What's behind the buzz of smart beta?

Alfred Lee, vice-president, portfolio manager and investment strategist for BMO Global Asset Management (BMO GAM), explains the value proposition of smart beta.

Q Smart Beta has become an industry buzzword. How do you define smart beta?

A There's no formal definition. The simplest way to explain smart beta is any weighting methodology that is different to traditional market capitalisation weighted. This could include something simple, such as equal weighting, to strategies that place an emphasis on specific market factors such as dividends or low volatility. Smart beta strategies provide different risk and return characteristics for investors, allowing them to better meet their specific objectives, while at the same time providing them beta exposure.

Q Smart beta ETFs have seen significant growth. Has this come from institutional or retail investors?

***Alfred Lee**, vice-president, portfolio manager and investment strategist, BMO Global Asset Management*

A The growth has come from both. Institutions have been utilising smart beta strategies such as low volatility for decades. The development of the exchange traded funds industry has provided these investors with instruments to implement their strategies more efficiently. Rather than having to go through a lengthy request for proposal (RFP) process, institutions can now simply invest in a readily available ETF. Additionally, innovation in the ETF industry has resulted in a growing universe of smart beta products, investors now have a greater number of factor exposures to choose from. On the retail side, ETFs have had a track record in democratising investing. Smart beta is another example where ETFs offer cost efficient access to institutional-like strategies.

Q Is smart beta just a fad or does it have long-term merits?

A Smart beta is here to stay, and in actuality has been around for a very long time. Keep in mind that institutions have used smart beta investing for quite some time, but ETFs have made them more accessible and brought them into the mainstream. It may be worth noting that academic studies have shown that, historically, certain factors have consistently added value over the long term, especially on a risk-adjusted level. It isn't necessarily about performance, however. Different investors will always have various objectives, which is why one investor may desire a certain factor tilt over another. Smart beta provides a different look to the same underlying market that maybe more suitable.

'Smart beta is complimentary to both active and passive investing and bridges the gap between the two'

Q Are factor-based ETFs a substitute for active management?

A Factor-based ETFs offer exposure to specific factors, whether these outperform the market or not. In contrast, a skilled active manager selects securities with the objective of outperforming the market while not necessarily focusing on a specific factor exposure. Smart beta is complimentary to both active and passive investing and bridges the gap between the two investment approaches. We believe smart beta should be viewed separately to both passive and active, exactly how some of the larger institutions are allocating in their overall mandates.

Q What does BMO GAM look for when launching smart beta products?

A At BMO GAM, we are selective when it comes to launching smart beta products, we identify outcome oriented solutions that meet the needs of investors. We deliberately select factors such as dividend, low volatility, quality and equal weight that deliver throughout all market cycles and provide the potential for better risk adjusted returns.

Q Is there one factor that smart beta ETFs provide exposure to that's more important?

A There are factors that work better in specific markets. For example, dividend yields tend to outperform in low-interest-rate markets, as the market places a premium on dividend-paying stocks. However, different factors may outperform at different points of the investment cycle. Smart beta ETFs aren't necessarily about performance, but instead about delivering exposure to certain factors. For example, an income investor may always desire higher dividends than what a traditional market-cap-weighted index offers, so may opt to utilise a dividend based ETF instead.

Q Are all factor-based strategies the same? Is one dividend strategy similar to another, for example?

A There are many different ways to construct a portfolio to deliver exposure to a certain factor. Take dividend based ETFs. Most strategies that provide exposure to the dividend factor simply place more weight towards higher dividend-paying stocks. While this approach may be simplistic, investors should be cognisant that yield is a function of price. As a result, a yield-weighted strategy could be overly exposed to companies that have experienced a significant drop in price, thus making their dividend yields look attractive. Rules for inclusion to the portfolio should be "smarter" to avoid these yield traps. Rather than just looking at yield, the dividend growth history and cash flows should be examined to determine the sustainability of the dividends and ensuring the portfolio is made up of higher quality companies.

Q Smart beta strategies can introduce unintended biases. How does that work and can it be avoided?

A Unintended biases are essentially unwanted exposures that may become present when trying to isolate a different factor. A dividend strategy may intend to isolate higher-yielding companies, but a specific company may have a yield disproportionately larger than its peers. If this resulted in a much larger weighting of that specific company in the index or ETF, it would introduce company specific or "idiosyncratic" risk, which was unintended. It is important that a well designed product should mitigate this by placing limits on certain criteria. The additional risk controls will benefit long-term investors of the ETF.

Q There has been plenty of innovation in smart beta. What's next on the horizon?

A We're already seeing a widespread acceptance of smart beta products offering single factor exposure. What's going to become more mainstream is that the gap between passive and active will continue to narrow as more quantitative-type strategies and multifactor approaches will be launched. We're already starting to see that develop in certain regions. While innovation for fixed income smart beta has certainly lagged developments in the equity space, we don't expect that to continue. In fact, we see a lot of opportunities for innovation in the fixed income space, given market capitalisation-weighted approaches in fixed income essentially means putting more emphasis on those issuers that borrow more. There are more constructive ways of delivering "beta" for fixed income, without sacrificing liquidity.

'What's going to become more mainstream is the gap between active and passive will narrow, with more quant and multi-factor strategies'

Q The adoption of Smart Beta products has been rapid, what do you see for the future of Smart Beta ETFs in Canada?

A At the end on 2014, there were 71 smart beta ETFs, accounting for 11% of all Canadian ETF assets[1], and we expect that this number will continue to rise. We are having an increasing number of conversations with both institutional and retail investors about how smart beta ETFs can fit in their portfolios. This is a good indication that demand is growing. On the supply side, we expect the industry to see more smart beta products being launched, which provides investors with more effective tools to adapt risk and return expectations in their portfolios.

Q What should investors look for in an ETF provider that offers smart beta products?

A Smart beta has become a hot topic. With a greater number of investors allocating to this area in the future, there are providers looking to benefit from this growth. It's important to look for an ETF provider that has the experience and "know-how" in developing products. BMO ETFs is one of the global leaders in smart beta solutions, with about 25% of our global ETF AUM in various factor-based and smart beta products. In addition to available solutions, investors should look for ETF providers that provide education in how the products work and how to use them in a portfolio overall.

[1]Source: Morningstar Canada, as at December 31, 2014.

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