equity smart beta space.

Finally, I'd say there have been a lot of new investment strategies, products and indices created, which has resulted in news flow and interest across our client base.

From our perspective the most evolved conversations tend to be in places like Australia and Japan where they have been investing into smart beta strategies for quite some time. We also see pockets of interest in North Asia, in places like Taiwan and Korea, from government pension funds and sovereigns. It's a bit mixed in Hong Kong and Singapore. While in Southeast Asia we see increasing interest in places like Malaysia and Thailand, which are currently focused on the equity part of smart beta.

Garland: Our experience broadly matches Paul's. The majority of investors have increased their exposure to smart beta through one way or another. You have the more mature, fee sensitive regulated markets like Australia and Japan where regulatory changes around remuneration structures and transparency really driving the adoption of smart beta strategies.

On the other end of the spectrum you've got markets where equity investing itself is fairly new and people are only beginning to dip their toes into the water in terms of plain vanilla smart beta strategies. But Asia is fighting above its weight in terms of footprint and global assets under management.

Q. What do you mean, Asia is punching above its weight?

Garland: Asia represents 20% of BlackRock's factors platform at this stage, whereas the region represents 10% of our overall business. So we are doubling our weight in terms of Asia representation to the rest of the firm and the growth is pretty exciting. But that is a small number of many large clients dominating the landscape with a long tail of smaller clients.

Shead: In the early years of smart beta there was a tendency for investors to follow whatever was working. So up to 10 years ago it was value and value strategies, then coming out of the financial crisis [of 2008] there was a lot of interest in low volatility structures that was part of the education process for investors in the Asia region.

We are starting to see interest for blended strategies rather than factor focused strategies, which reflects the fact the broader market is realising that timing the market is difficult. The other area where we are seeing interest is strategies [helping] to plug holes in portfolios.

Jonathan Shead, State Street Global Advisors

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> Ben Garland, BlackRock

Vass: The one factor or smart beta strategy that has been popular or continuously popular has been yield or income, but what has changed is that we have seen more clients requesting to add other factors like quality to reduce volatility or risk.

Q. Are you being asked about different blends?

Vass: Yes, we see a lot of requests on how to blend factors, but I think clients are looking for a bit of guidance on how to combine factors and what they should expect from factors in different market conditions.

And this is really where asset managers and index providers can add value to clients about what to expect from their factor portfolios.

Q. Jonathan, how do you go about navigating discussions with clients?

Ben Garland, BlackRock

Shead: There are a few early questions we like to ask. So, for example, what are your tracking error expectations? What kind of active risk expectations are you thinking about? That can be quite a good early warning if a client is not as long term focused as factor investing requires you to be. You need to invest for five to 10 years to benefit from a lot of these single factors.

We like to keep to the basics. When blending factors we talk about return-seeking pro-risk factors, which tend to be things like value and size, and then more defensive kind of factors like quality and low volatility. And if you are looking to blend factors you probably have a foot in both camps.

We normally don't go much beyond quality, low volatility, value size and perhaps momentum in those initial conversations, as it can make things too complicated before clients get comfortable with the basics.

Garland: We always start by trying to translate [investor goals] into simple concepts. These are broad persistent drivers of return that are well understood and documented: value, quality, size, momentum, minimum volatility are the factors we all talk about when discussing style premia or style factors in equity.

We start at the basics, asking what the factors are, and why do they exist? They exist because of a risk premium, or some sort of structural anomaly, and these things are well understood and documented. There needs to be empirical evidence of these factors have existed across multiple market cycles, and of course they need to be diversifying and additive to your portfolio and you need to be able to trade them.

If you go through that checklist of four different hurdles you can quickly whittle down your checklist of 200 potential different factors into those four or five families of value, quality, size, momentum and minimum volatility.

Colwell: What our clients are really considering is the role of factor investing in the overall portfolio. Many of these factor-blended strategies are being used to replace active equity. Many of our clients have become disillusioned with active equity management. For several, I think this is primarily because they have maintained portfolios that are quite narrow, focused on one or two active managers. And then they fail to hold onto those managers during periods of underperformance, or perhaps selecting the wrong manager to begin with. So they are now looking for blended strategies as a replacement.

Then, from the passive end of the spectrum, some clients are just looking for some return enhancement in a way that is systematic and in a form they are quite familiar with through investing passively. It's beliefs driven; they believe in the factors and their durability through time.

Q. Over what lifespan should investors keep multi factor and single factor approaches?

Colwell: It needs to be at least five to 10 years. Some factors will underperform for at least five years, maybe longer. Most of the academic literature is focused on time periods that are beyond 10 years; it's 20, 30, 40, 50 years kind of research on data. You need to be able to hold it through the cycle to capture the return premium.

Vass: In Asia a lot of active managers have been outperforming passive investments in local equity markets, so investors have been coming to us and asking for [indexes for] smart beta strategies on Asian equities, just because of this reason. They think smart beta can add value in Asia. We also see investors switching some of their active investments into passive, more for developed markets in US and

Christopher Vass, FTSE Russell

> "MANY OF FACTOR-BLENDED STRATEGIES ARE BEING USED TO REPLACE ACTIVE EQUITY. MANY OF OUR CLIENTS HAVE BECOME DISILLUSIONED WITH ACTIVE EQUITY MANAGEMENT"
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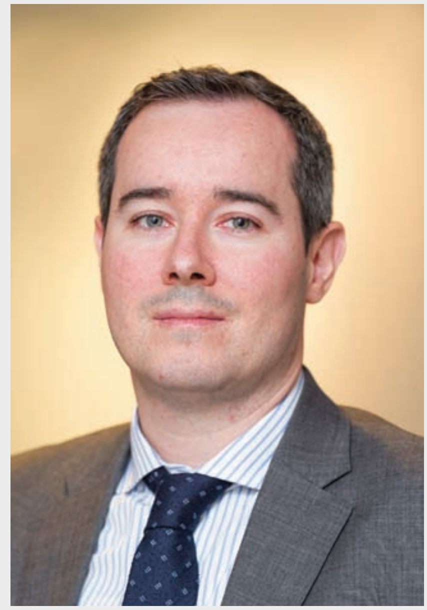
Europe, and this has been a trend and is continuing.

Q. Can you offer examples of how you each met client needs through factor investing solutions?

Vass: I'd give two different examples, one from an ETF (exchange-traded funds) provider in Australia, and the other from a pension fund in Southeast Asia.

The ETF provider has a big range of market cap-rated indices, but Australian equity markets are concentrated in a few names. So they were looking at a [index-based] strategy to diversify their product range. This led them to look at fundamental [index-based] strategies,



Paul Colwell, Willis Towers Watson

where you look at fundamental values such as book value, sales, cash flow and dividends.

By having this alternative rating [methodology] strategy they ended up with a portfolio different to their normal market cap weighted index and diversifies their clients' existing portfolio holdings. It has a nice story to it as well, as with fundamental investing you are buying companies that are cheap, going against momentum or trendy stocks.

We also worked with a pension client in Southeast Asia. They had a specific objective in mind: to reduce risk. Their home country had a volatile equity market, and to get more stability they opted for a minimum variance [index-based] strategy on the local equity market. The aim of the strategy is to deliver market-like returns at a lower risk. This [index-based] strategy has been going for the last couple of years and has performed quite well.

Garland: A lot of money has been going into minimum volatility [factor strategies] over the past few years. It might be the easiest factor to get your head around because it does exactly what it says on the tin. It gives you equity exposure but with lower volatility than the typical cap-weighted portfolio.

One of our Hong Kong pension clients had been concerned about equity valuations in the global space for some years but didn't want to be so bold as to sell equities in the market portfolio. So instead they moved the core cap weighted exposure into a low vol equity exposure. This still gave them upside participation exposure, albeit in a slightly more muted fashion, but more importantly it gave them downside protection in the event the markets wobble and their worst fears are realised.

The other example was going the other way. They are a wealth and pension platform in Australasia, and have realised that being a low cost provider commercially is not perhaps where they want to be on the spectrum. So they are looking to take a little bit more active volatility risk and use the fee budget in their portfolio to go up the spectrum from the standard MSCI world Index with a multi-factor approach. In their words they want to try to make the boat go a little bit faster, taking long term exposures to reward-seeking factors, value, quality, momentum. We typically see examples of people looking to reduce risk with minimum volatility strategies or to enhance returns.

Q. Where they shifting from other particular investment areas?

Garland: We have seen huge flows into passive vehicles for the past decade or two. But in the low return environment, with forward beta returns expected in the low single digits, people are starting to ask 'will cap weighted returns get me where I need to be?' And the answer is typically, 'no, probably not in the next five years.'

And therefore people are looking for uncorrelated sources of additional return in their portfolio and that either comes from alpha, or alternatives or in this case adding some factor exposure to the portfolio.

Therefore the idea of adding factors to give the sort of insights used by an active manager but in a more transparent liquid manner is ticking boxes for institutions, and also mums and dads.

Shead: We had a large Australian superannuation fund, which has been picking smart beta factors to implement what they believe in. They had several different single factors they had in their portfolios but weren't completely happy with how the pieces came together. They asked us to run a customised smart beta portfolio to fill in some missing holes such as countries or sectors where they were underweight, and we ended up creating a strange little smart beta portfolio that helped them plug those holes. It shows just how flexible smart beta or factor investing can be as a tool.

> “THE BROADER MARKET IS REALISING THAT TIMING IS DIFFICULT TO DO, SO WE ARE SEEING AN INCREASE IN BLENDS OF STRATEGIES RATHER THAN FACTOR FOCUSED STRATEGIES”
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> Jonathan Shead, SSGA

Another example was one that didn't result in a portfolio but an interesting exercise for a pension fund in Asia. We had a look through the active manager lineup on a no-names basis on their returns and holdings. We said, 'You could get 80% of the risk or return profile that this active managers deliver you on a smart beta core and maybe have some active managers outside that smart beta core.' It was an interesting exercise for the client to understand the inefficiencies and excess fees the overlaps [of the active funds] generated. They found it very educational.

Colwell: I'll refer to two instances. The first one is similar to Jonathan's, where we worked with a sovereign client in the region that was coming from the passive side of the spectrum and looking to set up a set of single factor exposures but struggling with it.

They came to the conclusion they wanted a multi-factor portfolio and were thinking about five factors. This included three more stable slower moving factors, typically value, quality and size and then two faster moving factors, volatility and momentum. Momentum in particular is a rapid factor whose signals were impacting the entire portfolio.

We worked to isolate the momentum factor to be complimentary to the other factors, rather than dominate the portfolio. We spent a lot of time in the implementation aspects.

The second example is when clients work with us on a delegated basis. Often the focus is more on active management and high risk active management, which can lead the portfolio to have some skew in it, such as a highly concentrated position in a sector or country or style; basically a factor. We found in one instance we had high underweights in the US market, which is basically value, so we plugged it by using some smart beta value in the US market to create a holistic structure.

Q. Christopher, do you see appetite for assets besides equities?

Vass: We recently acquired Citibank's fixed income index business and so I have some insight into this now. Speaking to my new colleagues they see a lot of interest in smart beta, especially within fixed income. The market is different and the available data isn't as good as equities due to the OTC nature of the market and also due to increased transaction costs. Yes, they see interest and strategies but they haven't seen the same level of implementation as in equity strategies.

Q. Is there is any expectation of passive investing or active management using a smart beta benchmark?

Shead: We are quite often asked this question and a client will sometimes come to us and say 'I quite like this smart beta index, can you manage it passively or can you manage it actively?'

You need to look at the liquidity and turnover in that smart beta index. If you have a smart beta index that is not very liquid then you might have difficulty running active management against it. Or, if you have a smart beta index with very high turnover, then adding active management on top of that might make it more difficult.

But we are generally quite happy to run active strategies over a smart beta index or just replicate smart beta indexes in the passive space.

Q. Has there been a push for ESG strategies that overlap with smart beta investing?

Colwell: In the last few years in particular the theme around sustainability and governance has become more of a focus for institutional investors in this part of the world.

They have gone about it in two different ways. First, they think about the filtering process. They start with an investment universe and seeing if there are certain stocks they want to

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screen out or water down due to their governance score, using a set of criteria that are considered important for scoring governance. Similarly, we are seeing assessments of their ESG factors more holistically, so the impact they might have on the environment and how sustainable the business model would be because of that risk. These are typically more complimentary to a more quality focus or biased investment strategy. You often see ESG and quality go together in the conversation because it's about being a bit more defensive. We haven't quite cracked it yet because it's a complex space but we are certainly making inroads.

Garland: The adoption of factor investing has been significant over the last five years, but the appetite for ESG has really picked up over the last year or so, particularly in Australia, New Zealand and Japan, where there is a lot of regulation pushing it.

Are we seeing it combine with factors? Yes, for a couple of reasons. Firstly, ESG on the whole is often a non-financial decision, which is driven not by motives to build better performing portfolios but for portfolios to better manage externalities and non-financial risks. People are coupling ESG with factor-based investing, because they are saying 'ESG is net neutral or maybe even costly to my portfolio, so if I add factors maybe that can make up on some of the lost performance'.

> "I THINK MORE STRATEGIES WILL BE DEVELOPED ON LOCAL EQUITY MARKETS … AND I THINK WE WILL SEE MORE UPTICK IN FIXED INCOME SMART BETA AS WELL"
>
> Christopher Vass, FTSE Russell

And the forward-looking view is to ask whether ESG will become a factor in the future, whereby companies with good ESG policies and management of risks will perform better than those with poor performance. Where that doesn't tick our framework right now is the empirical evidence. But there are indications that some elements of good ESG management are indicators of good company performance.

For example, a percentage of females in company management can be a positive indicator of robust diversity management and [potentially] good performance.

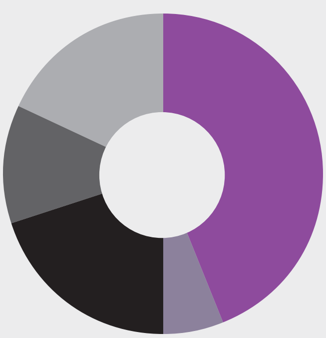
But good ESG data is so hard to come by it's hard to test your theories. It's work in progress and getting enough data is the real challenge.

Q. Are we seeing more invstor demand for factor strategies in credit, rates or other spaces?

Colwell: We are seeing some interest in the credit space but for our client space it's more muted [than in equities]. Where we see more is in the alternative beta space, which I'd characterise as a set of investment strategies that look similar to hedge funds.

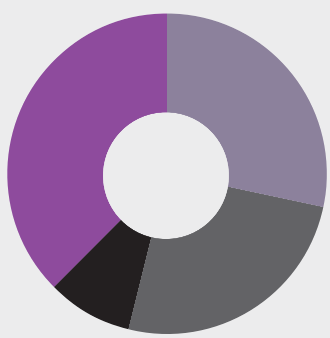
It's more a substitution type strategy, where there are aspects of the hedge fund industry that can be systematised and replicated in a very cost effective way. Because of that it becomes very attractive for those paying very sizeable fees in the hedge fund allocation. They want to deconstruct their hedge fund portfolios and concentrate on the active hedge funds where they see

What would be your priority for using/expanding factor strategies?



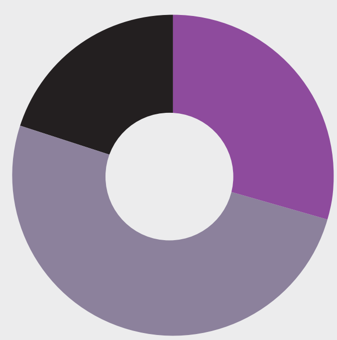
- A mixture of the above 44%
- Fee compression 6%
- Investment/asset diversification 20%
- Portfolio outperformance 12%
- Portfolio risk mitigation 18%

Which of the following asset classes are you interested in using factor strategies to invest into apart from equities?



- Emerging market equities 29%
- Fixed income 26%
- Long/short equity 9%
- Multi-asset strategies 38%

Do you/your clients intend to increase your allocations to multi-factor strategies in the coming 12 months?



- No, we don't intend to include factor strategies yet 30%
- Yes, by a few percent 51%
- Yes by, at least 5% of assets 20%

real alpha, and compliment that with these strategies. Examples of that would include merger arbitrage, multi-asset carry, would be another, volatility strategies, and trend strategies. These take long-short positions, use derivatives and leverage. They help primarily with overall portfolio diversification.

Shead: We have been involved in the alternative hedge fund space, and in fixed income and credit factor based investing in that asset class. In addition, we are also involved in currencies, and some common factors like carry and so on.

The only caution I would note is that in terms of academic research and broad consensus of what value is and momentum and so on; we do not have that broad consensus in other asset classes other than equities. Where we don't have that broad base of academic consensus, we think development [of new factor-based products] will be a little bit slower.

Colwell: I believe we will see much more interest in multi-asset and credit in general. I don't see the regulatory environment impacting on the trend of investing in smart beta.

Vass: I think more strategies will be developed on local equity markets; that is an area that is a bit underdeveloped. As Paul said, I don't see any regulation having a big impact on the growth of smart beta and I do think we will see more uptick in fixed income [smart beta products] as well.

Shead: I am going to back Chris on that. I think that when it comes to some of the smaller local markets, there is more work to be done. Factor investing works best on large deep markets like the US or a global universe.

When you get to a small local markets it can get quite tricky, because of the concentration risk of the dominance of particular sectors and so on.

So that's where I think we will see more development [in Asia-focused factor investing] over the next couple of years.

Garland: I would like to see our clients thinking of factors as just another tool in their portfolio construction toolkit, and being very deliberate about getting exposure to these factors. What we'll probably find is that people become far more conversant with using risk tools to understand what's already in their portfolio and then being more deliberate about taking factor exposure for the right reasons: to get the outcomes they need for their portfolios, and most importantly paying the right price for the right components.

Cap-weighted beta will remain the lowest paying piece, with genuine skill-based alpha being sought after and worth paying for, and factor strategies sitting somewhere in the middle.

Colwell: One supplementary point I'd make is that the cost of technology is coming down quite sizeably. In the past quite a few active managers offered quant-type strategies, and they are increasingly offering slightly more straight forward versions of these in the smart beta space at a cheaper and comparable price to other factor strategies. So you might see more competition in the years to come.